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DEBT MANAGEMENT CONFERENCE**

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NOTE

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Executive summary

This document is a compilation of presentations made by debt management experts and professionals at UNCTAD's Third Inter-regional Debt Management Conference, held in Geneva in December 2001. The conference addressed recent trends in the area of debt management, and in particular aimed at highlighting the consequences which recent developments have had, and will have in the future, for individual national debt offices and for the profession of debt management.

A recent trend in developing countries is to establish autonomous or semi-autonomous debt offices. This is a model that has been implemented by most European countries over the last 10 years. It is important to bear in mind, however, that the borrowing instruments used by developing countries are very different from those used by developed market economies. The creation of an autonomous debt office is therefore an issue that should be treated with some care.

In many countries, local governments and municipalities have the right to engage in domestic and foreign borrowing on their own. Although this is in principle not a liability at the level of the central Government, the effects on the economy could be disastrous in the event of default by a major municipality. An increasing number of debt offices are therefore setting up institutions and procedures to improve the monitoring of such indebtedness.

To support ongoing institutional changes, it is necessary to upgrade procedures and information systems to comply with the new requirements for data compilation. The rapid improvement in computer technology contributes to some extent to driving the development of procedures. Sophisticated integrated computer systems open up new possibilities and challenges that affect the institutions where they are used.

The conference attempted to address the challenges faced by debt managers as they strive to manage change. Specifically, it set out to analyse recent institutional trends in debt management as the role of the national debt office changes; discuss the resulting changes to procedures; discuss the general usefulness and impact of risk management systems; and analyse the new requirements for computerized debt management tools in changing environments.

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ABBREVIATIONS

| | |
|-----------------|---|
| ADB | African Development Bank |
| ADO | autonomous debt office |
| AFJP | Retirement Pension Fund Administration (Argentina) |
| ALM | asset and liability management |
| ARO | advances of fiscal revenue (Brazil) |
| BCB | Central Bank of Bolivia |
| BCEAO | Central Bank of West African States |
| BEAC | Bank of Central African States |
| BI | Bank Indonesia |
| BIS | Bank for International Settlements |
| BOI | Board of Investments (Philippines) |
| BPRN | Bank of the Province of Río Negro (Argentina) |
| BSRD | Bangko Sentral Registration Document (Philippines) |
| CBDMS | computer-based debt management system |
| CEMAC | Economic and Monetary Community of Central Africa |
| CIDE | Center for Research and Teaching in Economics |
| COLT | Commercial Offshore Loan Team (Indonesia) |
| CPSS | Committee on Payment and Settlement Systems (BIS) |
| CS-DRMS | Commonwealth Secretariat Debt Recording and Management System |
| DAMS | Debt Analysis and Management System |
| DDFB | Debt and Development Finance Branch (UNCTAD) |
| DFID | Department for International Development (United Kingdom) |
| DMFAS | Debt Management and Financial Analysis System |
| DMO | debt management office |
| DO | debt office |
| DOF | Department of Finance (Philippines) |
| DSA | debt sustainability analysis |
| EMBI | Emerging Market Bond Index |
| ERSA | electric power supply enterprise (Argentina) |
| FFDP | Trust fund for Provincial Development (Argentina) |
| G-30 | the Group of Thirty |
| GAO | General Accounting Office (United States) |
| GATT | General Agreement on Tariffs and Trade |
| GCP | gross city product (Moscow) |
| GDDS | General Data Dissemination System (IMF) |
| GDP | gross domestic product |
| HIPC | heavily indebted poor country |
| IBRD | International Bank for Reconstruction and Development |
| ICC | Investment Coordination Committee (Philippines) |
| IDB | Inter-American Development Bank |
| IFMS | integrated financial management systems |
| IIP | International Investment Position |
| ILACO II | Administrative Decentralization and Responsibility Project (Bolivia) |
| IMF | International Monetary Fund |
| INEGI | National Institute of Statistics, Geography and Informatics (Mexico) |
| INSS | National Social Security Institute (Brazil) |
| IOSCO | International Organization of Securities Commissions |
| MAE | Electronic Open Market (Argentina) |
| MEDD | Management of External Debt Department (Philippines) |
| MEFMI | Macroeconomic and Financial Management Institute of Eastern and Southern Africa |
| MRS | margin of real savings (Brazil) |
| NEDA | National Economic and Development Authority (Philippines) |

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|-----------------------------|--|
| NPV | net present value |
| NSFC | National System of Fiscal Coordination (Mexico) |
| ODA | official development assistance |
| OECD | Organization for Economic Co-operation and Development |
| ORTN | Reajustable Obligations of the National Treasury (Brazil) |
| PRGF | Poverty Reduction and Growth Facility (IMF) |
| PSED | private sector external debt |
| RBI | Reserve Bank of India |
| SAFyC | integrated financial administration and monitoring system (Argentina) |
| SAI | supreme audit institutions |
| SAP | Structural Adjustment Programme |
| SDDS | Special Data Dissemination Standard (IMF) |
| SDR | Special Drawing Right |
| SEUD | Unified Debt Statistics System (Colombia) |
| SIGMA | Integrated Management and Administrative Modernization System (Bolivia) |
| SIIF | Integrated Financial Information System (Bolivia) |
| SISER | System for Monitoring and Evaluating Performance-Based Government Management (Bolivia) |
| SISIN | Public Investment System (Bolivia) |
| SNDO | Swedish National Debt Office |
| SNG | sub-national government |
| SOE | state-owned enterprise |
| SSUE “Mosfin Agency” | Specialized State Unitary Enterprise “Financial Agency of the City of Moscow” |
| TCP/IP | Transmission Control Protocol/Internet Protocol |
| TFFS | Inter-Agency Task Force on Finance Statistics (IMF) |
| TGN | General Treasury of the Nation (Bolivia) |
| UEPEX | external loan management units (Bolivia) |
| UNCTAD | United Nations Conference on Trade and Development |
| USAID | United States Agency for International Development |
| WADMO | World Association of Debt Management Offices |
| WAEMU | West African Economic and Monetary Union |
| WAIFEM | West African Institute for Financial and Economic Management |

OPENING STATEMENT

Yilmaz Akyuz

Distinguished participants, ladies and gentlemen,

It is a great pleasure to welcome you to UNCTAD's Third Inter-regional Debt Management Conference. Some 150 government officials from more than 50 countries are here to listen to experts, participate in debates and meet with colleagues from around the world. This is a great opportunity for all of us, and UNCTAD is honoured to host such an important meeting.

Like the previous inter-regional debt management conferences organized by UNCTAD, this meeting will focus on recent developments of interest to professional debt managers. The institutional set-up for effective debt management continues to be one of the most difficult issues in that area. In this regard, an interesting phenomenon is the recent establishment in some developing countries of autonomous or semi-autonomous debt offices – a model that has been successfully implemented by most European countries over the past 10 years. It is important to bear in mind, however, that these institutions cannot simply be replicated in developing countries without the proper adjustment, as their circumstances are very different from those of developed countries. This is a key factor to consider when setting up an autonomous debt office.

In many countries, local governments and municipalities have the right to engage in domestic and foreign borrowing on their own. Although in principle such borrowing does not constitute a liability of the central Government, the effects on the economy could be disastrous in the event of default by a major municipality. An increasing number of national debt offices are setting up procedures to improve the monitoring of such borrowing. These entities are also putting in place mechanisms to monitor their debt portfolios.

To support ongoing institutional changes, it is also necessary to upgrade procedures and information systems so as to comply with the new requirements for data compilation. Sophisticated integrated computer systems

create new possibilities and challenges that affect the institutions where they are used.

UNCTAD has for many years been advocating orderly debt workout procedures, drawing on a number of broad bankruptcy principles such as temporary standstill, lending into arrears and debt restructuring. The international community has started to address this problem, as indicated by recent statements in Ottawa and by the First Deputy Managing Director of the International Monetary Fund. There can be little doubt that effective debt management should include know-how and competence regarding debt workout procedures.

Similarly, much more attention should be paid to the implications of global financial instability for debt management. I am particularly referring to sharp and unexpected movements in interest rates in the major industrial countries, as well as to gyrations and misalignments among the exchange rates of the G3 currencies. It is no longer possible to hedge against such disruptions simply by matching the currency composition of debt and export earnings. Developing countries do not often have the freedom to choose the currency in which to borrow, particularly in bond markets, or choose the currency denomination of their exports. Nor do they have the kind of easy access to hedging techniques employed in developed countries. I intend to generate synergy between the Debt Management and Financial Analysis System (DMFAS) and substantive work in these areas in UNCTAD.

UNCTAD's DMFAS programme continues to grow. Sixty countries have already benefited from the products and services of the programme, and project negotiations are ongoing with another 10. During the past few years, the programme has established close links with the IMF and the World Bank as well as several regional institutions. DMFAS now participates in the IMF-led task force on new guidelines for the compilation of external debt statistics and has a cooperation agreement with the World Bank for dissemination of the Debt Sustainability Model (DSM Plus), a tool for debt analysis. In the coming years, the programme

intends to broaden and deepen such collaborative arrangements.

In addition, UNCTAD is organizing the second General Assembly of the World Association of Debt Management Offices (WADMO), to be held on 7 December. Since its establishment on 6 April 2000, the association has continued to grow and now has 37 full members and two associate members. We hope

this second General Assembly will push the association into an active phase, one in which agreed activities may be implemented.

In closing, I would like to thank all of you once again for participating in this event. Our special thanks are due to our donors, who have provided financial support to the DMFAS programme for many years. I wish you a successful meeting.

PART 1

THE INSTITUTIONAL ENVIRONMENT FOR EFFECTIVE DEBT MANAGEMENT

THE INSTITUTIONAL AND LEGAL BASE FOR EFFECTIVE DEBT MANAGEMENT

Tomas Magnusson

I. INTRODUCTION

Let me start by saying that I'm truly honoured to have been invited here today to address this important conference.

The topic of my presentation is "The institutional and legal base for effective debt management". The outline is as follows. First, what do we mean by "effective sovereign debt management"? Secondly, what are the important factors to be considered in developing a sound institutional structure for effective debt management? Thirdly, and finally, which institution should be responsible for carrying out debt management?

II. "EFFECTIVE SOVEREIGN DEBT MANAGEMENT"

In the Guidelines for Public Debt Management, prepared by the staffs of the International Monetary Fund and the World Bank and dated 21 March 2001, "sovereign debt management" is defined as follows:

"Sovereign debt management is the process of establishing and executing a strategy for managing the government's debt in order to raise the required amount of funding, achieve its risk and cost objectives, and to meet any other sovereign debt management goals the government may have set, such as developing and maintaining an efficient market for government securities."

Let us start to analyse this definition from an institution-building perspective.

The first goal according to this definition is to raise the required amount of funding. The first reaction to that statement is that this is the main purpose of all borrowings. But things become more complicated when we are dealing with the State, and that has to do with the fragmentation and the complicated structure of the modern State, and the size of the debt. A central Government's debt portfolio is usually the largest financial portfolio in the country.

Provided that the State has a comprehensive budget system, the main purpose of State borrowings is to finance:

- Budget deficits;
- State on-lending and State guarantee payouts;
- Amortizations, redemptions and repurchasing of State debt; and
- Replenishment of the Central Bank's currency reserves.

In order to raise the required amount of funding in an effective way it is essential to monitor the State's in and out payments, to forecast the budget outcome and any future on-lending, to monitor the credit risks in the outstanding State guarantees, and to have full control of the outstanding debt. Let me just mention here that an essential step in getting better control of the State's in and out payments is to create a comprehensive budget system that includes all financial flows, and to set up a treasury single account.

The second goal is to achieve an optimal balance between the costs and the risks in the State debt. If, for instance, costs are measured by the average running yield to maturity, they can be reduced if the duration (calculated by multiplying the time to each cash flow by the size of the cash flow) of the debt portfolio is shortened. However, if the duration is shortened the interest rate risk will increase. The presumption is that on average, yield curves have an upward slope, plus the fact that a more short-term portfolio is refinanced more frequently and is therefore more affected by interest rate volatility.

Another and a more comprehensive way to look at the risks in the debt portfolio is to use an asset and liability management (ALM) approach. The debt is then seen in the broader perspective of the State finances and the analysis is focused on the correspondence between the attributes of the State assets (primary future tax revenues) and those of the debt (future expenditure assumptions). With this approach the risk is

shifted from the pure interest rate and currency exchange risk to the budget effects of the State debt. As a result of putting the management of the central government debt in this broader perspective of the central government finances, it is clear that the risks do not stem primarily from the risk of rising interest costs and exchange losses. Instead, they arise from the sharp increase in the cost of central government debt during periods when there are strains on central government finances, for example due to a sharp economic downturn. In other words, the risk is defined in terms of the contribution that the debt portfolio makes to fluctuations in the budget balance.

For the purposes of analyses and evaluations, the costs here can be measured by their relation to gross domestic product (GDP), the “debt–cost ratio”. The presumption is that the budget balance normally co-varies with GDP via both tax bases and government expenditures.

To fully apply this ALM approach it is insufficient to analyse how future interest rates and exchange rates may evolve. Also, it is necessary to ascertain how, aside from interest payments on the debt and exchange losses, State income and expenditures co-vary – cyclically and structurally – with these financial variables.

Another interesting implication of the ALM approach is that it becomes clear that financial obligations in addition to the State debt, for example State guarantees, must also be factored into the analysis. Guarantees may be regarded as contingent State debt, since if a guarantee must be honoured, money must be raised by means of increased State borrowing, which is added to the State debt.

The third goal mentioned in the definition above is the development and maintenance of an efficient market for government securities. This is important mainly for three reasons. First, a well-developed domestic market makes it unnecessary for the State to finance its expenditures through the central bank. Secondly, the State will be able to raise funds in its own domestic currency and thus avoid the currency exchange risks. Thirdly, it will provide all other domestic borrowers with readily accessible financing, even in times of global financial instability.

According to the Guidelines the following, in addition to a sound macroeconomic environment, are needed for an effective government securities market:

- Good securities market regulation;
- Good market infrastructure;
- Demand for government securities; and
- Supply of government securities.

III. SOME IMPORTANT FACTORS TO BE CONSIDERED

Before we start to discuss which institution is most suitable for managing debt, let us look at some factors related to debt management that need to be considered. Which State debt should be managed by the debt institution? In my opinion, the same institution should manage all State debt, domestic and foreign as well as overnight funding. It is important, however, to have full control of borrowing needs. But once a system has been established for that purpose, I cannot see any advantages in having debt management split up into different institutions. On the contrary, the concentration of all debt into one institution will make it easier to coordinate borrowings and risk management. Moreover, the knowledge of different borrowing techniques used abroad, which would be acquired through external borrowings, can be applied in the State’s own domestic market. After the abolition of exchange controls, a foreign investor can buy a bond issued in the domestic market as easily as a bond issued abroad and, for example by using derivatives, change the currency exposure of the investment according to his or her preferences. In the same way, the State can use the swap market not just to adjust its interest rate exposure, but also to adjust its exposure in foreign currencies in a cost-effective way. If, as is often the case, the State has a competitive advantage in its own domestic bond market, it can use a currency swap structure to receive cheaper funding in the foreign currency through the swap spread, compared with a direct borrowing in the foreign currency.

It is important for the active debt institution to get close to the financial markets and maintain a dialogue with the market participants. One reason being to simply know the market’s appetite for different maturities and so forth. Knowing this would allow the debt institution to

adjust issuances to better meet demand and thereby receive cheaper funding. Another reason would be to assist in improving the functioning of the capital market, including better securities regulations and infrastructure, and thus lower long-run borrowing costs, which is an indisputably beneficial strategy.

Financial guarantees, both credit guarantees and standing or open-ended guarantees, are issued by the State to financially promote projects that are deemed to be in the public interest. They serve as economic incentives for the capital market to finance such projects. The other side of the coin is that the credit risk for the borrower (the “beneficiary”) is transferred from the lender to the State. Thus, if the credit risks are not properly assessed and monitored, the financial guarantees can easily cause a “hidden” budget deficit. The challenge here is to create a system under which the State will be able to issue financial guarantees without losing its grip on the budget. Because of these risks, it is important that a professional institution be responsible for the pricing of the credit risks, the drafting and the actual issuing of the financial guarantees, and the monitoring of the guarantees issued. In my opinion, the debt institution is well suited to that task, mainly for the following reasons:

- The debt institution will get a holistic grip on the entire debt burden – not just the explicit debt, but also the financial guarantees (the contingent debt); the financial guarantees affect both the borrowing requirement and the duration of the loan portfolio;
- Similar analytical competence is needed both for active debt management and for active management of financial guarantees; the basic methods for calculating market and credit risks are similar;
- Knowledge of the financial markets is needed both in debt management and for an effective management of financial guarantees; as the risk taker, the State should have some control over what the beneficiaries are doing in the markets and consequently must have the competence to evaluate their activities from a market risk perspective;
- The debt institution will have the competence to control the pricing of the loans raised by the beneficiary; the price difference between the loans raised by the State and the State-guaranteed loans should not

be unreasonably high. (The guarantee should support the beneficiary, not the banks!); and

- The debt institution should coordinate its own borrowings and the borrowings of the beneficiaries, particularly in the foreign markets.

On-lending is a substitute for guarantees, involves the same credit risk for the State and should be priced and managed, *mutatis mutandis*, in the same way as guarantees. The only difference is that the State instead of the beneficiary borrows the necessary amount in the market. It is thus important to include on-lending activities in the same framework as the State guarantees.

In order to achieve an effective sovereign financial guarantee and on-lending management, the following points are important:

- Financial support through guarantees or on-lending should be given only to a beneficiary that is likely to generate sufficient income to recoup its costs;
- The credit risks should be reduced by various means, if possible, and always be assessed and priced;
- Reserves for future payouts and loan losses should be built up;
- Any subsidies should be accounted for;
- During the term of the guarantee/loan, all proper means should be used to reduce any losses; and
- Management should contribute to achieving the political goal of the support, but only within the guidelines stated above.

Ultimately, taxpayers must cover the cost of the State debt, for the simple reason that the State’s assets predominantly consist of the discounted value of future taxes. One could say that management of State debt is the management of future tax payments. From this it follows that the political bodies – the Parliament and the Government (the Cabinet) – ought to have some say in its management. As the Parliament is normally the institution that has the power of taxation, it is appropriate that it sets the goals for debt management. The role of the Cabinet would then be to adopt binding guidelines for the debt institution. These guidelines would take the form of a strategic benchmark

and indicate to the debt institution how the Cabinet values the trade-off between costs and risks. The guidelines should thus include the share of foreign currency debt, if any, the acceptable interest rate risk and the maturity profile of the debt, aimed at reducing the rollover risk. Expertise in this field is likely to be found within the debt institution, since these are variables that the professionals of this institution will need to follow during their daily debt management activities. A proposal from the debt institution is thus a natural starting point for the process of establishing the guidelines. The question of possible conflicts of interest between a suggested debt policy and the rules set for monetary policy also needs to be addressed within the framework of setting the strategic benchmark. The simplest solution is for the central bank to have the opportunity to provide its comments on the guidelines before the Cabinet makes a final decision.

One of the goals of a clearly communicated strategic benchmark is to achieve increased transparency. To accomplish this, it is important to make all documents of the guidelines process public, including the proposal of the debt institution, as well as the comments of the central bank. There are at least two good reasons for this. First, the quality of documents that are to be made public and sent directly to the financial markets in general becomes better. Secondly, and more importantly, if analysts can understand clearly and fully the entire process that has led to a certain strategic benchmark decision, they will be more successful in forecasting the actions of the debt institution, which thereby will be perceived as more transparent and predictable.

Finally, which institution should be responsible for debt management? There are three natural choices: the central bank, an autonomous debt office (ADO) reporting to the Ministry of Finance, or a separate unit/department within the Ministry of Finance, which we simply can call a debt office (DO). Let us look first of all at the central bank.

The central bank's prime responsibility is the implementation of its country's monetary and foreign exchange policies. If the central bank is pursuing an inflation target through buying and selling securities in the domestic market in order to adjust the monetary situation (which is quite common), it makes sense to separate

accountability for debt management policy from that for monetary policy.

The main reason for such a separation is that in implementing the monetary policy, the market will listen and react to signals from the central bank. If the bank is responsible for implementation of the debt management policy as well, there is a risk that the latter could be seen as another instrument of monetary policy aimed at reinforcing the price stability objective. Even if the debt management is handled in a separate department within the central bank, there is still a risk that the debt management decisions could be perceived as being influenced by inside information on interest rate decisions. In such a case, neither the implementation of the monetary policy nor the implementation of the debt management policy will be optimal.

A clear separation of roles means that the State debt is sold directly by the ADO or DO, and that the central bank neutralizes the monetary impact of the State borrowings through its own market operations.

If, on the other hand, there is no developed domestic market and the bulk of the State borrowings are made in foreign currencies, the central bank can be used to make the borrowings on behalf of the State. The advantage here is that the central bank, as one of its core activities, is managing the currency reserves. The competence gained in that field can easily be used for borrowing activities in foreign markets. Also, from an ALM perspective it makes sense to try to match the currency composition of the debt with the currency composition of the currency reserves.

An ADO is a governmental agency with a clear long-term goal for debt management and with at least some independence from the political sphere. There are some clear advantages with an ADO.

First, it decreases the risk that fiscal policy advisers will view debt management policy as another vehicle for opportunistically reducing debt-servicing costs in order to reduce a budget deficit in the short term. This "political risk" is based on the following reasoning. In the short run everyone can borrow cheaply. The easiest way is to borrow in a currency with a low coupon rate and with a short interest-fixing period, since on average yield curves tend to have posi-

tive slopes. And if the fundraiser is still not satisfied, he or she can probably make the borrowing even cheaper with the help of derivatives such as swaps and options. In an urgent political situation any head of funding can be tempted to choose such a borrowing strategy in order to soften internal budget constraints. But anyone with some experience in financing knows that this kind of borrowing is very risky, – that is to say, it can be very costly for taxpayers, at least in the long run.

Secondly, an ADO will focus only on its core issue, namely debt (and guarantees and on-lending) management. If, as an alternative, debt/guarantee management is to be handled within a DO, the risk increases that competent employees will be moved to other departments and that the DO will be “burdened” with tasks not related to its core activities.

However, there are also some important disadvantages with an ADO. One is the agency risk. The further away from the principal (the Ministry of Finance) the ADO is, the greater the risk that things will go wrong. The ADO might, for example, be too keen on trading activities and focus more on the status it could gain from its financial counterparts (i.e. investment banks) than on doing the best possible job for the State. The ADO can, in other words, become a pure borrowing machine.

This risk could of course be mitigated by setting up within the ADO a board of directors with an experienced and reliable chairman, and creating both an independent risk control department and an internal auditing department, which would report directly to the board. However, the most important thing is to find the right chief executive, one who is able to create the appropriate culture within the organization. And that is an operational risk in itself.

Another risk is that the ADO will be too partial in its debt management – that is, it will run its own shop, forgetting that it is a part of the State, and thus ignore some aspects of the fiscal risk. Equally, its distance from the Ministry of Finance might lead the latter to refrain from using the competence and the knowledge of the financial markets which will be accumulating in the ADO over time. The advice of the ADO could be useful to the Government, for instance in matters such as privatization of State-owned companies and law reforms affecting the bond

market, including the clearing and settlement of securities.

Another argument, which is often put forward for the establishment of an ADO, is that wages could be increased and that it would thus be easier to hire professionals from the market. This is, in my view, not a strong argument since the ADO, irrespective of how it is organized, must still report to the Ministry of Finance. If the ministry is to be able to fulfil its role it must, in a broad sense, have the same competence in these matters as the ADO. This is even more important if guideline-based debt management, as recommended in this paper, is adopted. Of course, it is important that the State and especially the Ministry of Finance have enough resources to be able to recruit the right people. That is, however, another topic not limited to State debt management.

Let us now look at the DO. The disadvantages mentioned above with an ADO will most probably disappear if the debt is managed by a DO. But what about the political risk? That risk will be substantially reduced if, as recommended above, the Parliament sets a clear goal for debt management and guideline-based management is introduced. The latter will increase transparency and predictability, make the DO focus on its task and result in a political commitment to a clear strategy for State debt management.

There are also other advantages with a DO. As mentioned above, the State debt ought to be seen in the broader perspective of the State finances and, consequently, the risk to be defined in terms of the contribution that the debt portfolio makes to fluctuations in the budget balance. In order to analyse the debt portfolio with this ALM approach it is necessary to study not only how interest rates and exchange rates vary in different scenarios, but also, and as equally important, how State income and expenditure vary in those scenarios. This is clearly a task that is more natural for the Ministry of Finance to perform than an ADO, especially since the Ministry of Finance has to carry out those analyses in its budget work.

Another advantage is that the Ministry of Finance through the DO will have direct contact with the capital market, which will be an essential input in its work to develop the market through regulations and infrastructure building.

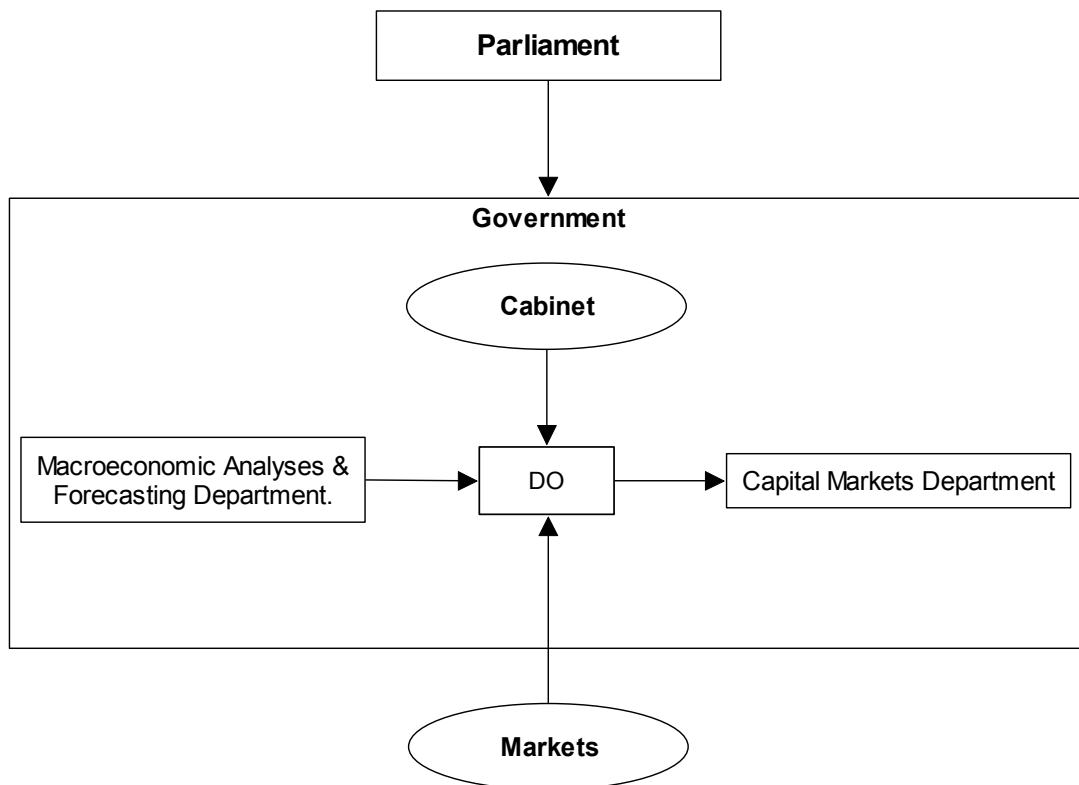
IV. CONCLUSION

In conclusion, after weighing the pros and cons, I recommend that a DO, – that is, a special unit within the Ministry of Finance – be responsible for carrying out debt management, any on-lending, and execution of guarantees. It is important, however, that the DO has clear goals for its activities, set by the Parliament, and that the

Cabinet determines guidelines for debt management. Regarding the organization, it would be a clear advantage for the DO to have good working relationships with both the macroeconomic analyses and forecasting department and the capital markets department (or similar departments) of the Ministry of Finance.

By way of illustration, see below.

Figure 1.



Finally, to those of you who do not agree with my analysis, here are some comforting words from the Guidelines for Public Debt Management:

“Experience suggests that there is a range of institutional alternatives for locating the sovereign debt management functions

across one or more agencies. Regardless of which approach is chosen, the key requirement is to ensure that the organizational framework surrounding debt management is clearly specified, there is coordination and sharing of information, and that the mandates of the respective players are clear.”

KEY FACTORS IN IMPROVING THE INSTITUTIONAL ENVIRONMENT OF DEBT MANAGEMENT - THE AFRICAN COUNTRIES OF THE FRANC ZONE

Georges Dikko Nigtiopop

For almost two decades, the member countries of the Central African Economic and Monetary Community (CEMAC) and the West African Economic and Monetary Union (WAEMU) have undertaken important economic and institutional reforms that have enabled them to improve their economic performance. These reforms have also strengthened their capacity in dealing with external shocks which they face. The establishment of dynamic systems for the issuance and management of sovereign equity, together with the development of financial markets, is in line with these reforms and should help to ease certain constraints concerning the funding of productive activities through the promotion and better allocation of financial savings. Such systems should also optimise of regional monetary policy implementation, particularly by strengthening the homogeneity and flexibility of member countries' economies and by promoting their financial integration.

Recent developments in domestic debt management¹ should lead to important changes in how financial policies are implemented, and even coordinated, within the Franc Zone. Limited by weak domestic savings and financial market developments, the African Franc-Zone countries have until recently preferred to mobilize external resources in order to meet their development needs. The accumulation of external commitments however soon became a handicap in achieving financial viability, and demonstrates debt management, its implications for the development of CEMAC and WAEMU countries and its impact on poverty needs to be addressed.

Due to the inappropriate macro-economic policies followed by African Franc-Zone countries over the past three decades, and to the poor

quality of their debt management at both the institutional and the operational level, the debt of almost all Franc-Zone countries has become unsustainable, despite the reforms that undertaken.

As such, although two countries are ineligible for it, the Heavily Indebted Poor Countries (HIPC) Initiative will help significantly to reduce the indebtedness of the African Franc-Zone countries. It is, however, clear from their medium-term and long-term macroeconomic forecasts that the viability of their indebtedness must be maintained beyond the completion point under the Initiative, through the financing of their growth and better redistribution of resulting benefits so as to perceptibly reduce poverty, gain greater control over medium- and long-term budget deficits, rationalize of resource mobilization policies and improve the institutional framework of debt management.

This paper will look at:

- The characteristics of the institutional framework of debt management in the Franc Zone;
- The key factors which can help strengthen this framework; and
- Prospects for capacity building.

I. CHARACTERISTICS OF THE INSTITUTIONAL FRAMEWORK OF DEBT MANAGEMENT IN THE FRANC-ZONE COUNTRIES

Although the African Franc-Zone countries belong to an integrated economic and monetary area, their experience of the structural organization of debt management varies. In particular:

- With respect to the entities responsible for debt, debt is managed by an independent structure, called the Autonomous Amortization Fund, in four countries (Benin, Cameroon, Congo and

¹ This relates principally to payments owing to staff of public administrations and to State suppliers, to large amounts of outstanding debt, monetary commitments consisting of total assistance by central banks to national Treasuries, State consolidation of debt initially owed by commercial banks to the central bank, IMF loans to States and overdrafts granted by the banking system to public administrations.

Equatorial Guinea), a Division of the Treasury and Public Accounts Department in three countries (Burkina Faso, Côte d'Ivoire and Gabon) and by a National Debt Office of the Ministry of Finance in the seven other countries (Central African Republic, Chad, Guinea Bissau, Mali, Niger, Senegal and Togo). However, the institutional organization of debt management in these countries has greatly changed over the past three decades. Until the beginning of the 1980s all had an office integrated within the Ministry of Finance. Due to the difficulties encountered by many of them in ensuring regular servicing of their external debt, most of these countries (the exceptions being Burkina Faso and Senegal), sometimes under pressure from the Bretton Woods institutions, established Autonomous Amortization Funds, legally independent national agencies responsible for managing government financial assets and liabilities, most of the resources of which, however, came from State budgets;

- Debt management functions, from loan negotiations to loan mobilization, monitoring and settlement, are centralized in some countries and in others are performed by different public administrations, without any real coordination (President's Office, Ministry of Finance, Ministry of Economics or Planning, debt management structures). In debt monitoring, for example, the Treasury in some countries is responsible for managing domestic debt while the Autonomous Amortization Fund or the Debt Offices monitor external debt;
- Last of all, there are many different kinds of software: most Franc-Zone countries now have debt processing and recording systems; Three countries use the CS-DRMS (Commonwealth Secretariat Debt Recording and Management System) software, developed by COMSEC (Benin, Cameroon and Mali), while four countries are full-time users of DMFAS (Debt Management and Financial Analysis System), developed by the United Nations Conference on Trade and Development (Burkina Faso, Guinea Bissau, Mauritania and Togo). Several countries have purchased DMFAS without ever really having used it (Central African Republic, Côte d'Ivoire and Senegal) or use only the basic functions of DMFAS (Burkina Faso and Togo) or CS-DRMS (Benin). The other countries

have only just acquired a system (Chad for DMFAS), or intend to purchase one of the above two systems, to strengthen their database management, currently carried out using Excel spreadsheets or using a "house-produced" system (Congo, Equatorial Guinea, Gabon and Niger). In parallel with the above systems, almost all of the countries eligible for the HIPC Initiative have purchased the DEBT PRO simulation software used to analyse the viability of external debt.

All these differences in approaching debt management do not always facilitate the dissemination of best international practices in public debt management, especially as the structural organization (independent or integrated into the Ministry of Finance, centralization or dilution of responsibilities) does not in itself ensure the success of a debt management system.

Nevertheless, the Franc-Zone countries have many similarities, which can encourage the search for harmonized solutions to the difficulties in managing their debt:

- The majority are eligible for the HIPC Initiative, the exceptions being Equatorial Guinea and Gabon;
- Their debt portfolios generally have common characteristics – a majority of foreign commitments, and debts owing to multilateral and bilateral creditor members of the Paris Club;
- Their domestic debt has grown very rapidly over recent years, as a result of the securitization of payment arrears. In this connection, it should be kept in mind that the texts limiting direct State indebtedness in the Franc Zone – apart from the provisions of Structural Adjustment Programmes (SAPs) – are those in the statutes of the Central Bank of West African States (BCEAO) and the Bank of Central African States (BEAC) that set ceilings for direct loans from central banks to national Treasuries. This rule, which is principally a response to concerns relating to monetary policy and support for a currency's parity in a fixed exchange-rate system, has not, however, prevented countries from accumulating excessive debt, partly because foreign debt is not

monitored, and partly because some countries, when faced with difficulties in mobilizing external funding, began to seek substitute financing means, including loans from primary banks, accumulating payments arrear and using funds paid in by the public to revenue offices or correspondents of national Treasuries;

- They are members of monetary unions having a unified monetary policy, integrated money and financial markets and harmonized statutory and institutional provisions;
- They face the same future challenges: less access to external resources when countries reach their completion points under the HIPC Initiative, and greater recourse to issuing government securities on national and regional financial markets;
- They have the same institutional weaknesses: their vision of debt policy is fragmented, and their coordination between their debt management and other macro-economic policies inadequate. Consequently, the growth of public debt does not take the capacity for future repayment into account, making it unsustainable. The main causes being are:
 - a) The absence of a clearly-defined debt strategy within a coherent economic policy framework and centred on a shared concept of medium-term and long-term viability;
 - b) A divided overall view on how to deal with debt problems, favouring traditional debt restructuring mechanisms for overcoming the consequences of excessive debt and debt-servicing difficulties rather than favouring a more comprehensive and coherent approach based on the sustainability of financial policies;
 - c) A dilution of responsibility in the debt chain, and even sometimes a weak statutory and institutional framework; and
 - d) Difficulties associated with the management and operation of debt processing software, resulting principally in debt statistics of poor-quality.

Weak capacity for formulating and implementing integrated and coherent debt management strategies, and thus limiting the countries' ability in preventing and managing future risks. The lack of logistical means and training of officials in the national debt management structures means that the countries are no longer able to

follow recent developments in the markets, debt processing mechanisms or methods and models for the analysis and management of the risks associated with indebtedness.

In these circumstances, it is essential to strengthen the institutional framework of debt management.

II. WHICH ELEMENTS MAY BE THE KEY FACTORS IN STRENGTHENING THE INSTITUTIONAL FRAMEWORK OF DEBT MANAGEMENT IN THE FRANC ZONE?

Several factors must be taken into account in strengthening the institutional framework of debt management:

Transparency: clarity of objectives and responsibilities within the debt chain

A separation of responsibility for the management of budgetary and monetary policies, which determine the level of debt, and the management of public debt, which is concerned with the composition of indebtedness must exist. At the same time coordination of all these policies must be strengthened in order to ensure the long-term viability of the debt. Responsibilities in the debt chain and in the process of formulating financial policy should therefore be clearly defined and transparent. In this view, the Code of Good Practices on Fiscal Transparency and the Code of Good Practice on Transparency in Monetary and Financial Policies, published by the World Bank and IMF, contain a number of benchmarks on transparency in debt management operations. They stipulate, in particular:

- Clarity in roles, responsibilities and objectives of the financial bodies responsible for debt management, is essential in reducing uncertainty and risks, in strengthening the credibility of public debt management by keeping the public fully informed about the policies followed in managing public debt, and in preventing conflicting objectives and responsibilities at the various levels in debt management;
- Proper organization of information flows between the various participants in the debt chain. This is essential for prudent and efficient debt management and in

this context, there should be clear procedures for information circulation, allowing debt policy objectives (resource availability at the lowest cost and risk) to be reached;

- The important material aspects of debt management operations, chiefly regulations and procedures applicable to the distribution of government securities, must be made public;
- Public access to information on debt management policies must be sufficiently wide to enable people to be aware of past, present and future budgetary activities and the Government's consolidated financial position. In this way, transparency in debt management operations can improve the quality of debt management through a greater accountability of the various structures involved in the public debt management chain. A clear definition of the objectives, directions and results of debt management and its availability to the markets, public and partners is in fact of major importance for the harmonious development of regional sovereign debt markets, especially in enabling the operators of those markets to assess the risks inherent in each country. In this way, transparency in debt management can become one of the best incentives for maintaining the long-term viability of debt policies within the Franc Zone;
- Transparency and simplicity in debt management operations can encourage greater investor participation and, in the long run, help States to reduce the cost of government debt servicing. In this sense, debt managers should regularly publish information on debt outstanding and on the composition of the State's public debt as well as its financial assets. This information should give currency breakdown as well as information on maturity dates, interest rates and financial movements. This information should be presented in a way as to be easily read and understood.

The implementation of recommendations given on the functions of debt management, their transparency and assumption of responsibility should form part of the regulatory system reform, part of the procedures for managing external and domestic debt, and of the establishment and operation of financial markets.

Assumption of responsibility: demonetization of budget deficits and direct loans on the financial market

Assumption of responsibility compels countries which tend to follow inappropriate financial policies to be subjected to risk premiums reflecting the reality of their economic situation.

The main objective of good debt management should be to meet the State's funding needs and payment obligations at the least possible cost over the long term, maintaining risks at a satisfactory level, while at the same time achieving other objectives such as financial markets developments.

Exhaustiveness: the debt management structure must enable monitoring of all the various categories of government debt (external debt, domestic monetary debt, bank and non-monetary debt, public companies' debt)

Debt management must be supported by a comprehensive computerized management system containing all the necessary security mechanisms. This information system should be capable, at a minimum, of:

- (i) recording and managing loans and databases;
- (ii) projecting amounts outstanding and debt servicing up to loan maturity;
- (iii) producing detailed and aggregated loan reports;
- (iv) calculating each loan's degree of concessionality;
- (v) meeting the needs of multi-aspect portfolio analysis;
- (vi) recording and updating all information and terms relating to the loan; and
- (vii) transferring data to other software (especially simulation software) or other systems (budgetary or risk management systems).

It should also be sufficiently flexible to allow speedy adaptation to changes such as the emergence of new types of loan and technological innovations. CS-DRMS and DMFAS software meet these conditions fully, while Excel spreadsheets and the "in-house" software developed in certain countries do

not. Consequently, all Franc-Zone countries should acquire software, providing the above minimum functionality.

Exhaustiveness also means that new functions or new skills need to be developed, particularly in relation to risk management. In this connection, Franc-Zone countries should also take into account:

- *Analysis and risk management of arising from domestic debt:* this will be initiated with the development of government securities markets in CEMAC and WAEMU and will require training programmes to be organized in this field for future domestic debt managers. As the securities to be issued in the initial phase of the of financial market development will be short-term, Franc Zone countries should mainly learn how to manage the risk of refinancing – the risk that the debt will have to be rolled over at an exceptionally high cost or cannot be rolled over at all, which could lead to crises and cause real economic losses due to the fact that direct advances by central banks to States will soon be stopped;
- *Analysis and management of market risks:* these are interest-rate and exchange-rate risks stemming from the composition of existing foreign debt portfolios and the impact of external or internal shocks on the debt profile. This activity is virtually non-existent in most Franc-Zone countries and to establish it would necessitate appropriate training. The analysis and management of risk mainly concerns those countries with loan portfolios the most diversified in terms of currency mix and with the shortest maturities, or those that are more exposed to interest-rate fluctuations. These are chiefly the oil-producing countries of Central Africa (Cameroon, Congo, Equatorial Guinea and Gabon) and the WAEMU countries formerly classified as medium-income countries (Côte d'Ivoire and Senegal).

Flexibility

Countries must have the freedom to choose the institutional arrangements that suit them or that they consider best adapted to their environment.

Coordination between debt management and financial policies within countries

The future development of government debt securities markets along with the requirements for a more dynamic management of budget liquidity increase the need of greater coordination between budgetary policies and public debt management.

One of the objectives of debt management is to enable public administrations to have the necessary resources for financing development without endangering financial stability or the medium-term viability of the economy. The impact of debt policy on macroeconomic and financial indicators thus fully justifies the establishment of a coordinating framework for the management of the national debt and macroeconomic policies. It is therefore important that debt managers inform the budget authorities of their views on the costs and risks associated with funding requirements and on the national debt and for them to obtain information on the current and future funding needs of the public administrations.

Until recently, coordination between debt management and budgetary policies was not a priority for officials responsible for economic policy in the Franc-Zone countries, and this resulted in little importance being accorded in the formulation of national economic and financial policies to the sustainability of public finances and the viability of medium-term and long-term debt. This lack of coordination is one of the main causes of the unsustainability of the Franc-Zone countries' debt, which has resulted more from the rapid growth of the debt stock than from the terms of the loans taken out by those countries. In fact, although the overall trend in the terms of their loans has been favourable, the viability of the external debt of the Franc-Zone countries has remained low, as the commitments they have undertaken have generally grown faster than their budget capacity and their ability to repay their foreign debt.

Moreover, economic policies within the countries are generally coordinated by the bodies (cells or committees) responsible for negotiating and monitoring structural adjustment programmes. These bodies have made it possible to establish a framework in which macroeconomic data can be rendered coherent

and aggregated, promoting regular consultation between national economic and financial authorities. However, one of their shortcomings is the fact that their work is, generally speaking, based mainly on the observance of implementation criteria and other benchmarks in structural adjustment programmes, and not on an independent and voluntarist financial management strategy built around a visible and shared development objective.

Weakness in the coordination of debt management and macroeconomic policies has also been encouraged by two factors: firstly, the inadequate ability to analyse debt viability, the risks associated with debt management and the sustainability of financial policies, and secondly, the absence for several years of a regional system for monitoring changes in debt and its impact on the macroeconomic and financial situation of member countries. Because of the interdependence between debt management and budgetary policies, some Franc-Zone countries have established structured systems (debt management committees) and formal procedures for coordinating all these policies. This is the case, in particular, in Burkina Faso, whose Debt Management Committee meets regularly to make a systematic assessment of the future impact of every new loan on budgetary liquidity and of the debt's viability before its final approval and the signature of funding agreements.

In view of the institutional organization of economic policy formulation and implementation within the Franc Zone, any coordination between debt management and financial policy can be credible only if it becomes fully part of the coordination and multilateral monitoring of macroeconomic policies in CEMAC and WAEMU.

Strengthening the coordination of financial policies at the regional level

Better coordination is needed between monetary policies and the new constraints imposed by the establishment of regional financial markets.

One of the important reforms now being put in place by the Franc-Zone countries is the establishment of financial markets and the development of a public savings appeal. In this context, a regional financial market already exists in WAEMU and is being established in

CEMAC, while in many countries public debt markets are emerging, in particular because of the securitization of public debt arrears. The next step in this reform will be the direct issuance of public debt on the national and financial markets. Some of the following basic principles are essential for the development of an effective government securities market:

- Establishment of an appropriate and transparent legal and statutory framework based on strict rules regarding accounting, auditing, information and the assumption of responsibility by the various participants;
- Development of an infrastructure that promotes market liquidity and reduces systemic risk;
- Choice of instruments in accordance with the development of financial markets;
- Establishment of appropriate mechanisms for the circulation of securities that are coherent with the State's liquidity requirements, the objectives of monetary policy and the need to reduce transaction costs;
- Appropriate training of officials responsible for managing government securities.

Modernization and integration of information systems

All countries should acquire effective debt management software that is integrated with public treasury management systems.

Strengthening and harmonization of the regulatory framework to ensure the widest possible coverage of the area of public debt and financial markets

Monetary policies in the Franc Zone are implemented by supranational central banks, whereas budgetary and debt policies are the responsibility of member States. However, since the objectives of these various policies differ (monetary stability and optimum mix of the costs and risks associated with the national debt), they can easily become conflictual, particularly in relation to the level of domestic interest rates and monetary conditions in general. The coordination of public debt management through financial markets with monetary policy is therefore important in re-

ducing the risks of conflict, especially as the re-orientation of the monetary policy mechanisms of BCEAO and BEAC favouring the use of indirect instruments (open-market operations using government securities) will inevitably affect the government bond markets. In any event, harmonization of the regulatory framework for managing public loans through financial markets, and even the adoption of unified rules and procedures, should help to ensure the coordination of monetary policies with national debt policies. Such coordination could in fact form part of the broader framework of harmonizing macroeconomic and financial policies in CEMAC and WAEMU and rendering them coherent.

Generally speaking, the convergence and multilateral monitoring indicators adopted since 1999 in WAEMU and in 2001 in CEMAC are increasingly emphasizing the sustainability of public finances and debt viability, and this marks a significant advance compared with the indicators used earlier. Specifically, the ratios relating to the basic budgetary balance, variations in payment arrears and indebtedness rates, and the fact that a time frame has been set for their determination, clearly demonstrate the Franc-Zone countries' determination to bring their debt levels down to a viable level.

Coherence of action and reforms

Reforms aimed at strengthening debt management systems must form part of an overall set of financial reforms.

Establishment of appropriate monitoring methods

The activities of debt management structures should be continuously assessed so as to ensure that they conform to the objectives of the public authorities, environmental trends and international practices. This assessment, which should be done within the framework of the coordination and multilateral monitoring of macroeconomic policies, should be supplemented by an external audit of debt management activities by independent auditors. This audit of national debt management agencies or structures complements the transparency rules to which are subject all economic participants who finance some of their activities through public savings appeals. In addition, continuous self-assessment of systems helps to make existing arrangements

more flexible, reduce the cost of institutional reforms and identify new priority areas for strengthening capacities.

Anticipating future risks

Real debt strategies must be put in place that enable future risks and costs to be anticipated and the financial vulnerability of States to be evaluated in relation to those traditional shocks to which they are exposed.

Public will

This must be clearly expressed so as to create synergy between the various state structures and to promote transparency.

III. STRENGTHENING CAPACITIES AND THE CONTRIBUTION OF PÔLE-DETTE

Strengthening human capital is an essential precondition for the success of the debt management reforms planned in the Franc-Zone countries. It can be achieved by:

- Training in new occupations: risk management, domestic debt management and development of public debt markets;
- Strengthening existing capacities for the formulation and implementation of debt strategies;
- Transferring skills: Pôle Dette serves as an interface between international expertise and States which still do not have access to it. This facilitates the acquisition of the best international public debt management practices by Franc-Zone countries;
- Establishing a framework for the exchange of experience among all countries: exchanges on the lessons learnt from debt renegotiation with the Paris Club, London Club or commercial donors. The exchange of experience is also being strengthened among countries, which have faced the same difficulties or use identical software. In the latter case the synergies which emerge, facilitate the establishment of partnership with certain international organizations such as UNCTAD and COMSEC.

In conclusion, reform of the institutional framework of debt management in the Franc-Zone countries is largely in construction. It must be seen in a medium-term perspective, in view of the underlying changes in the current regulatory system which it will probably bring about, and the large number of institutions which will no doubt be involved. Such reform is of individual concern to each State, but it will undoubtedly take place in the broader context of the Franc Zone, given the common nature of their financial management.

Reform of the statutory framework of public debt management should also take account of the progress made in regional integration and all

regional innovations and structural reforms. These include systems for the convergence and multilateral monitoring of macroeconomic policies in the Central African Economic and Monetary Community (CEMAC) and the West African Economic and Monetary Union (WAEMU), the abolition of statutory ceilings on direct central bank advances to States, intensification of operations for the securitization of domestic payments arrears, the adoption of texts concerning the issuance and management of government securities, and the establishment and development of regional financial markets in Central and West Africa.

KEY FACTORS IN IMPROVING THE INSTITUTIONAL ENVIRONMENT FOR ECONOMIC MANAGEMENT

The way ahead for HIPC's and other severely indebted nations

Jian-Ye Wang

I. INTRODUCTION

This paper examines the role of external debt management in the Initiative for Heavily Indebted Poor Countries (HIPC's). The international community launched the HIPC Initiative in 1996 with the aim of providing a lasting solution to the problems of many countries that suffered from unsustainable external debt burdens and abject poverty. The creation of the HIPC Initiative had generated broad public interest that focused mostly on debt relief issues. The Initiative was enhanced in 1999 to provide deeper, broader and faster debt relief. Significant progress has since been made, with debt relief packages agreed for 24 countries under the enhanced framework by the end of November 2001. Thanks to this Initiative and other debt relief initiatives, these countries' stock of public external debt will be reduced by about two thirds, from \$57 billion to \$22 billion in net present value (NPV) terms.¹ However, debt relief alone, no matter how generous, provides no guarantee that these countries will not return to unsustainable levels of debt.

This paper argues that sound debt management must play a central role in maintaining long-term debt sustainability. The HIPC Initiative is not only about debt relief; it is also about strengthening debt management capacity. Without the latter the Initiative's objective of providing HIPC's with a permanent exit from repeated debt rescheduling will not be achieved.² On the basis of a simple analytical framework and a review of past experience, this paper suggests that debt relief could induce new borrowing. Whether a country after debt relief remains on a sustainable path will depend critically on how well it manages the amount and terms of new

borrowing and on how efficiently it uses borrowed resources to increase repayment capacity. These are increasingly relevant issues in the implementation of the HIPC Initiative as more countries are approaching their completion points and at a time when a worsened global economic environment may weaken HIPC's repayment capacity.

Drawing on a recent survey conducted by the World Bank and IMF staffs, this paper looks at the current status of external debt management in HIPC's and assesses whether progress has been made during the HIPC process. It was found that countries that have reached or are close to reaching their completion points are more likely to have in place the relevant laws and regulations, perform better in certain basic debt management functions, and show improvement in the use of computers and software. However, progress appears to be lacking in other areas that are important for effective implementation, such as transparency and accountability in debt management. This paper argues that sufficient progress will need to be made in strengthening a HIPC's governance and implementation capacity during the period prior to the completion point if the country is to maintain external debt sustainability over the longer term.

The remainder of this paper is organized as follows. The next section develops a simple model to analyse the role of debt relief and debt management in achieving long-term debt sustainability. Section III reviews the experience of HIPC's in the 1980s and early 1990s with debt relief and accumulation of external debt. Section IV assesses progress made under the HIPC Initiative in various aspects of debt management on the basis of a recent survey of 33 HIPC's' public debt managers. Key areas for further improvement are highlighted in section V, which concludes the paper.

¹ See IMF and World Bank (2001a) for more details of the financial impact of HIPC debt relief on the first 23 decision point countries, including on their debt stock, debt service and social expenditures.

² The challenges HIPC's are facing in achieving long-term external debt sustainability are discussed in IMF and World Bank (2001b). Abrego and Ross (2001) discuss the impact of debt relief on HIPC's' debt sustainability outlook and resource flow.

II. DEBT RELIEF, DEBT MANAGEMENT AND LONG-TERM DEBT SUSTAINABILITY

A. Simple analytical framework

As in the HIPC Initiative, we use the NPV of the debt-to-exports ratio as a key indicator of external debt sustainability. Let D_t represent the NPV of a country's outstanding public and publicly guaranteed external debt at time t . X_t denotes export earnings, or more generally a country's repayment capacity, fiscal or external, whichever is a binding constraint for debt servicing. The initial level of debt relative to exports, $(D/X)_0$, is assumed to be very high and unsustainable. At time 0, the country's creditors provide debt relief R in NPV terms, thereby reducing the debt-to-exports ratio to a sustainable level, $(D/X)^*$.

$$\frac{D_0 - R_0}{X_0} = \left(\frac{D}{X}\right)^*, \quad \left(\frac{D}{X}\right)^0 > \left(\frac{D}{X}\right)^* \quad (1)$$

How the debt-to-exports ratio would change over time after debt relief will depend on the growth of debt relative to the growth of exports. Taking the derivative of (D/X) with respect to time, we have

$$\left(\frac{\dot{D}}{X}\right) = \frac{\dot{D}}{D} - \frac{\dot{X}}{X} \quad (2)$$

where a dot over a variable denotes the time derivative of that variable. Equation (2) implies that the debt-to-exports ratio will rise, remain unchanged, or decline if the growth rate of debt is greater than, equal to, or lower than the growth rate of exports (figure 1).

$$\left(\frac{\dot{D}}{X}\right) \geq 0, \quad \text{if } \frac{\dot{D}}{D} \geq \frac{\dot{X}}{X} \quad (3)$$

Changes in the debt stock during period t can be considered a function of repayment, P_t , new borrowing, B_t , and other factors summarized in a vector, Ω_t (such as the world market interest rate used to discount interest and principal payments to present value, and exchange rates if loans were contracted in different currencies). As is evident in discrete time, $D_t = D_{t-1} - P_t + B_t$, the debt stock is an increasing (decreasing) function of new borrowing (repayment). The debt stock may increase even in the absence of new borrowing if scheduled repayment is not made, resulting in the accumulation of late interests on outstanding arrears.

$$\frac{\dot{D}}{D} = F(B, P; \Omega), \quad F_B \geq 0, \quad F_P \leq 0 \quad (4)$$

A country's export performance can be influenced by investment in the export sector, domestic policies that affect the incentives for production and exports, and the external environment, including the terms of trade and access to major markets. To focus on the role of debt management, we use θB to denote the amount of borrowed resources allocated for investment, where θ is a choice variable of the authorities and $(1-\theta)B$ is allocated for consumption. Other factors are captured in a vector Ψ . ε is a random variable representing uncertainty in world markets.

$$\frac{\dot{X}}{X} = G(\theta B; \Psi) + \varepsilon, \quad G_B \geq 0, \quad \theta \in [0, 1] \quad (5)$$

It should be noted that θ is endogenously determined in a standard intertemporal model of national wealth and external borrowing (e.g. Obstfeld and Rogoff, 1996) by more fundamental variables. A country with a high time preference rate and low intertemporal elasticity of substitution will have a high desired ratio of consumption to income or net wealth. Under such circumstances and without changing behavioural parameters, debt relief may be followed by a period of high borrowing for consumption. The partial derivative, $\frac{\partial D}{\partial \theta}$, can be interpreted as the efficiency of using borrowed resources to increase exports.

Substituting equations (4) and (5) into (2), we have an equation suggesting the role of debt management in maintaining long-term debt sustainability – B , P and θ in equation (6) are under the control of a country's debt management authorities. This management would need to coordinate with other aspects of domestic policies, taking into account external factors and uncertainty.

$$\left(\frac{\dot{D}}{X}\right) = F(B, P, \Omega) - G(\theta B, \Psi) + \varepsilon \quad (6)$$

B. Key elements of external debt management

The simple analytical framework outlined in the preceding section suggests a number of key roles for external debt management. First, the accumulation of new foreign liabilities must be prudently managed. This applies to new borrowing of the public sector and the provision of public (government or central bank) guarantees for new external borrowing. The fundamental guiding principle is that borrowing must be kept in line with repayment capacity. Debt management authorities need to analyse and assess the development of a country's export earnings and fiscal revenue, including over the medium term, before undertaking new borrowing. Such consideration would need to take into account the vulnerability of HIPC's exports/fiscal revenue to exogenous shocks and uncertainty in world markets. Controlling new borrowing would be especially important right after debt relief. Debt relief reduces a country's debt service obligations but does not directly increase repayment capacity.

Prudent liability management also implies close coordination of borrowing policies with other macroeconomic policies, especially in the face of adverse economic shocks. An appropriate balance of policy adjustment and financing is essential in order to prevent the build-up of unsustainable debt at a time when a country's repayment capacity is weakened. If a country's repayment capacity is expected to remain weak over the medium term or subject to great uncer-

tainty, as is often the case in HIPCs, seeking larger grant financing and limiting borrowing to highly concessional terms would help maintain external debt sustainability.

Second, borrowed resources should be used productively, contributing to the strengthening of a country's repayment capacity. Our model suggests that the larger the share of borrowed resources used to finance productive activities instead of consumption or other not directly productive expenditures, the more likely it is that the country would remain on a sustainable path. Increasing the efficiency of using borrowed resources through better expenditure and project management (e.g. public investment programme, medium-term expenditure framework) would also ensure adequate economic returns to meet future debt service obligations.

Third, payment of debt service should be made timely. This would require accurate recording, close monitoring, analysing and reliable forecasting of debt service obligations of the public sector, including contingent liabilities, as well as good risk and liquidity management. Timely payment would ensure that existing debt is reduced as scheduled, thereby providing the space for new borrowing, given a country's payment capacity constraint. Non-accumulation of arrears is essential in maintaining access to new financing.

Fourth, while not explicitly modelled in section II.A, governance and institutional framework are generally recognized as a key

element for effective debt management. Indeed, the choice between adjustment and new borrowing, investment and consumption, as well as which projects to finance, is ultimately a governance issue. The specific organizational arrangements for debt management could be different across countries, but an effective framework would typically require an open process in the formulating and reporting of debt policies and clear responsibility and accountability of the relevant agencies. Regular disclosure of debt information, and public/parliamentary oversight of debt management operations would enhance transparency and accountability.

Finally, adequate human and technical resources are necessary for debt management agencies to perform their functions effectively. Capacity building is a cumulative process. It takes time and resources to acquire the requisite human capital and hardware.

III. EXPERIENCE PRIOR TO THE HIPC INITIATIVE

Official creditors have been providing substantial debt service relief to low-income countries since the late 1970s and early 1980s. Most debt relief by official bilateral creditors was under the auspices of the Paris Club. Over time Paris Club rescheduling shifted from simple cash flow support to concessional rescheduling. The degree of concessionality gradually increased, from "Toronto terms" (up to 33 per cent NPV reduction of eligible debt) agreed in October 1988 to "London terms" (50 per cent NPV reduction) in December 1991 to "Naples terms" (67 per cent NPV reduction) in January 1995.³ Between 1988 and 1995, 27 rescheduling agreements were signed under Toronto terms, 24 under London terms and a further 11 under Naples terms, covering payments falling due of about \$6 billion, \$8.8 billion and \$4.2 billion respectively (table 1).

Besides explicit debt relief, there had been an implicit form of debt relief going on throughout the period, namely the substitution of concessional debt for non-concessional debt. While bilateral creditors shifted from commercially priced credits to official development assistance,

the exposure of the concessional arms of multilateral lending agencies had increased.

Despite the continuing waves of debt relief, HIPC's external public debt continued to rise. Prior to 1988, the Paris Club's flow rescheduling approach provided cash flow relief with no reduction of the NPV of debt outstanding. The introduction of concessional debt rescheduling in 1988, in the absence of new borrowing, would have led to a lower debt stock in NPV terms. However, largely owing to new borrowing, the debt stock of 42 HIPC's increased rapidly from some \$120 billion in 1988 to almost \$190 billion in 1995. As new borrowing clearly outpaced export growth, the debt-to-exports ratio also increased during the same period. While debt stocks were clearly rising well beyond sustainable levels in many cases, the average paid debt service ratio for HIPC's fell initially, owing to the concessional rescheduling, but rose again when the grace period of these rescheduling agreements ended (figure 2).

The evidence prior to the HIPC Initiative indicates that (a) concessional debt relief alone was not sufficient to achieve debt sustainability; (b) there was a strong correlation between debt relief and new borrowing in certain countries – that is, the reduction of old debt was accompanied by the build-up of even larger new debt; and (c) a factor contributing to the accumulation of unsustainable debt after debt relief was the absence of responsible economic management, debt management in particular, as pointed out by a number of studies of the external-debt history of low-income countries (e.g. Brooks et al. 1998; Easterly, 1999). In addition to weak governance and debt management practices, important factors that contributed to the deterioration of HIPC's debt indicators in the early 1990s were adverse terms-of-trade developments, a lack of sustained macroeconomic adjustment and structural reform, and poor lending decisions by creditors.

IV. PROGRESS UNDER THE ENHANCED HIPC INITIATIVE

Our analysis in the preceding sections suggests that whether the HIPC Initiative will succeed in achieving external debt sustainability in the countries that receive HIPC debt relief will depend critically on progress made in strengthening their debt management capacity. Three

³ Daseking and Powell (2000) provide a concise history of these developments.

questions arise in this regard. What is the current status of debt management in HIPC? Was progress made during the period when a HIPC is striving to become eligible for receiving all relief under the Initiative? What are the key areas for further improvement if the HIPC Initiative is to achieve its goals? This section looks at these questions, particularly the latter two, primarily on the basis of a recent survey conducted by the IMF and World Bank staffs.

The questionnaire sent to the debt offices of the HIPCs consists of some 74 questions, covering key aspects of external debt management, including institutional and legal arrangements, implementation and resources of the debt management agencies, as well as technical assistance provided by the donor community. Of the 42 HIPCs contacted, 33 sent back completed questionnaires (table 2). These countries can be divided into four groups based on the basis of their HIPC status as of the end of November 2001: 10 countries yet to reach their decision points, 13 countries in the first year of the interim period between the decision and completion points, 6 in the second year of that period and 4 completion point countries (Bolivia, Mozambique, Uganda and the United Republic of Tanzania).

A. Legal and institutional arrangements

The key questions asked were whether there were clearly defined legal mandate and institutional arrangements for debt management functions and whether these functions were carried out in a systematic and coordinated manner. About half of the HIPCs that responded reported that there was a framework governing the debt office and its functions related to negotiating, contracting, managing and monitoring external debt. A clear pattern emerges as countries are grouped according to their HIPC status: all completion point countries have in place laws/regulations that set out the responsibilities, mandate and objectives of the external debt management agency/agencies. In contrast, over 60 per cent of the pre-decision point countries admitted that there was no such legislation. The share of countries without any relevant law on debt management declines in country groups that are more advanced in their HIPC status, a fact which suggests that progress has been made in this regard (figure 3.A).

Where laws or decrees are in place, nearly half of the countries reported that they were not implemented. Non-implementation was highest among pre-decision point countries (90 per cent), with implementation improving once countries had reached their decision points. All four completion point countries reported that the relevant laws/regulations are being implemented (figure 3.B).

However, when asked whether there were laws/legislative provisions obliging the Government to publish comprehensive information about the country's external debt and the authorities' debt analysis and policies, two thirds of the respondents replied negatively. There was no major difference between the countries prior to the HIPC decision point and after the completion point, a fact which suggests little or no progress during the HIPC process (figure 3.C).

The evidence on institutional set-up indicates that there was no prevailing institutional arrangement in HIPCs, nor was there a clear trend towards change during the HIPC process (figure 3.D). Debt management functions are carried out either by the ministry of finance (over 45 per cent of the countries responding) or by multiple government agencies, involving the ministry of finance, the central bank and, in some cases, other ministries such as the ministry of economy and planning. (45 per cent). Independent or autonomous body accounted for only a small fraction of the countries. The key issues here are transparency and accountability, whatever the institutional arrangements. Some division of labour was observed where more than one office was charged with debt management responsibility, but in these cases there was scope for improving information flows and coordination among different agencies. As will be discussed later, debt management offices are accountable to various authorities, depending on the type of decisions, but there was no clear trend towards change during the HIPC process.

B. Coordination with macroeconomic policies

To ascertain the debt management offices' role in the design and implementation of macroeconomic policies, countries were asked about, for example, debt strategy, information sharing among government agencies, and the mechanisms with which the results of debt analysis

were incorporated into fiscal and other aspects of macroeconomic management. On the issue of the Government's debt strategy, about 25 per cent of the countries reported that a comprehensive debt strategy report had been prepared on a regular (annual) basis and made available to the public (figure 4.A). The other 75 per cent did not prepare debt strategies or their reports were for internal use only, lacking comprehensiveness and availability. Limited progress has been made during the HIPC process, but the progress was slow; and half of the completion point countries did not prepare and update their debt strategies in a comprehensive manner.

There appears to be a correlation between the preparation and updating of an overall external debt strategy and other debt analyses. Countries that prepared and updated their debt strategy tended also to carry out debt portfolio analysis, debt sustainability analysis, public investment programme review and a medium-term expenditure framework exercise (figure 4.B). Fewer than 30 per cent of the pre-decision point countries reported preparation of debt sustainability analysis. Many debt offices attributed this to the lack of necessary technical skills and rated the latter as a priority area for training and foreign assistance.

Most countries reported that their debt offices' linkages to overall macroeconomic policies were limited to one-way provision of debt data as an input to policy formulation and monitoring. Nearly 70 per cent of the countries indicated that information sharing among government agencies either was poor or needed improvement. In spite of this, the self-assessment by HIPC debt offices indicates a clear pattern of progress as countries moved closer to their completion points, although the frequency of such coordination and collaboration varied across countries (figure 4.C). Countries with more frequent coordination tended to have a regular forum in which to discuss debt servicing needs and their impact on the budget and the balance of payments.

C. Managing new borrowing

Prudent foreign liability management requires not only a comprehensive, forward-looking strategy on external borrowing but also consistent policies on the provision of State guarantees. These strategies/policies need to be operationalized into concrete guidelines/ceilings

and proper procedures for evaluating requests for new borrowing or State guarantees. Only one fourth of the responding countries stated that they have comprehensive and forward-looking strategies on external borrowing. The remaining countries indicated that they have elements of a debt strategy, which in many cases amount to a restriction on contracting only concessional loans (figure 4.D).

Countries appear to have made progress in instituting guidelines for and limits on non-concessional borrowing after reaching the decision point under the enhanced HIPC Initiative. Virtually all countries approaching their completion points reported that their guidelines cover public enterprises and were enforced (figure 5.A.). On concessional borrowing, there was no indication of quantitative limits. The restriction was in respect of concessionality – most countries required a grant element of at least 35 per cent with the exception of a few countries that set the minimum concessionality of new loans at a grant element of 45–65 per cent.

Little progress has been made, however, in evaluating new borrowing proposals. A careful analysis of the impact of borrowing proposals on the overall debt portfolio, including on its currency composition, interest rate structure and maturity profile, is a precondition for prudent borrowing decisions. About 50 per cent of the completion point countries and those in their second year of the interim period did not undertake technical evaluation of new borrowing requests (figure 5.B). This is clearly an area needing improvement if new borrowing policies are to be implemented effectively.

Parliament was seen to play a larger role in approving public sector external borrowing in countries that have reached their decision points. In nearly half of the countries before the decision point, new external borrowing needed only approval by a minister. Parliamentary approval was increasingly required as countries advanced along the HIPC process (figure 5.C). The change of the approval authority from a minister to Parliament or in some cases to an inter-ministry committee appeared to have helped tighten control and enhance the accountability of government external borrowing. However, the approval of State guarantees was mostly in the hands of finance ministers and there was no clear change during the HIPC process (figure 5.D).

D. Managing existing debt

Performing the basic debt management functions requires adequate coverage of debt data, accurate recording of debt servicing and disbursement transactions, periodic data reconciliation with creditors, and timely reports by the debt office. Regarding the monitoring of different types of debt, virtually all respondents reported complete coverage of government and government-guaranteed debt. However, public enterprise debt was often not monitored or only partially monitored by government debt offices. There was no clear progress in this area during the HIPC process (figure 6.A). Few countries reported monitoring of private non-guaranteed debt or contingent liabilities.

The provision of information on debt disbursement and debt servicing transactions to the debt office was problematic in many HIPCs, and often a source of discrepancy in projecting debt service obligations. Only one quarter of the countries acknowledged regular reconciliation of debt records with their creditors. A number of countries therefore called for disbursement statements to be automatically sent to the debt management office rather than to the project coordination unit or other government agencies.

A number of HIPCs received external technical assistance in preparing for Paris Club rescheduling negotiations and commercial debt buy-back operations, but most were keen to build up capacity to do so on their own. Many respondents expressed interest in receiving training on the mechanics as well as the strategies of debt renegotiations and rescheduling operations.

E. Human and technical resources

Most respondents indicated that their debt offices lacked either staff or skills to perform needed debt analysis. This situation has not really improved during the HIPC process (figure 6.B). Many countries cited these two factors (staffing and skills) as major impediments to improving debt management capacity. They also highlighted problems of high turnover of experienced staff and the lack of proper training of their replacements. They considered improvements in remuneration levels to be a key to improving the morale of the staff and reducing the high turnover rates.

Regarding technical resources, about one third of the countries believed that their debt office was adequately equipped with computers and appropriate software (figure 6.C). Another third of the countries stated that they lacked both computer hardware and software. As countries moved through the HIPC process, progress was visible in improving the availability of computers and software to debt management offices.

V. CONCLUDING REMARKS

The enhanced HIPC Initiative has brought much hope that deep debt relief under it will help break the vicious circle of debt overhang and poverty, and once and for all restore external debt sustainability in HIPCs. As more countries are approaching their completion points, it has become apparent that debt relief alone is not enough to realize this high hope. This becomes especially true when the global economic environment worsens, clouding HIPCs' prospects for fast export growth. In this paper, we have argued that prudent debt management in HIPCs will have to play a central role in maintaining their external debt sustainability after debt relief.

We have considered whether HIPCs' debt management capacity has been strengthened during the HIPC process, drawing on a recent self-assessment by the HIPCs. Our analysis pointed to a number of areas where progress has been lacking and significant improvement is needed:

- Transparency of debt management needs to be greatly enhanced through strengthened legal requirements and regular publication of debt information, including on new borrowing and the use of borrowed resources. Government's overall debt strategy and debt analyses, including debt sustainability analysis, should also be made available, not only to various government agencies, but also to Parliament and the general public.
- Accountability of debt management is crucial in preventing the recurrence of unsustainable debt. Institutional arrangements could be different across countries, but moving towards a single debt management office would enhance accountability. Improving information sharing and coordination would also help in a multi-agency environment. Government decisions on new borrowing, the provision of State or central

bank guarantees, and the use of foreign financing should be subject to close scrutiny by Parliament and taxpayers.

- Greater integration of debt policies with macroeconomic management could be achieved through regular review of debt strategies, debt analyses, and the public investment programme and medium-term expenditure framework. This is especially important for increasing the efficient use of borrowed resources and ensuring fiscal sustainability. Domestic debt, which has not been discussed in this paper, will be an important element in these considerations. HIPCs lack the requisite skills in this area and would need technical assistance from the international community.
- With regard to managing new borrowing, careful evaluation of borrowing proposals should be undertaken before making decisions. For many HIPCs where repayment capacity is expected to remain weak over a long period, limiting new borrowing to concessional loans may not be enough to keep external debt at sustainable levels. A restraint on concessional borrowing would need to be enforced.

- Finally, HIPCs need to continue their efforts to strengthen the basic debt management skills and functions. Lack of trained staff was identified as a key constraint. Staff training should thus be accorded high priority. Despite the fact that HIPC relief is also provided for public enterprise debt, this category of debt was not monitored by the debt offices in many HIPCs. The coverage of debt offices should therefore be broadened to include all public enterprise debt.

Making progress in the above areas would go a long way to ensuring external debt sustainability in HIPCs. While these steps may not guarantee that debt problems would not re-emerge, it would certainly greatly reduce such a possibility. Therefore, it is fundamentally important for the HIPCs to make sufficient progress in strengthening their debt management capacity by the time they reach the HIPC completion point.

Table 1. HIPCs: Paris Club Reschedulings By Type of Terms, 1976 – July 2001

| | | Number of reschedulings | Number of countries | Total operations | Amounts con- solidated of which stock | Stock or flow rescheduling |
|---|----------------------------------|----------------------------|------------------------|---------------------|---|-------------------------------|
| | | (millions of US dollars) | | | | |
| I. Paris Club reschedulings, 1976–1995 | | 149 | | 42 259 | | |
| Non-concessional | Before October 1988 | 87 | 28 | 23 269 | - | flow deals only |
| Toronto terms ¹ | October 1988 – June 1991 | 27 | 19 | 5 984 | - | flow deals only |
| London terms ² | December 1991 – December 1994 | 24 | 22 | 8 774 | - | flow deals only |
| Naples terms ³ | January – December 1995 | 11 | 10 | 4 232 | 991 | 2 stock deals |
| II. Paris Club rescheduling, 1996–2001 | | 50 | | 22 202 | | |
| Non-concessional | Since January 1996 | 2 | 2 | 395 | - | flow deals only |
| Naples terms ³ | Since January 1996 | 27 | 21 | 13 286 | 2,109 | 6 stock deals |
| Lyon/Cologne terms | Since December 1996 | 21 | 18 | 8 521 | 3,639 | 6 stock deals |

Sources: Paris Club secretariat and IMF staff estimates.

¹ Rescheduling with a net present value reduction of up to one third of the eligible debt.

² Rescheduling with a net present value reduction of 50 per cent of the eligible debt.

³ Rescheduling with a net present value reduction of 67 per cent of the eligible debt.

⁴ Rescheduling with a net present value reduction of 80 (90) per cent of the eligible debt under Lyon (Cologne) terms.

Table 2. Status of HIPCs as of November 2001

| Pre-decision point | Interim period – first year | Interim period –second year | Completion point reached |
|---|-----------------------------|-----------------------------|--------------------------|
| Countries that responded to the questionnaire | | | |
| Angola ¹ | Cameroon | Benin | Bolivia |
| Burundi | Chad | Burkina Faso | Mozambique |
| Central African Republic | Ethiopia ² | Honduras | Uganda |
| Comoros | Gambia | Mali | United Republic of |
| Côte d'Ivoire | Guinea | Mauritania | Tanzania |
| Ghana | Guinea-Bissau | | |
| Kenya ¹ | Madagascar | | |
| Sudan | Malawi | | |
| Togo | Nicaragua | | |
| Viet Nam ¹ | Niger | | |
| | Rwanda | | |
| | Sao Tome and Principe | | |
| | Senegal | | |
| Country totals | | | |
| 10 | 13 | 6 | 4 |
| <i>Memorandum items:</i> | | | |
| Other HIPCs | | | |
| Democratic Republic of the Congo | Zambia | | |
| Congo | | | |
| Lao People's Democratic Republic | | | |
| Liberia | | | |
| Myanmar | | | |
| Sierra Leone | | | |
| Somalia | | | |
| Yemen ¹ | | | |
| Grand totals: | | | |
| 18 | 14 | 6 | 4 |

¹ Sustainable countries not expected to require HIPC relief.

² Ethiopia reached its Decision Point on 6 November 2001.

Figure 1. Debt relief, debt management and debt sustainability

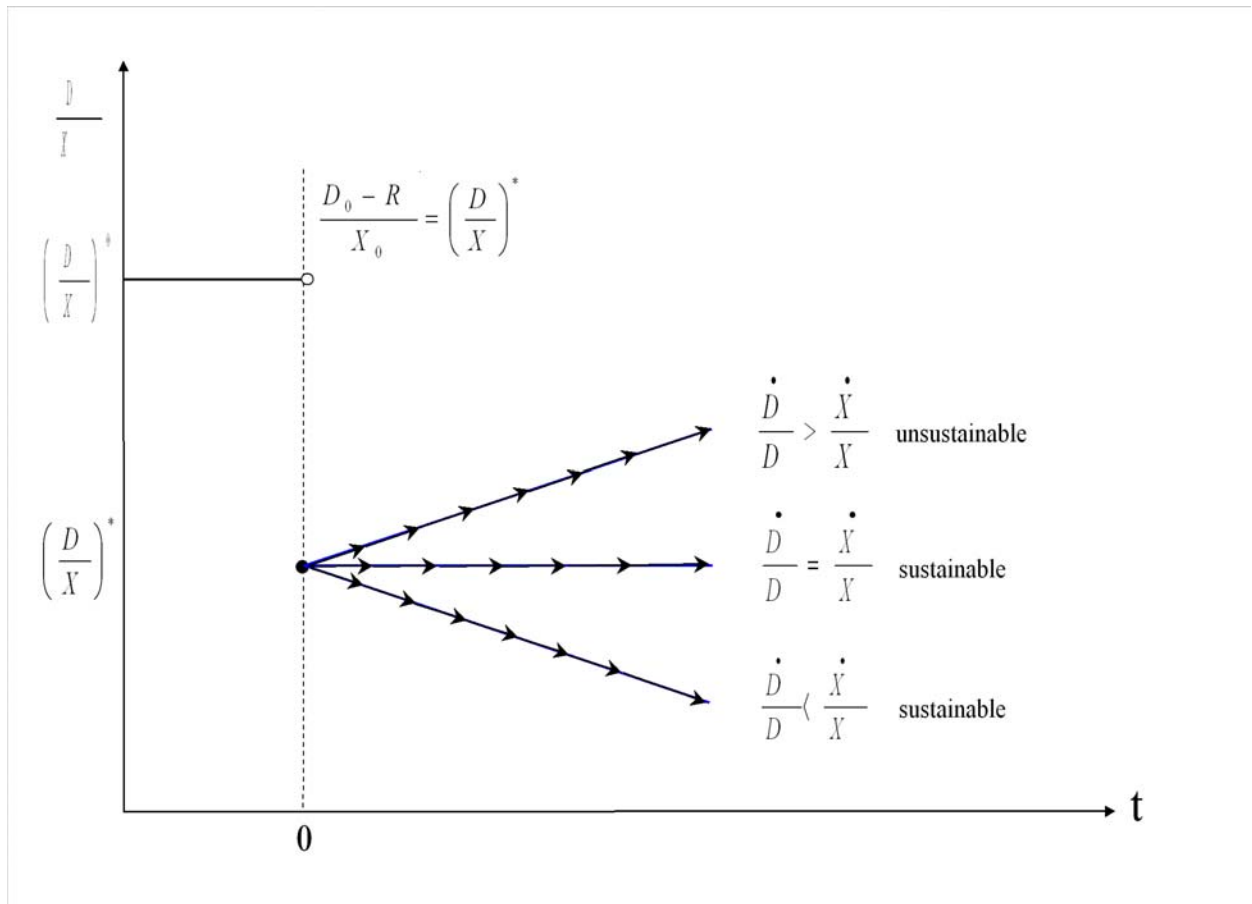
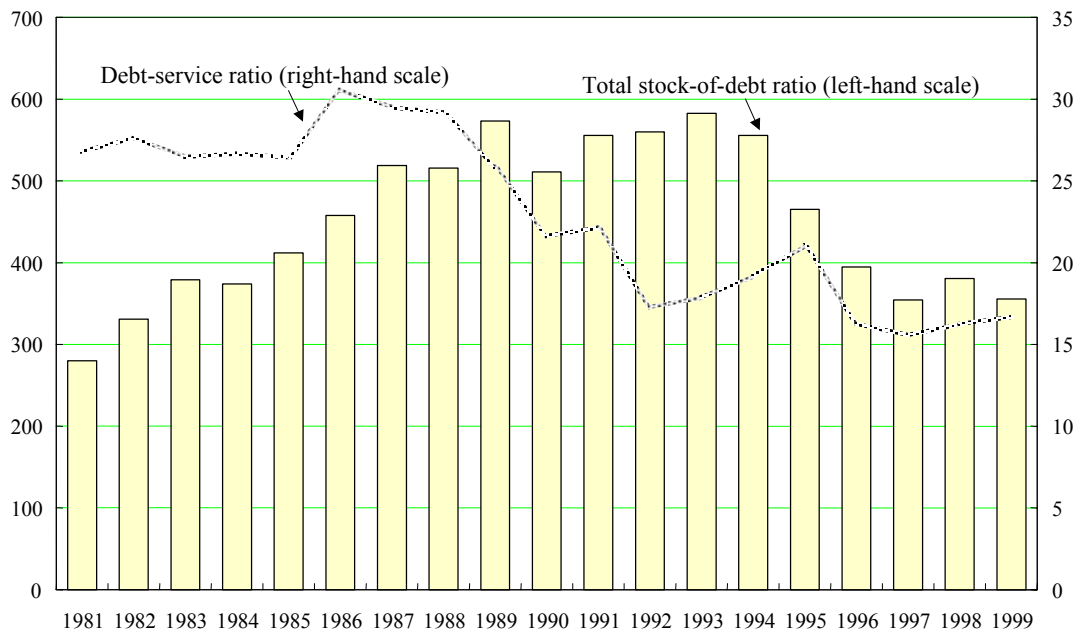
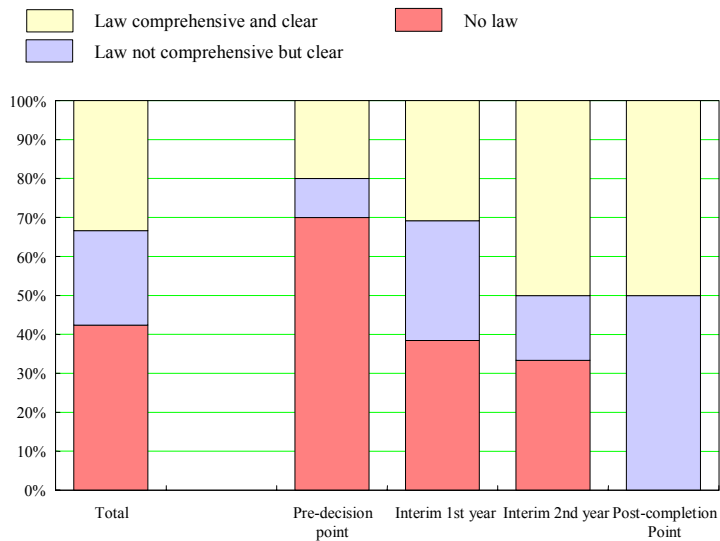
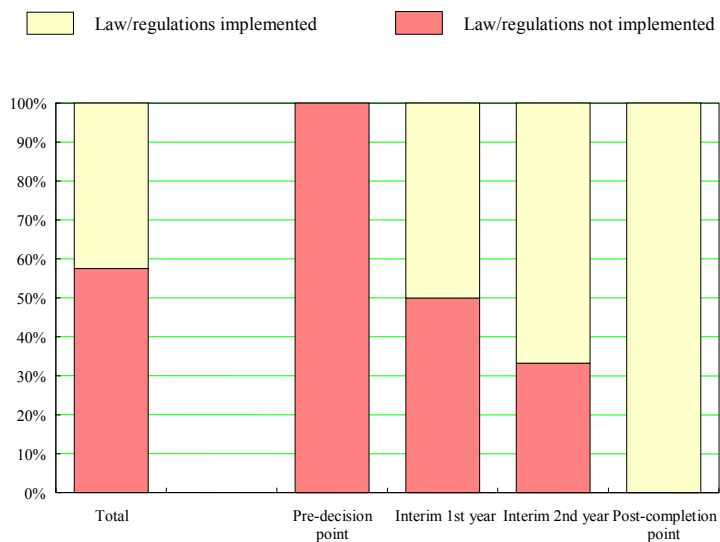
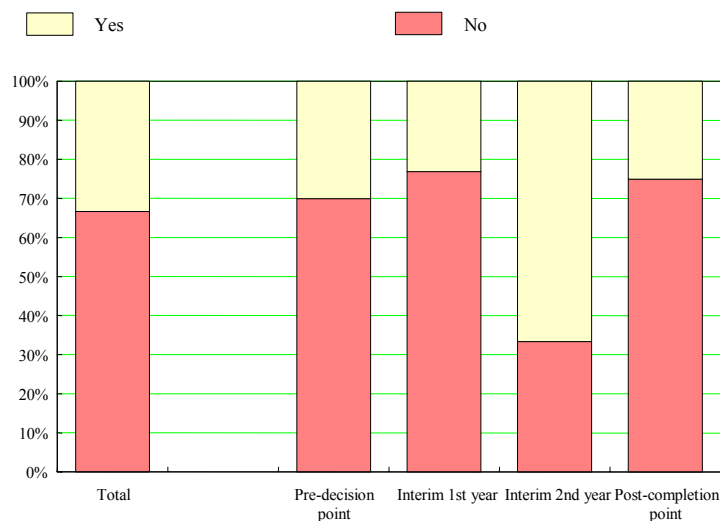


Figure 2. HIPC's debt service and total external debt, in 1981–1999¹
(In percentage of exports)



Source: World Bank, *Global Development Finance*, 2001

¹ Average of individual ratios for the HIPC's listed in table 2.

Figure 3. Legal and institutional arrangements (Source: HIPC Debt Management Survey for 2001)**A. Are legal/institutional arrangements in place?****B. Are laws/regulations implemented?****C. Are there legal provisions to publish debt information?**

D. Who manages debt?

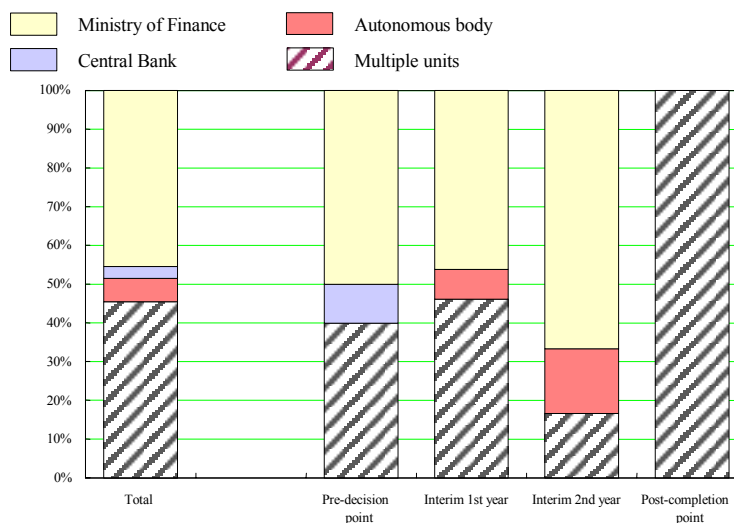
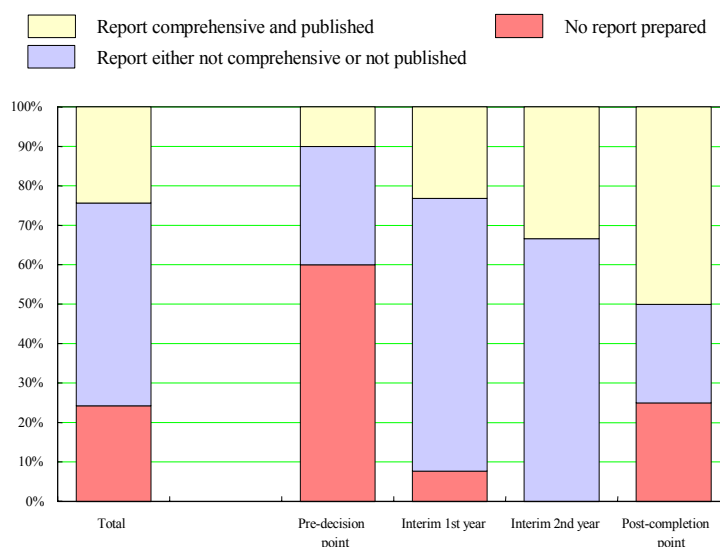
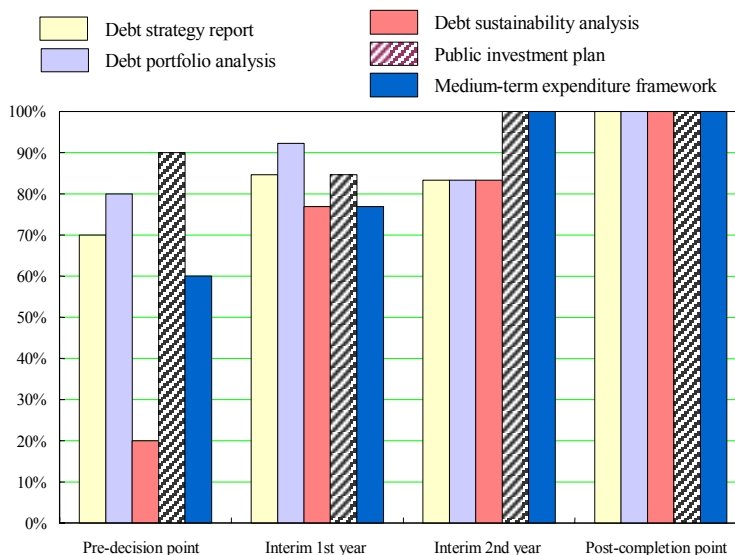


Figure 4. Coordination with macroeconomic policies (Source: HIPC Debt Management Survey for 2001)

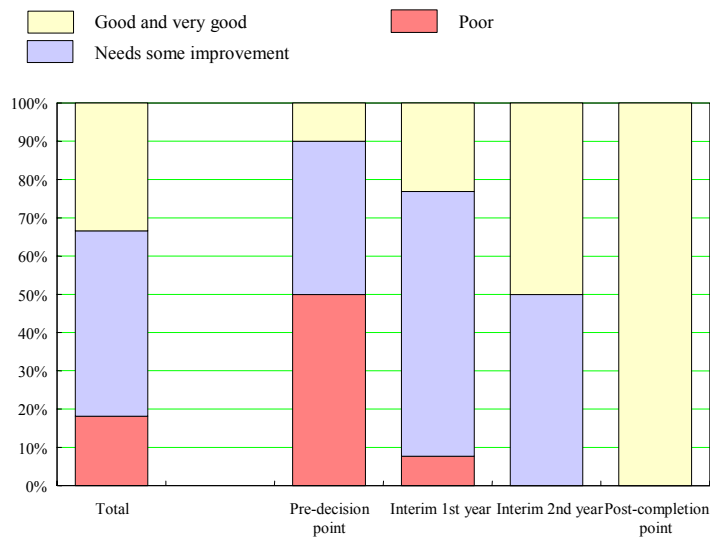
A. Does the government prepare the annual debt strategy report?



B. What debt analyses are prepared?



C. Flow of information/coordination on debt issues among government agencies



D. Are there comprehensive policies on new external borrowing?

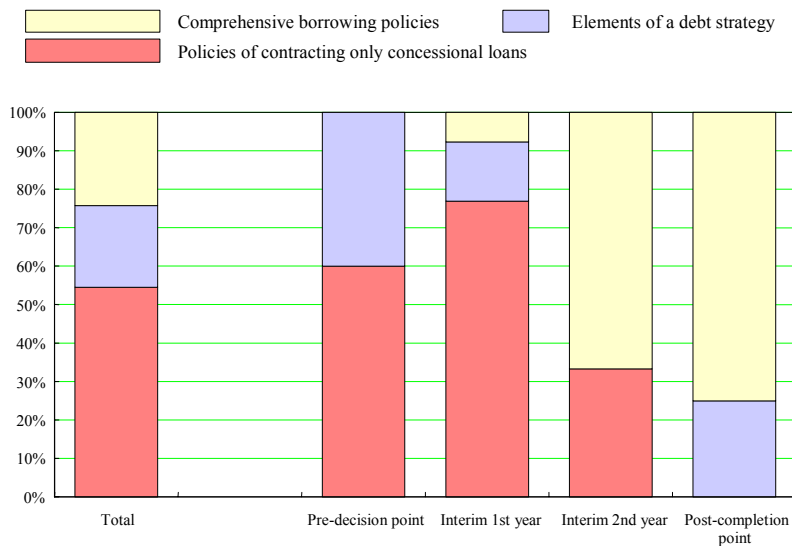
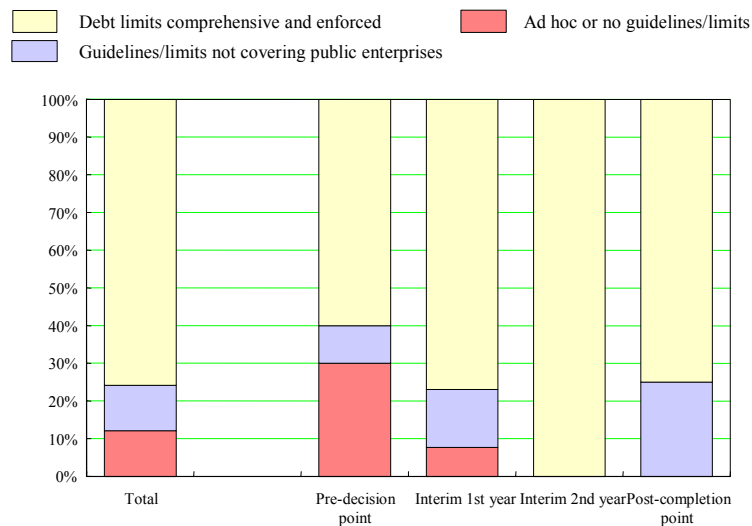
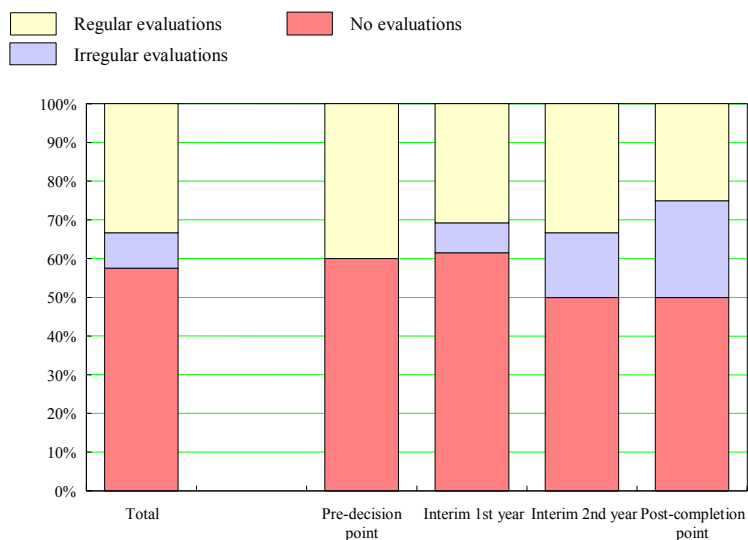


Figure 5. Managing new borrowing (Source: HIPC Debt Management Survey for 2001)

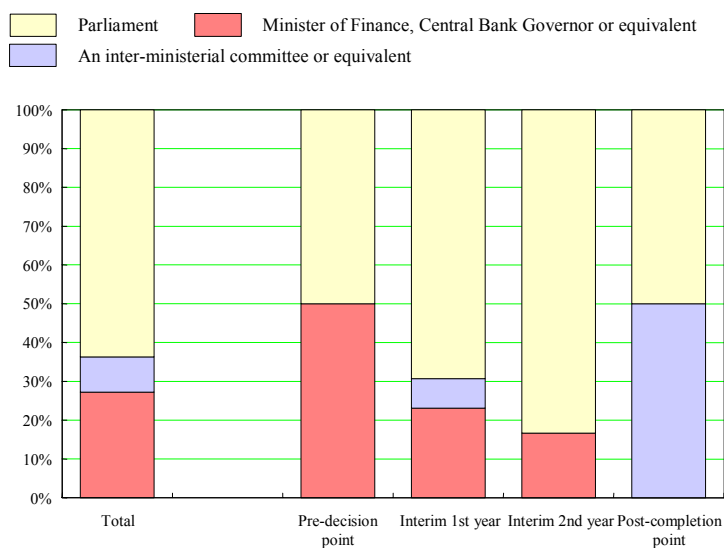
A. Are there guidelines/limits for non-concessional borrowing?



B. Are technical evaluations carried out for new borrowing proposals?



C. What is the highest authority approving all new borrowing?



D. What is the highest authority approving State guarantees on external debt?

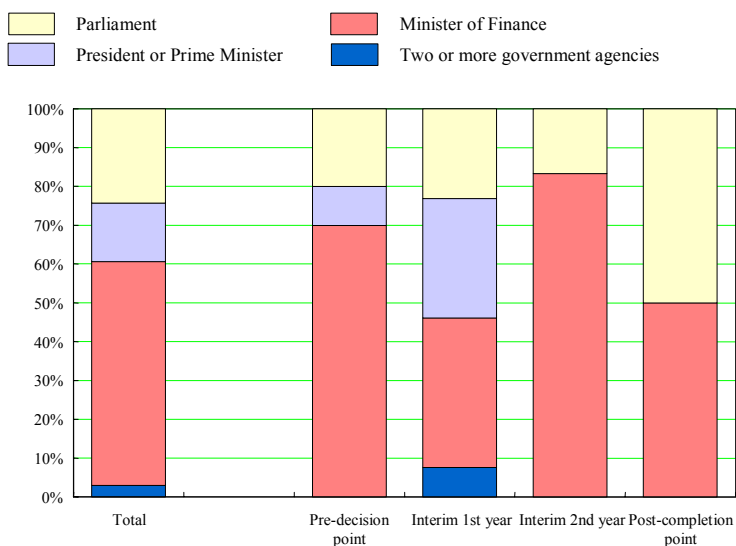
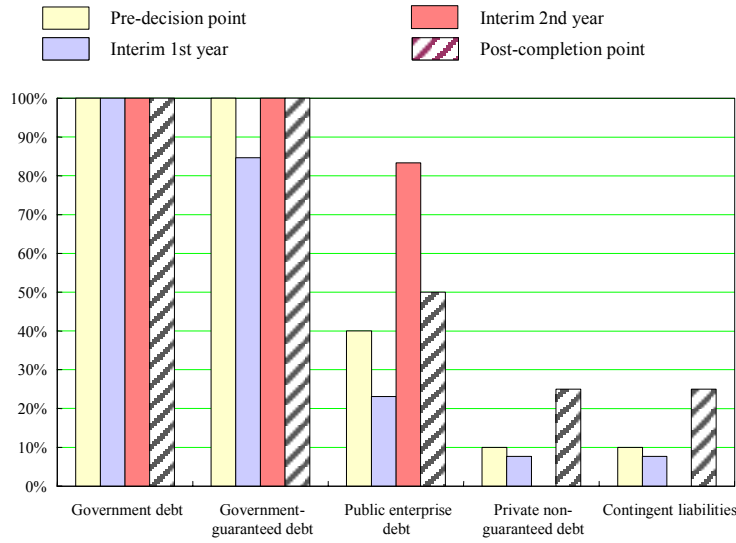


Figure 6. Human and technical resources (Source: HIPC Debt Management Survey for 2001)

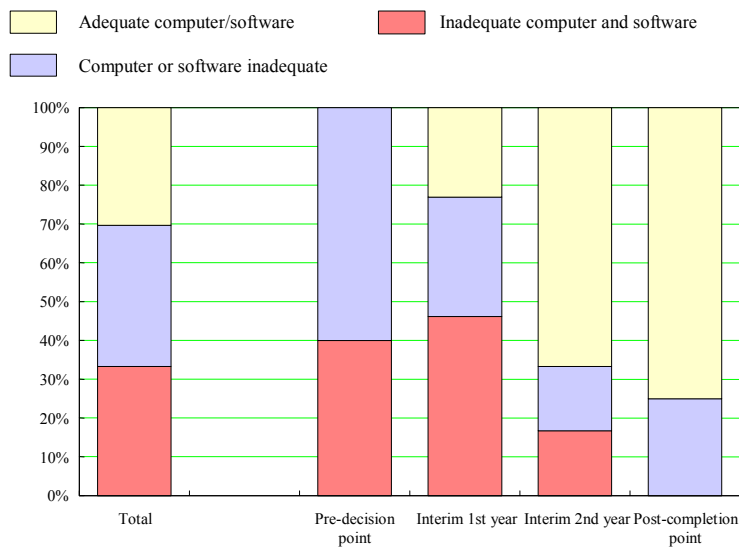
A. Which categories of debt are monitored by the debt unit?

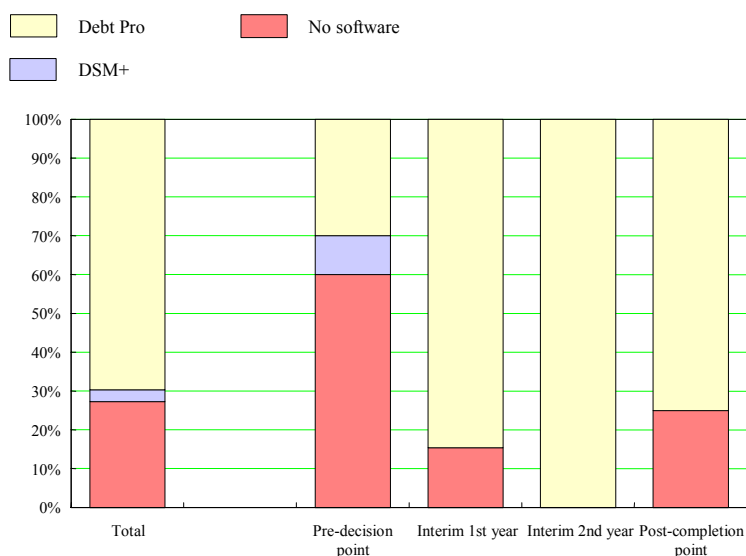


B. Staffing situation in the debt unit



C. Software and computers used by the debt unit



D. Type of software for DSA**REFERENCES:**

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THE EMERGENCE AND CHALLENGES OF NIGERIA'S DEBT MANAGEMENT OFFICE

Akin Arikawe

I. BACKGROUND

Rapid growth Of Nigeria's debt burden

Debt management had become a real issue of concern in Nigeria as far back as the mid-1980s when the country's external financial balance slid into structural disequilibrium. The external debt stock, which was about \$9 billion by 1980, grew to \$19 billion by 1985 while debt service to export ratio was as high as 33 per cent. At the end of 1999, the external debt stock had risen to well over \$28 billion, over 70 per cent of gross domestic product (GDP). As at 31 December 2000, Nigeria's external debt stock amounted to \$28.496 billion, which was over 180 per cent of export earnings.

As the debt stock ballooned, it impacted negatively on economic growth, which further diminished the country's ability to manage the stock in an orderly and efficient manner – all to the frustration of the Government and the consternation of the creditors and the multilateral financial institutions.

In spite of the magnitude of the hardship caused by the debt burden, it was not until the last quarter of 2000 that a full-fledged office, dedicated solely to managing the country's debt, was considered an imperative. The delay in realizing the need for improved management of Nigeria's external debt could be traced to a couple of reasons. One was the initial thought that the problem was transient. The initial response was therefore to deal with it within the existing structures and processes of government bureaucracy. A second explanation was that the many years of continuous military rule up to 1999 tended to obscure the gravity of the debt crisis and the economic malfeasance of its chaotic management. The period was fraught with numerous other grave problems, political and economic, which made it easy to underplay the magnitude of the debt crisis.

Defective institutional arrangement and costly mistakes

Before October 2000, debt management in Nigeria was split amongst several government departments and agencies. In our Ministry of Finance alone, about five departments were involved in external debt management, while at the Central Bank some four other departments were also involved. The diffused responsibility implicit in the arrangement created a number of interrelated shortcomings, including:

- Operational inefficiencies and poor coordination;
- Inadequate debt data recording and poor information flow across agencies, with consequently inaccurate and incomplete loan records;
- Extreme difficulty in the verification of creditors' claims due to conflicting figures from the various bodies handling debt management;
- Complicated and inefficient debt service arrangements, which created a protracted payment procedure, leading to accumulation of penalties that added to the debt stock;
- Inadequate manpower and poor incentive systems; and
- Lack of a coherent, well-defined debt strategy.

The absence of an appropriate debt strategy and a well-articulated borrowing policy had costly implications for the country. There were maturity mismatches with some short- to medium-term loans directed at long-term development projects. Many high-interest-bearing loans were contracted for social-sector projects such as the building of schools and hospitals. In other cases, loans for directly productive projects were contracted on commercial terms but allowed to go to waste because of a lack of monitoring, technical incompetence or other forms of mismanagement. There were no guidelines on project follow-up or the monitoring of loan utilization by the Federal or State Governments.

Although the country did carry out some measure of debt rescheduling and restructuring even as far back as 1986, they were only as ameliorative and efficacious as the obvious institutional constraints would allow. In particular, appropriate attention was not given to issues of debt sustainability in the various restructuring exercises which preceded the recent institutional reforms.

Decision to effect a change

The decisive shift in policy towards the attitudinal and institutional aspects of debt management came with the advent of a democratically elected Government in May 1999. The new Nigerian President made normalization of relations with external creditors and the resolution of the debt crisis a priority item on the agenda of his Government. Other reasons that caused priority attention to be given to effective debt management included the following:

- A realization that good debt management practices affect growth and development positively and vice versa;
- Consciousness of the fact that the effectiveness or otherwise of the national debt management strategy has serious implications for the Government's ability to alleviate poverty since a high outflow of resources for debt servicing erodes the capacity of the Government to alleviate poverty, whereas a well-engaged debt negotiation scheme would secure debt reduction and the resultant savings could be directed to poverty alleviation;
- The efficiency and efficacy of debt management impact directly on the efficiency and efficacy of overall macroeconomic management, including fiscal and monetary policies;
- The debt crisis distorts economic planning and management, and constitutes an irritating distraction from orderly management of growth and development;
- When a country's debt status is regularized, access to current borrowing to augment local savings and support economic growth is facilitated;
- A country's debt position is an important determinant of its external image and national pride, and the democratically elected Government was committed to restoring

the status of Nigeria's relationships within the international community;

- In the new democratic dispensation, professionals from both the public service and the organized private sector were enthusiastic for reforms as society anxiously looked forward to an imminent turnaround of the economy; and
- In particular, the country desired early and substantial debt relief from its creditors to be ploughed into the revitalization of infrastructures and poverty reduction.

By March 2000, within the first 10 months of its inauguration, the Government commissioned a review of Nigeria's debt management practices with a view to developing an effective approach for managing the national debt. In line with the findings and recommendations of the review, the Government established the Debt Management Office in the last quarter of 2000 to take over the responsibilities for debt management functions in the country.

II. ESTABLISHMENT OF THE DEBT MANAGEMENT OFFICE

Commencement, objectives and functions

The Debt Management Office (DMO) commenced operations on 2 October 2000. Its creation has centralized debt management functions in a single, semi-autonomous, professionally staffed agency. Apart from the general objective of achieving efficient debt management, a particularly pressing objective in establishing the DMO was the production of credible and comprehensive debt data and information for impending negotiations with the Paris Club of creditors.

The DMO's specific functions include:

- Maintenance of a comprehensive inventory of loans and credits, together with a forecast of the debt service requirement;
- Provision of timely and accurate information on the country's debt stock to assist policy makers and improve transparency in debt management;
- Effecting debt service payments in an accurate and timely fashion as and when due;

- Managing the country's debt portfolio so as to minimize cost and maximize returns with an acceptable risk profile;
- Advising the Government on borrowing policy;
- Assisting in formulating and implementing the country's debt management strategy and ensuring appropriate linkages to fiscal and monetary policies as well as overall macroeconomic management; and
- Negotiating with, and securing debt relief from Nigeria's creditors.

Consolidation of structures and functions

When it established the DMO, the Federal Government decided it would focus initially on external debt management. Once this is consolidated and centralized and the systems are fully functioning, it will then take over the management of domestic debts from the Central Bank. The transfer of external debt management functions from the Federal Ministry of Finance and the Central Bank of Nigeria to the DMO has now been completed.

The DMO has also started discussions with the Central Bank on the modalities for the take-over of domestic debt management functions. To facilitate the process, technical assistance support is being provided by the United States Treasury Department. A technical adviser is already drawing up details of the transfer as well as providing technical guidance to the process. Initial efforts are focusing on the following areas:

- (i) Rationalizing the relationships between the Ministry of Finance, the Debt Management Office and the Central Bank of Nigeria through appropriate legal and institutional arrangements;
- (ii) Improving fundamental domestic debt management arrangements and practices, and building the institutional capacity of the DMO, including organization of domestic debt data; and
- (iii) Establishing and consolidating "best practices" in the legal and regulatory framework for the government securities' primary and secondary markets.

Organizational structure and staffing

To facilitate the smooth take-off of the DMO, ensure continuity and minimize disruptions, selected staff were transferred to the DMO from the Ministry of Finance and the Central Bank. This was complemented by direct recruitment of experts and specialist staff to fill the skill gaps. The Government approved conditions of service, at a level above those obtaining in the civil service, for DMO staff in order to provide needed incentives. Efforts have now focused on continuous training of staff and capacity building to ensure skill acquisition and enhancement, as well as guarantee efficiency of the debt management processes.

A detailed organizational structure has been drawn up for the DMO. A Director-General, who is assisted by Departmental Directors, heads the DMO. The Departmental Directors supervise the work of Group and Team Leaders. The Director-General reports to the Minister of Finance on matters relating to debt acquisition and servicing; to the Chief Economic Adviser to the President on debt rescheduling and negotiations with the Paris Club; and to the Vice President on administrative matters.

When its enabling Act has been enacted into law by the National Assembly, the DMO is expected to have a Supervisory Board to be chaired by the Vice President. Other members of the Board will include the Minister of Finance, who will be the Vice-Chairman, the Chief Economic Adviser to the President, the Governor of the Central Bank, the Accountant-General of the Federation, the Attorney General of the Federation and the Director-General of the DMO. A detailed schedule of duties and responsibilities has been prepared for all levels of staff in the DMO.

Legal and constitutional backing

A bill has been drafted to provide legal and constitutional backing for the establishment and operations of the DMO. In preparing the bill, the DMO consulted various governmental and private sector agencies and organizations. The bill was further enriched by the insights derived from the May 2001 conference on "Sustainable Debt Strategy", which the DMO organized. It has been reviewed by the Attorney General's Office and has been submitted to the Council of

Ministers for approval, preparatory to its enactment into law by the National Assembly.

III. OPERATIONAL ACTIVITIES AND ACHIEVEMENTS

Reliable database

Within the one year of its establishment, the DMO could be said to have justified the confidence reposed in it by both the authorities that set it up and members of the public by producing a reliable external debt database for the country. The auditing of the country's loan portfolio, and updating and computerization of the debt database, have been completed, while the next stage of fine-tuning and reconciliation with creditors is nearing completion. This has put the country in a confident position to approach its creditors for negotiations.

Paris Club debt rescheduling Agreed Minute

In line with its mandate, the DMO has been actively involved in negotiations for the rescheduling of Nigeria's Paris Club debts. Nigeria held a first round of talks with the Paris Club on the rescheduling of its debts in October 2000. The second round of formal negotiations, held in December 2000, resulted in an agreement for rescheduling Nigeria's debts, on Houston Terms, the details of which are contained in an Agreed Minute.

The Agreed Minute provides for the rescheduling of Nigeria's Paris Club debts totaling \$21.4 billion over an 18–20 year period. Official development assistance (ODA) credits are to be rescheduled over 20 years at interest rates that are no less concessional than the original concessional interest rates with a 10-year grace period. Commercial credits are to be rescheduled over 18 years at market-based interest rates, including a three-year moratorium. As part of the rescheduling frameworks, it was also agreed that debt service payment to members of the Paris Club in 2001 would be kept at \$1 billion.

Bilateral negotiations and debt data reconciliation

The Paris Club Agreed Minute sets out the general framework for debt restructuring with the respective creditor countries, while the spe-

cifics are to be worked out in a bilateral agreement with each of the creditor countries. Nigeria has so far begun bilateral negotiations with all of the 15 member countries of the Paris Club to which it is indebted. The bilateral negotiations have focused on the final reconciliation of eligible debt as well as the specific terms for rescheduling the eligible debts, including the applicable interest rates. Some of the agreements will be signed soon.

Although the debt data reconciliation exercises have been very demanding on our time and limited resources, we consider them to be very crucial in the process of establishing a smooth and effective debt management system. We are therefore committed to working with the various creditors to resolve the few outstanding differences between the DMO's figures and those of the creditors, which stem from the following causes:

- (i) Inclusion by creditors of previously rejected, short-term private sector claims submitted during the refinancing of Nigeria's trade debts in 1983/1984;
- (ii) Inclusion by creditors of new claims, including short-term trade arrears, and medium- and long-term as well as post cut-off date loans, which were not submitted for rescheduling in the past;
- (iii) Adoption of different methods of interest rate calculation and varied exchange rates by some creditors; and
- (iv) Practice by some creditors of applying debt service payments to late/penalty interests, instead of initially offsetting the principal repayment and scheduled interest.

Bilateral agreements on debt rescheduling

The DMO has reviewed the draft bilateral agreements prepared by all the 15 countries of the Paris Club to which Nigeria is indebted and the negotiations held with their representatives. The critical issues which the DMO has proposed for inclusion in the bilateral agreements include:

- Reduction in loan currencies making up the debt portfolio, with a view to minimizing complications in the management of the debts (currently there are 15 currencies in the debt stock);
- Adoption of a fixed interest rate regime for the entire rescheduling period to re-

duce the adverse effects of interest rate fluctuations on Nigeria's external debt stock;

- Removal of interest on ODA loans;
- Grace period of one to two months after the due dates of debt service payment under the agreement before the application of penalties;
- Application of payments to offset principal and scheduled interest before late interest/penalties; and
- Provision for debt conversion programmes so that debt reduction can propel foreign direct investment inflow.

IV. OUTREACH EFFORTS

International Conference On Sustainable Debt Strategy

As part of its outreach efforts and stakeholder consultation process, the DMO successfully hosted an International Conference on Sustainable Debt Strategy in May 2001. There were over 300 participants, as against the initial projection of 150.

The conference was very productive and largely accomplished the objectives for which it was convened. The debates generated about economic reforms and the useful ideas advanced for developing a sustainable debt strategy have provided additional impetus for driving the DMO's work forward. The public at large is also now better informed about the nature of Nigeria's debt problems and the Government's efforts to address them. Plans are under way to publish the conference proceedings in book form, and we hope they will come out by the first quarter of 2002.

Membership of the World Association of Debt Management Offices

In May 2001, the DMO was granted full membership of the Geneva-based World Association of Debt Management Offices (WADMO) as its 36th member. Membership provides an opportunity for the DMO to acquire the following key benefits:

- Learning about best practices in debt management from the experiences of other

countries, thereby becoming better informed when advising the Government on the formulation of debt management policies and strategies;

- Gaining access to technical assistance, training and funding from relevant bilateral and multilateral agencies for the development and implementation of effective debt management programmes;
- Publicizing the efforts of the Nigerian Government to enshrine transparency in debt management; and
- Having a platform for the exchange of ideas on our day-to-day work.

V. CHALLENGES AND CONSTRAINTS

Challenges

The economic and political environments in Nigeria have generated a Revolution of expectations. At all levels of the polity, there has been a revolution of expectations regarding a quick turnaround of the economy and the restoration of a decent standard of living. The DMO is part of the major focus of these public expectations. It is hoped that substantial debt relief will be secured so that the resources released can be channelled to economic growth and alleviation of poverty.

As is well known, effective negotiations for debt relief are normally contingent on credible implementation of an IMF-supported economic reform programme. Some in-built conflict is inevitable. While the Government is under pressure to produce urgent improvements in the people's standard of living, the required economic reforms emphasize stabilization and longer-term objectives. Despite this, the current democratic Government in Nigeria is determined to work closely with the IMF to evolve a realistic action plan that would facilitate the adoption of a Medium-Term Economic Programme supported by the Fund's Poverty Reduction and Growth Facility (PRGF) during the first half of 2002. It is believed that the programme would pave the way for Nigeria to access concessional debt relief from its creditors.

Nigeria is a federation with one federal government, 36 state governments, one federal capital territory authority and 774 local governments. The democratic constitution adopted in

1999 confers fiscal autonomy on each tier of government. With such a multiplicity of governments, the problem of public debt management is onerous. The DMO has to contend with sub-sovereign debt philosophies, policies and operations. Effective debt management therefore calls for the design of comprehensive guidelines and systems that capture the fiscal operations at all three tiers of government. Such systems will reflect the apparently simple fact that while there are various tiers of government, there is only one economy, which should be responsive to a single macroeconomic framework.

Income from the export of crude petroleum accounts for over 75 per cent of the revenue of the Nigerian Government. The Constitution provides that the revenue be paid into a Federation Account from which it is shared out to the federal, state and local governments in accordance with a revenue allocation formula. Consequently, the Federal Government, which is responsible for macroeconomic policy, does not have full control over oil export revenue, the monetization of which is one of the most important determinants of money supply in the economy. The situation has two major implications for external debt management:

- (i) Even when there is windfall revenue from oil export, the Federal Government cannot significantly use the surplus to boost debt service payments; and
- (ii) Debt restructuring initiatives are usually underpinned by IMF programmes, which require that certain benchmarks in respect of public expenditure, deficit financing, rate of inflation, exchange rate and so forth be met. In view of the constitutional prescription for the sharing (and implicit monetization) of the oil revenues, it has always been extremely difficult to meet some of the programme's targets as designed.

The issues highlighted above point to the fact that the DMO requires very strong and sophisticated institutional structures and highly specialized skills across diverse professions. It also requires a well-articulated and co-ordinated communication and consultation system, to enable it to cope effectively with the management of the various power groups who must buy into the perspective of a new type of macroeconomic set-up capable of supporting a management strategy aimed at turning the present debt burden

into an asset for the promotion of growth and development within the shortest time possible.

Constraints

The DMO still faces many constraints, which require urgent attention in order to meet the high expectations of its founding fathers. These constraints include:

- Inadequate number and mix of manpower;
- Limited professional training opportunities due to inadequate funding;
- Insufficient data processing and specialized financial market monitoring facilities; and
- Inadequate infrastructural facilities, including telephones, official vehicles and IT-networked environment.

VI. THE WAY FORWARD: RECOURSE TO STRATEGIC PLANNING

A. Rationale for a strategic plan

In order to achieve its objectives, with a meaningful and sustained momentum, while taking into account the urgency of society's expectation, the DMO has embarked on its five-year Strategic Plan (2002–2006), within the framework of which it hopes to tackle its immediate and medium-term assignment. The plan seeks to address the following areas:

- The need to build on the initial achievements of the DMO, overcome the identified constraints and manage the challenges confronting it proficiently, and in an orderly and predictable manner;
- The need for a document containing guideposts to guarantee focus and unity of purpose among the workers as the organization grows and begins to take on more responsibilities; and
- The need to take into account a complex set of situations and relationships in the course of executing the organization's mandate.

B. Interactive and consultative plan process

The Strategic Plan was drafted in a participative process with identified stakeholders who had to be involved in preparing the plan as their

coordinated support and collaborative action are required for effective implementation. The stakeholders include:

- The members of the management team and staff of the DMO – the internal stakeholders – who occupy an important position as active agents in the formulation and implementation of the plan;
- The Presidency and the National Assembly members, who have political and oversight responsibility for the DMO's activities and results;
- The Ministry of Finance, the Central Bank of Nigeria and the Office of the Accountant-General of the Federation, who are a repository of the relevant history of and data on Nigeria's debt, and who will continue to play a major role in debt management activities; a great deal of collaboration with them is required for ensuring appropriate implementation linkages between the strategy and the overall macroeconomic management of the economy;
- Officials of various local and foreign institutions who are partners in the exchange of

ideas and expertise, and who also provide support for capacity building; and

- Private sector market players, particularly in the financial sector, who account for part of the major clients in domestic debt management.

VII. CONCLUSION

Nigeria has taken the decisive step of establishing a well-focused debt management office. The DMO faces a number challenges which are being approached with commitment and vision in order to facilitate a turnaround of Nigeria's debt overhang. In that connection, the support of bodies such as WADMO and donor agencies is greatly needed. We have been receiving very useful assistance from the United Kingdom's Department For International Development (DFID) and the United States Agency for International Aid (USAID). We need more of such support from other agencies and organizations.

**Debt Management Office
Nigeria**

**External debt service projections 2002 to 2011
(in US\$ millions)**

| S/No | Category of debt | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|------|--|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|---------------|
| 1 | Paris Club | | | | | | | | | | |
| | (a) Agreement III | 255.80 | 243.90 | 232.30 | 220.60 | 209.00 | 4.10 | 3.90 | 3.80 | 3.60 | 3.50 |
| | (b) Agreement IV | | | | | | | | | | |
| | i. Reprofiled debt (\$2.76b) | 411.59 | 380.29 | 365.11 | 349.93 | 334.75 | 319.57 | 304.39 | 253.33 | - | - |
| | ii. Balance of arrears (17,150.43 less 905.3 for post-cut-off portion) | 1 042.39 | 893.48 | 893.48 | 856.96 | 873.74 | 854.57 | 828.98 | 796.45 | 756.74 | 709.52 |
| | iii. Consolidated debts (maturities) (1.8.2000 - 31.7.2001) | 19.06 | 14.98 | 14.98 | 14.87 | 14.66 | 14.33 | 13.90 | 13.35 | 12.68 | 11.89 |
| | iv. Consolidated interest (1.8.00 - 31.7.01) on arrears of 19,322.55 | 277.83 | 256.39 | 244.70 | 233.01 | 221.32 | - | - | - | - | - |
| | v. Rescheduled post-cut-off (905.30 - 144.85) | 183.79 | 211.43 | 219.32 | 226.24 | - | - | - | - | - | - |
| | (c) Non-previously rescheduled | 10.38 | 9.30 | 8.40 | 7.80 | 7.50 | 7.30 | 7.10 | 6.90 | 6.70 | 6.40 |
| | (d) Non-rescheduled post-cut-off | 67.53 | 64.30 | 27.90 | 26.30 | 25.80 | 23.30 | 22.80 | 21.10 | 20.30 | 19.40 |
| | Sub-total [1a - 1d] | 2 268.37 | 2 074.07 | 2 006.19 | 1 935.71 | 1 686.77 | 1 223.17 | 1 181.07 | 1 094.93 | 800.02 | 750.71 |
| 2 | Multilateral | 478.92 | 467.80 | 448.20 | 426.60 | 386.20 | 328.30 | 303.50 | 192.00 | 146.10 | 103.70 |
| 3 | London Club - par bonds | 127.70 | 127.70 | 127.70 | 127.70 | 127.70 | 127.70 | 127.70 | 127.70 | 127.70 | 127.70 |
| 4 | Promissory notes | 195.03 | 195.03 | 195.03 | 195.03 | 195.03 | 195.03 | 195.03 | 195.03 | 48.76 | - |
| 5 | Non-Paris Club creditors | 32.90 | 15.10 | 14.90 | 11.00 | 10.40 | 9.90 | 9.30 | 8.80 | 8.20 | 3.90 |
| | Total [1+2+3+4+5] | 3 102.92 | 2 879.70 | 2 792.02 | 2 696.04 | 2 406.10 | 1 884.10 | 1 816.60 | 1 618.46 | 1 130.78 | 986.01 |

Note:

a. Assumptions

- (1) fixed interest rate of 5.5% p.a. for Paris Club Agreement IV debts
- (2) no debt conversion
- (3) interest due from 1.8.01 to 31.3.02 to be paid on 31.3.02 & half yearly for subsequent periods

b. The following payment obligations in 2001 are to be met in 2002

| Category of debt | Amount (\$m) |
|--|-----------------|
| Paris Club Agreement III | 142.04 |
| Non-previously rescheduled pre cut-off | 28.49 |
| Non-rescheduled post-cut-off | 61.30 |
| Non-Paris Club creditors | 52.77 |
| Par bonds adjustment warrant | 6.00 |
| Total | 290.60 |

THE ESTABLISHMENT OF AN INDEPENDENT EXTERNAL DEBT OFFICE IN SUDAN

Omar Ibrahim El Tahir

The debt problem in countries with developing economies is a result of both external and internal factors. The sharp increase in oil prices during the late 1970s led to a severe deterioration in the trade accounts of most developing countries and thus increased their dependence on external savings, which were mainly in the form of loans. Moreover, the deflationary policies adopted by the developed countries to combat the inflationary pressures during the 1980s resulted in high interest rates and lower commodity prices. This exacerbated the debt burden in the developing countries.

Internationally inappropriate macroeconomic policies, domestic adverse shocks and bad external debt management have also contributed to the escalation of the external debt burden.

Sudan's experience

Before 1979, there was no clear vision regarding Sudan's external debt position. The basic debt management functions (recording, disbursement and payments) were scattered among various government units, namely the Bank of Sudan, which is the central bank, the Ministry of Finance and the Ministry of Economic Planning. In fact, no coordinated system was used among these agencies to monitor the debt position.

In 1979, the country decided to embark on its first debt rescheduling experience, based on Paris Club terms and conditions. A ministerial decree was therefore issued in that year for the establishment of the rescheduling department in the Central Bank of Sudan on behalf of the Government of Sudan. The department was given the responsibility for collecting and maintaining documents, and for recording all Sudan's external obligations to Paris Club countries and to international commercial banks, before and after the rescheduling process. It was also required to assist in the preparation of annual reports on Sudan's external obligations position, as at the end of each year.

Soon the department was faced with the problem of unifying the diverse system, hitherto

used by different government units, to manage the external debt. Foreign financial accountants provided help in the areas of recording, verifying and reporting the debt. Thus, at that time, the Government used the services of Peat Marwick (United Kingdom), for the reconciliation of the Paris Club's figures and Morgan Grenfell as a financial adviser on all matters relating to international commercial banks refinancing and so forth.

Moreover, the department helps in many other external debt issues, for example debt restructuring and sustainability analysis, debt buy back, debt swaps, debt conversion and international commercial banks refinancing.

In 1984, owing to the importance of the debt problem, internally and externally, the Government had the intention of establishing a debt unit. This idea was aborted because of disagreement between the Ministry of Finance, the Ministry of Planning and the Bank of Sudan about the whereabouts of where the unit would be located, each of those bodies wanting to establish the unit within the framework of their own institutional responsibilities.

A second shock to the debt problem came in the early 1990s when the Bank of Sudan suddenly dismantled its rescheduling department and transferred the duties and functions of this department to the Ministry of Finance. However, the Ministry, unprepared to handle these new duties and functions properly, simply ignored what it saw a burden. Consequently, no tangible work was carried out regarding the improvement of debt recording and the issuance of annual and other related reports.

Finally in 1993, the debt functions were transferred back to the Bank of Sudan. At that time, the African Development Bank (ADB) provided technical assistance to Sudan under its Institutional Strengthening Programme, which included the issuance of external debt. Thus, the ADB supported the programme by supplying an expert specialized in the field of external debt and related issues.

The expert's tasks were as follows:

- To prepare a detailed information needs inventory to enable full debt management and financial analysis to be carried out;
- To examine the utility and appropriateness of the debt monitoring system in the Bank of Sudan;
- If not found suitable for the Bank of Sudan to install the system in the Ministry of Finance and enhance it to include full debt management and financial analysis functionalities;
- If not found suitable, or migratable to a new computer environment as currently perceived, to adopt new packages such as UNCTAD's system, and to install and operate it;
- To plan and supervise data collection, compilation and entry into the computer;
- To prepare, in conjunction with the computer expert, specifications for the computer and workstations to be purchased with funds for this project; and
- To prepare and submit periodic reports to senior officials and those in charge of planning at the Ministry of Finance and ensure the appropriateness of details to each level, to be improved as required.

The expert and the ADB team initiated, through the Institutional Strengthening Programme, the establishment of an external debt management department to carry out verification, reconciliation and reporting. The expert recommended that an external debt unit be established within the Bank of Sudan, which he believed a suitable location due to the Bank's staff he considered well qualified. The staff, working closely with the expert, prepared and updated the information concerning the debt figures, and also worked on restoring relations with international creditors and organizations.

The setting-up of the debt management department was supported by a 1995 ministerial decree. This provided for a debt-recording department in the Bank of Sudan to be responsible for receiving, collecting and maintaining all foreign loan data. Unfortunately, the unit did not come into existence due to the Ministry of Finance and the Ministry of Economic Planning strongly resisting its establishment. Meanwhile with the generous help of the United Nations

Conference on Trade and Development (UNCTAD) the institutional strengthening programme was activated by supplying the unit with the Debt Management and Financial Analysis System (DMFAS), which is a computerized system designed for use by Ministries and/or Central Banks for the management of both public and private debt.

The reason for using the DMFAS system is so as to create a sound, accurate database for Sudan's external debt management. The programme is now well installed thanks to the financial support of the African Development Bank. The latter (through UNCTAD) has also provided generous technical assistance in three categories: a) installation; b) training of the debt unit staff in recording and reporting, and c) training in Egypt, a country experienced in utilizing this system.

The issue of establishing an external debt unit arose because of the ongoing economic policies and policy measures being taken to improve macroeconomic management in Sudan. The debt unit intends to be the official reference for the Government in areas concerning external debt information, and to be specialized in designing and executing external debt policies and strategies.

By mid-2000, an autonomous External Debt Management Unit had been established in the Bank of Sudan, fully mandated by a ministerial decree. The Decree was issued as part of the measures to improve national macroeconomic management after the success of the economic liberalization policies, and as such it improves the financial credibility of the country. It is now the official information reference for the country regarding external debt and related issues.

The unit is required to:

- (a) Collect and keep all documents and agreements relating to Sudan's long-term, medium-term and short-term external debt;
- (b) Maintain, record, tabulate and analyse Sudan's external debt in terms of both sovereign and private debt;
- (c) Follow up debt servicing procedures with the concerned parties according to the agreed conditions;
- (d) Issue reports on a regular basis and make sufficient statistical information available to the relevant institutions;

- (e) Receive queries from creditors and devise authentication procedures to ensure accuracy of the external debt volume of Sudan, in coordination with other government institutions and private sector institutions;
- (f) Conduct studies that help and promote the design of policies and procedures for external debt management;
- (g) Participate in negotiations for rescheduling arrangements and to cater for all other debt settlement procedures;
- (h) Take part in studies on financing terms involving the amount, period, amortization, returns and required guarantees;
- (i) Take part in negotiations for new loans, taking the best favourable terms into consideration;
- (j) Lay down the strategic basis for settling external obligations in view of the overall economic situation in Sudan and in accordance with the prevailing conditions in the international money markets;
- (k) Follow-up initiatives concerning debt settlements in the framework of rescheduling, debt forgiveness, and swaps, and those in the area of debt trading in secondary markets;
- (l) Follow up current issues regarding recent debt initiatives, for example the HIPC Initiative;
- (m) Work towards initiating tools and means for lowering debt burden on the balance of payments;
- (n) Serve as the information point of reference on external debt;
- (o) Participate in evaluating external loans;
- (p) Pursue external debt policies and strategies; and
- (q) Issue regular data on external debt sustainability analysis for both the Ministry of Finance and the Bank of Sudan.

The unit is empowered with access to all external obligations (government as well as private), whether these were concluded before or after the establishment of the unit.

The unit is required to coordinate with all the local institutions that have entered into external obligations on matters concerning timely repayments.

Officially, the unit is the sole recognized agency responsible for Sudan's external debt portfolio, and formulates long-term borrowing policy for Sudan, and prepares database figures and analysis for policy makers, researchers, students and concerned beneficiaries.

Level of achievement

The unit has contacted all creditors regarding authentication of the external debt and made the necessary reconciliation. Most of the debt profiles in the different ministries and debt-recording units in the government agencies have been collected. It has updated records concerning schedules of disbursements, payments, arrears, and contractual and accumulated interest. It has provided a more accurate statement of Sudan's external debt position as of 31 December 2000, and produced the external debt strategy that led to the establishment of Sudan's external borrowing policy. Also, it took the opportunity to prepare reports in accordance with Paris Club reports, regarding Sudan's pre- and cut-off date reports.

These achievements were realized in accordance with the programme designed by the Minister of Finance and the Governor of the Bank of Sudan. The unit approached all creditors in order to normalize and restore previously established relationships with Sudan.

We have by now resumed relationships and expanded the relationships with most creditors, based on multilateral and bilateral relationships with regard to regional and international financial institutions as such. In addition, we have designed a strategy to restore the relationship with neighbouring countries. Concerning Paris Club terms and preconditions, Sudan is committed to implementing a medium-term programme with the IMF as an economic reform programme in accordance with the detailed road map designed by the IMF for Sudan. Hopefully, Sudan will enter the Rights Accumulation Programme in early 2002 as a prerequisite for joining the Paris Club and hence the current Highly Indebted Poor Countries Initiative.

Regarding the international commercial banks, the unit is in the process of hiring an international financial adviser who would be familiar with international banks' dealings and Paris Club countries in order to help us monitor

and solve the problem relating to our obligations to them.

Future vision

It is worth noting that the External Debt Unit was established under a consensual agreement between the Minister of Finance and the Governor of the Bank of Sudan. A very experienced and qualified staff has been chosen from the Ministry of Finance and National Planning, the Ministry of International Cooperation and the Central Bank of Sudan, to accept the challenge of creating the debt unit. The unit is in the process of carrying out the following:

- Issuing a guide for external borrowing for Sudan, including interest rates in the international stock markets;
- Publishing an external borrowing policy to cover all private and public borrowing;
- Formulating a clear external debt strategy for Sudan for solving the problem of external debt;
- Issuing external-debt-related studies, dealing with debt burden and impact, poverty alleviation etc.;
- Constructing a solid forecasting method and conducting studies on external financial needs;
- Issuing quarterly reports regarding the development of the external debt of Sudan, together with the relevant indicators;

- Participating in studying external loans to further ascertain their implementation within the context of the national borrowing policy; and
- Issuing debt sustainability analysis for policy-making and decisions.

Urgent requirements

As can be seen, the duties, functions and the scope of the responsibilities of the new unit are quite intense and complex. This fact, I believe, requires short and long-term capacity building, at least to keep up with international developments in these issues.

Moreover, the staff of the debt unit, which is small in number and well qualified, with advanced university degrees and fluent in English, is in need of more relevant technical assistance in the areas relating to external debt issues.

To achieve the objectives of the newly established unit as summarized above, as well as to enhance its managerial capacity, any logistical, financing or training support in external debt management, including opportunities for participating in courses, seminars and symposiums would be greatly appreciated

I request the kind assistance of this conference and of regional organizations, whether United Nations' or otherwise, in supplying us with such assistance.

PART 2

MANAGEMENT OF SUB-NATIONAL DEBT

CONTROL AND MONITORING OF DECENTRALIZED DEBT IN COLOMBIA

Gustavo Adolfo Navia Márquez

Although in many developing economies regional and public entities are autonomous in determining their own debt policies, central governments are concerned that closer coordination and better monitoring and supervision take place.

Public debt management in Colombia is aware of this concern. In order to achieve orderly and prudent management of its public finances, an effort has been made to equip the national Government with appropriate tools and mechanisms for the control and monitoring of decentralized debt, which, while not directly affecting the indebtedness of the Central Government, has a considerable impact on the national economy and on the independence of its fiscal policy.

Briefly set out below are some of the points that the General Directorate of Public Credit of the Ministry of Finance and Public Credit, Republic of Colombia, have considered of crucial importance for achieving efficient and orderly administration of decentralized public debt, so as to ensure the sustainability of public debt and promote confidence in fiscal policy.

I. LEGISLATION

Among the developing countries, Colombia has been recognised for the orderly and coherent management of its internal and external debt, which has enabled it, for example, to avoid a moratorium on, or large-scale rescheduling of, its debt during the debt crisis of the 1980s.

An appropriate legislative framework has played a primary role in the responsible management of its public debt. The existing legislation aims at:

- Adequately regulating the procedures for approval and authorization of public credit operations, by the decentralized authorities (Decree 1222 of 1986);
- Restrictions on undertaking public credit operations when the debt service exceeds

30% of ordinary revenues (Decree 1333 of 1986);

- Regulating the approval, undertaking and execution of public credit operations in the central and decentralized sector, by the Central Government (Decree 2681 of 1993);
- Measurement of the indebtedness capacity of the contracting bodies (Law 358 of 1987 and Decree 696 of 1998); and
- Measurement, valuation and management of contingent liabilities (Law 448 of 1998).

II. CONTROL PROCEDURES

An essential feature of the control procedures developed for decentralized agencies is the determination and monitoring of the ability to pay.

Two indicators are used to calculate this ability. The first indicator is calculated on the basis of the ratio between debt interests and operational savings, which enables measurement of the ability to service the debt punctually together with the impact of interest rate movements, while at the same time acts as a disincentive to the bunching of maturities.

$$\text{Ability to pay} = \frac{\text{Debt interests}}{\text{Operational savings}}$$

The second indicator is calculated from the ratio between outstanding debt and current income, which enables the evaluation of debt sustainability while at the same time avoiding bunching of maturities under subsequent administrations.

$$\text{Ability to pay} = \frac{\text{Outstanding debt}}{\text{Current income}}$$

Depending on certain stipulated limits, determined by law for these indicators, the decentralized entities may or may not be autonomous in regard to their indebtedness.

The debt autonomy referred to, together with the source of the funds, determines the procedures to be followed for effecting the public loan operation. After obtaining the relevant approvals and authorizations, and before disbursement of the funds, it is compulsory in all cases to register with the Unified Debt Statistics System (SEUD) of the General Directorate of Public Credit, Ministry of Finance and Public Credit, which marks the beginning of the control phase of such operations.

III. REPORTING REQUIREMENTS

After completion of the registration of the public loan operation with SEUD, which constitutes the basis for follow-up and control of the indebtedness of the decentralized bodies, those bodies must duly report the new developments pertaining to each operation.

In these monthly reports each decentralized body must inform the General Directorate of Public Credit, by electronic mail, in the formats designed for that purpose, of disbursement of funds and payments of capital, interest and commissions.

IV. MANAGEMENT OF FINANCIAL RISK OF SUBNATIONAL PUBLIC DEBT

One of the most emphasised points made in the past years has been the measurement and management of public debt risk. Applying the debt management principles contained in the *Draft Guidelines for Public Debt Management* of the International Monetary Fund and the World Bank, and by developing internally a risk management methodology, the General Directorate of Public Credit has achieved world-wide recognition.

Defined as the volatility of debt and other expenses in relation to income, "risk" for the Republic of Colombia is managed in the aim of securing the financing requirements, reducing the costs of indebtedness, and reducing or covering the risk inherent in public loan and debt management operations.

Regarding debt management operations, these must not increase the net indebtedness of the State entity, and should result in an im-

provement in the debt profile, in consideration always of the ability to pay. Such operations include, among others, substitution, rescheduling, debt swaps, hedging and securitizations.

The General Directorate of Public Credit has since 1999 used as a risk measuring tool the Value at Risk methodology, adapted for the risks inherent in public debt servicing (Debt Service at Risk), such as exposure to exchange rate or interest rate fluctuations; with this methodology we obtain the maximum expected increase in the debt service or outstanding debt within a time horizon, for a given confidence level.

As a control mechanism Colombia adopted a methodology of defining reference portfolios or benchmarks for the external debt profile, by means of which the acceptable and maximum levels of exposure to risk are determined. This has resulted in a reduction in refinancing and market risk, as well as a moderation of the impact of international financial crises on debt management and inspired greater confidence among international investors.

In view of the growing importance of the domestic capital market as a source of financing for the government, the General Directorate of Public Credit is currently determining the reference portfolios or benchmarks for the domestic debt.

Information on these mechanisms, developed by the Ministry of Finance and Public Credit, is now being disseminated among the various decentralized bodies, with the intention of the adoption by them in the near future. In the meantime, the public loan operations of the decentralized bodies are being evaluated by the General Directorate of Public Credit, by means of these mechanisms.

V. CONTINGENT LIABILITIES

These are defined as liabilities which arise at the time the loan agreement is signed, which are recognized or paid at some later time, and which appear somewhat to the borrower's surprise as an expense or debt increase. Accordingly, the General Directorate of Public Credit has tried to evaluate, budget for and distribute the risks arising in contracts entered into by the State.

Taking into account the growing role played by private enterprises in public infrastructure projects and in the provision of public services, and the increasing demand for national guarantees in such contracts, an attempt has been made to evaluate such guarantees, which by becoming operative effect the indebtedness ceiling of the nation and the flow of funds in the public sector.

According to calculations made by the National Department of Planning, contingent liabilities in infrastructure projects could amount to about 6% of Colombia's gross domestic product. This is attributable to the deficiencies in the framework of the projects, the furnishing of unforeseen guarantees, the conclusion of contracts with excessive risks for the State entity, and the lack of follow-up, control and measurement.

The objective of contingent liability management is to distribute the risks of projects in a technically sound and equitable way, to budget for the costs and cash flows expected from the guarantees provided to State contracts, to render more precise and reliable the measurement of the government's ability to pay, and to create greater confidence among private investors. This enables us to minimize the deficiencies in the risk evaluations of public entities and to enhance capacity for follow-up and control.

After determining the value of the public guarantee, which is equivalent to the expected value discounted for the contingent expenses determined in a contract, a schedule is drawn up of contributions to be earmarked for the establishment of a Contingency Fund. This Fund will await the occurrence of the contingency or will accumulate value until the scheduled contributions are fully paid; this mechanism ensures that funds are available for responding to contingencies.

In addition, the development of the methodology for the management of contingent liabilities includes the formulation of models for the estimation of long-term macroeconomic variables, indispensable for the assessment of contingencies in infrastructure projects.

VI. INFORMATION SYSTEMS

In the pursuit of continuous improvement in the quality of public credit information, indispensable for proper control and monitoring of the national and subnational debt, the Directorate General of Public Credit is currently putting into operation the Debt Management and Financial Analysis System (DMFAS), a computerized system designed to provide timely and reliable information on public and private debt and guarantees.

This system, developed by the United Nations Conference on Trade and Development (UNCTAD) for more than 20 years, is used in 60 countries and provides reliable, simple, flexible and real-time access to debt databases and improves the quality of relevant reporting and analyses.

VII. FINAL CONSIDERATIONS

For the Ministry of Finance and Public Credit of the Republic of Colombia it has been and will continue to be of vital importance to identify more and better mechanisms for the control and monitoring of public debt, especially as the trend moves towards a greater decentralization of fiscal policy, to the advantage of the territorial entities.

In this endeavour, an appropriate legal framework has been devised for the control and follow-up of public loan operations, while at the same time a constantly evolving methodology has been successfully established; it is hoped thus to achieve satisfactory debt management for the central and decentralized sectors.

Thanks to continuous progress in the methodology of debt measurement and monitoring, and continuing concern for ordinary and prudent debt management, the Colombian public sector can be assured of having a sustainable and credible fiscal policy.

ANALYSING THE CITY OF MOSCOW'S BORROWING AND DEBT MANAGEMENT DECISION

Sergey B. Pakhomov

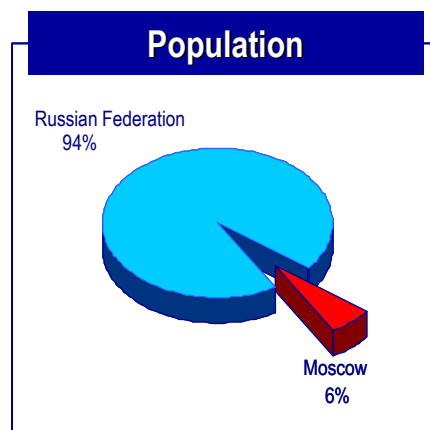
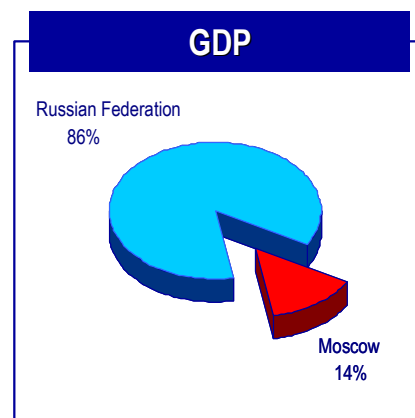
I. CITY OF MOSCOW AND ITS BORROWING ACTIVITY

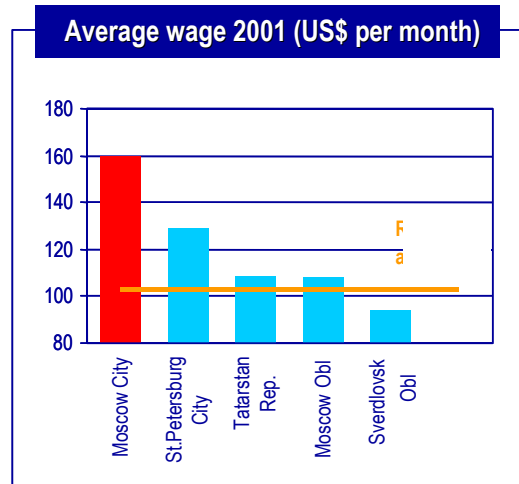
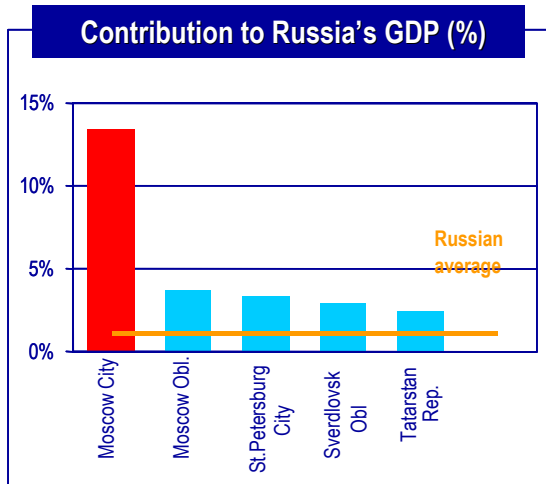
Moscow is the capital and largest city of the Russian Federation, as well as the country's financial, commercial, scientific, educational and cultural centre. Located in the centre of the European part of the Russian Federation, Moscow is a modern metropolis of 8.54 million inhabitants.

One of 89 administrative divisions of the Russian Federation, the city is self-governing with a locally elected legislature. It has a developed infrastructure and has always been praised for its high degree of adaptation to the market economy. The largest Russian and foreign corporations and financial institutions have offices in Moscow and the city is the recipient of a substantial flow of financial funds from all over the country.

Although its population constitutes only 6 per cent of the population of the Russian Federation, up to 14 per cent of Russian gross domestic product (GDP) is generated in Moscow and the city's revenue accounts for one third of the total revenue of the country

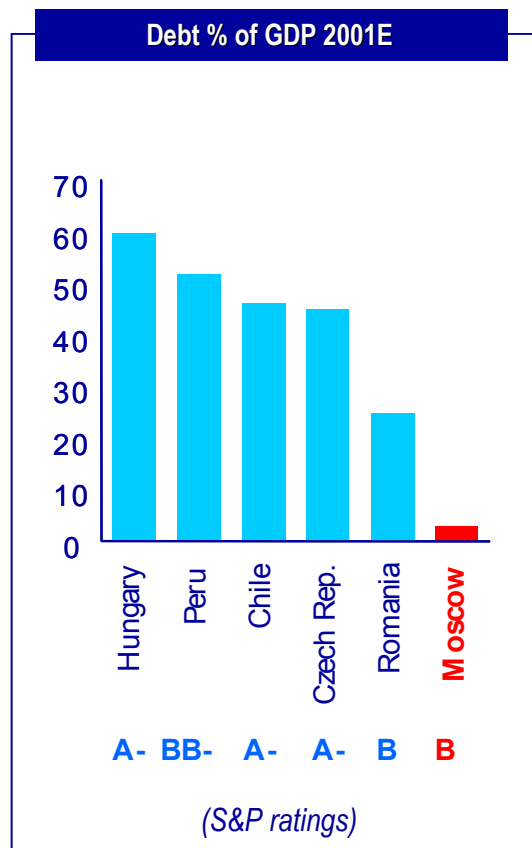
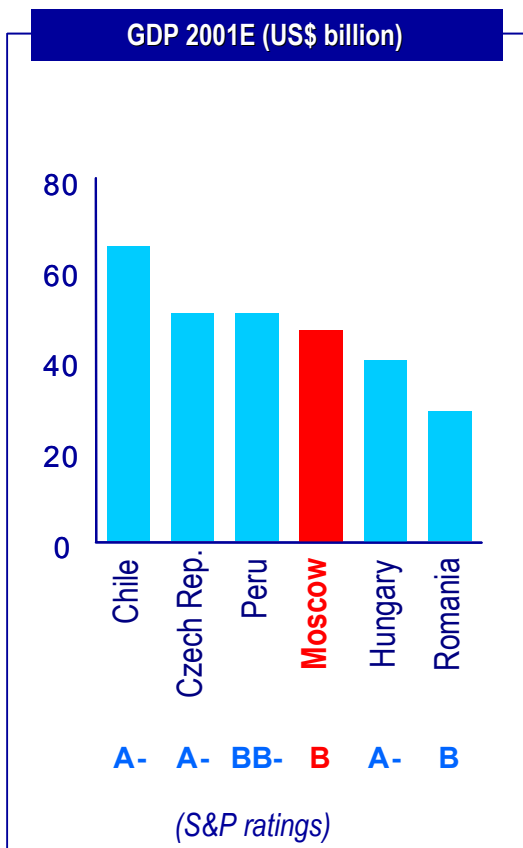
Forty-four per cent of Russian financial institutes and 83 per cent of Russian banks are located in Moscow. Thirty-eight per cent of foreign investments are directed to it. The average revenue of a Moscovite is 55 per cent higher than the Russian average and the level of unemployment in Moscow is 2.4 per cent in comparison with the average level of unemployment for the RF (9.2 per cent). At the same time the city's contribution to the Russian GDP is the biggest in the country.





If we make a comparative analysis of the City of Moscow's economics with other parts of the world, we can see that the volume of the city's gross city product (GCP) exceeds the GDP of such countries as Hungary and Romania, and is only a little smaller than the GDP of Chile, the Czech Republic and Peru. At the same time the debt to GDP ratio is less than for the above-mentioned countries.

However, the ratings assigned by Standard & Poor's to these countries are often a few notches higher than the City of Moscow ratings. This fact may be regarded as a temporary underestimation of the Russian economy.



The total amount of the City of Moscow's debt as of 1 December 2001 was \$ 1,519 million, one third of which constituted domestic borrowings in Russian rubles. This is a rather small amount, being equivalent to 3.7 per cent of the City of Moscow's GDP, or 21 per cent of the city's budget revenue in 2001.

Throughout the existence of its debt management system, the City of Moscow has never failed on the periods, terms and conditions of its debt servicing and repayment. Thus the city has a positive credit history.

As a result, Moscow's ratings assigned by the international rating agencies are limited only by the sovereign ratings of the Russian Federation (B, Standard & Poor's; B2, Moody's).

Because of the high estimations of Moscow's reliability as a borrower, the Moscow Municipal Debt Committee can successfully attract foreign capital, notwithstanding earlier doubts about the possibility of repayment by the city of its external debt obligations (which, however, were repaid on time). In particular, at the end of last year we successfully placed two issues of Loan Participation Notes for a total amount of euro 700 million. Starting in 1997, the Moscow Municipal Debt Committee attracted Rub. 41.4 billion, \$ 1.67 billion, DM 625 million, Lit 400 billion, and euro 700 million

The City of Moscow raises funds to secure accelerated implementation of social and economic programmes and infrastructure development, stimulation of business activity and further improvement of the tax base. Borrowed funds are used exclusively for financing of investment projects and programmes. Before 1998 these projects and programmes included commercial investment programmes implemented on a pay-back basis, starting in 1997 – the City of Mos-

cow Investment Programme, and starting in 1999 – solely the City of Moscow Capital Budget.

The City Government and the debt management decision-making process

The borrowings by the administrative divisions of the Russian Federation (one of them being the City of Moscow) are regulated by the Budgetary Code of the Russian Federation, which determines the level of authority of the administrative divisions of the Russian Federation, as well as by the special Federal Law "on the Procedure for the Issuance and Circulation of State and Municipal Securities".

Legislation sets the following guidelines on bond issuance:

- Presence of the Debt Issuance Programme of the City of Moscow as an annex to the City Budget Law;
- The budget deficit cannot exceed 15 per cent of total budget revenue;
- The total debt size cannot exceed the yearly budget revenue;
- Total debt service expenditure cannot exceed 15 per cent of total budget expenditure;
- Debt maturity cannot exceed 30 years;
- External borrowings can be assumed only for refinancing of existing or repaid debt obligations; and
- All administrative divisions issuing external debt securities must have a rating from at least two leading rating agencies.

The relationship with the Federal authorities is shown in the diagram below:



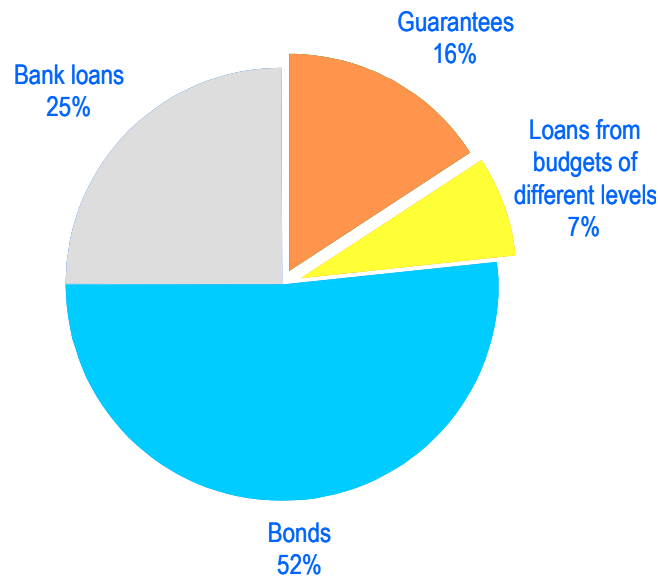
The local authorities of the administrative divisions of the Russian Federation, including the City of Moscow, have the following powers as far as decision-making in relation to borrowing activities is concerned:

- Independent planning, approval and execution of budgets, as well as defining of budget deficit and surplus;
- Independent, within certain limits, borrowing powers regarding debt obligations and establishment of debt issuance procedure;
- Decisions on use of borrowed funds; and
- Decisions on funds to be spent on debt service and debt repayment;

New external borrowing is allowed only for refinancing of existing external debt. Russian legislation also sets certain limitations regarding the types of debt instruments. The administrative divisions of the Federation can operate only the following types of debt instruments:

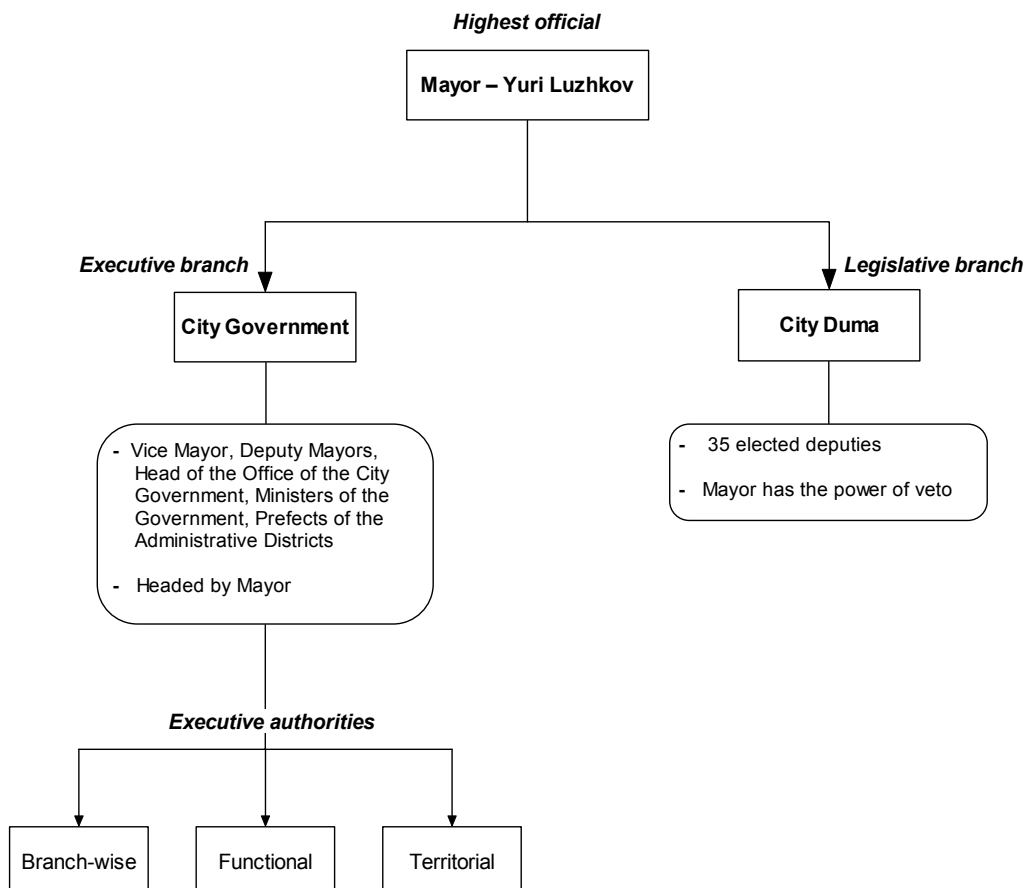
- Bank loans;
- Bonds;
- Loans from budgets of different levels;
- Guarantees; and
- Agreements on debt restructuring.

The current debt structure of the City of Moscow (as at 1 December 2001), comprising the above-mentioned types and classification of debt instruments, is shown below:

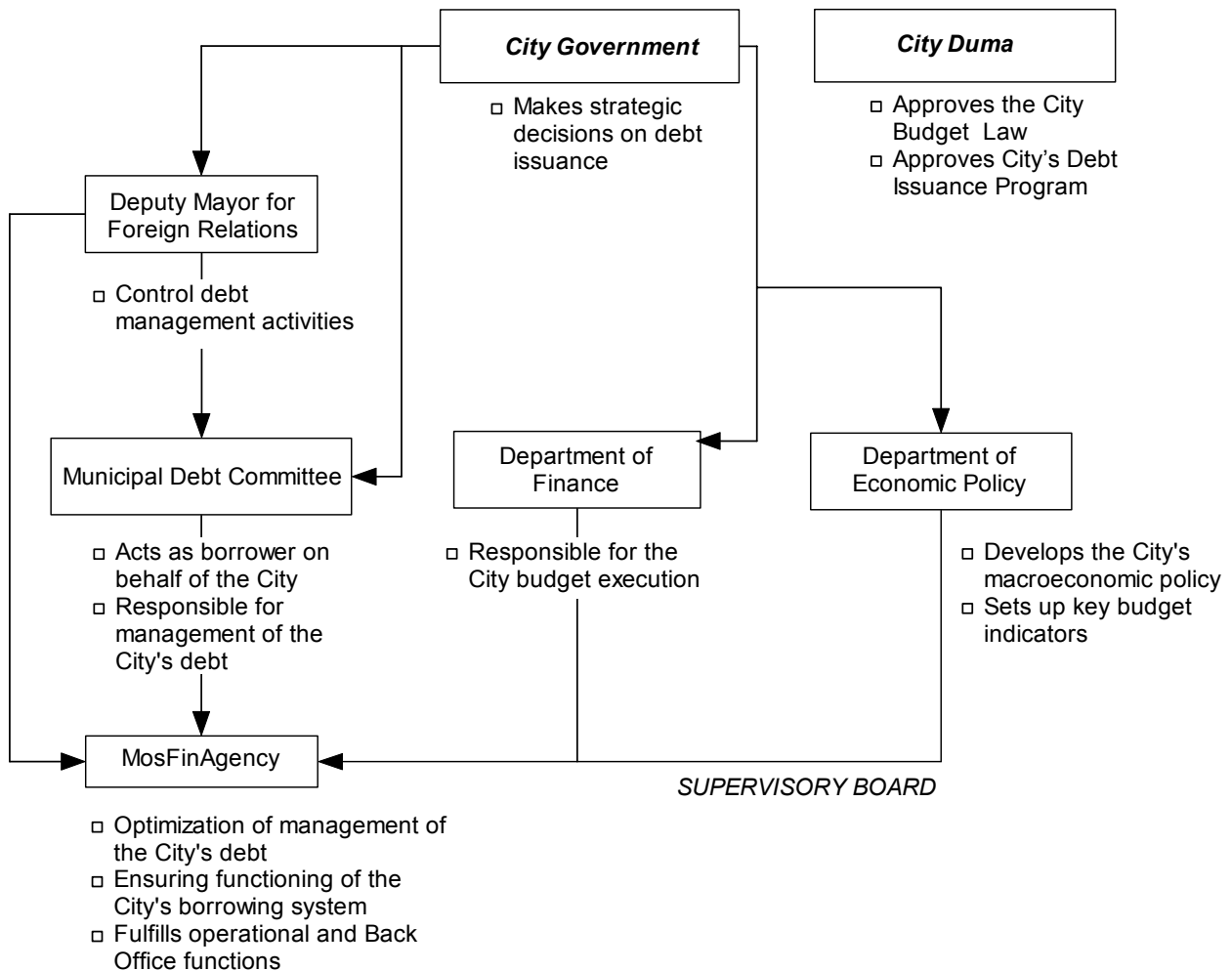


City of Moscow Debt Management System and decision-making procedure

The structure of the City of Moscow Government is shown in the following diagram:

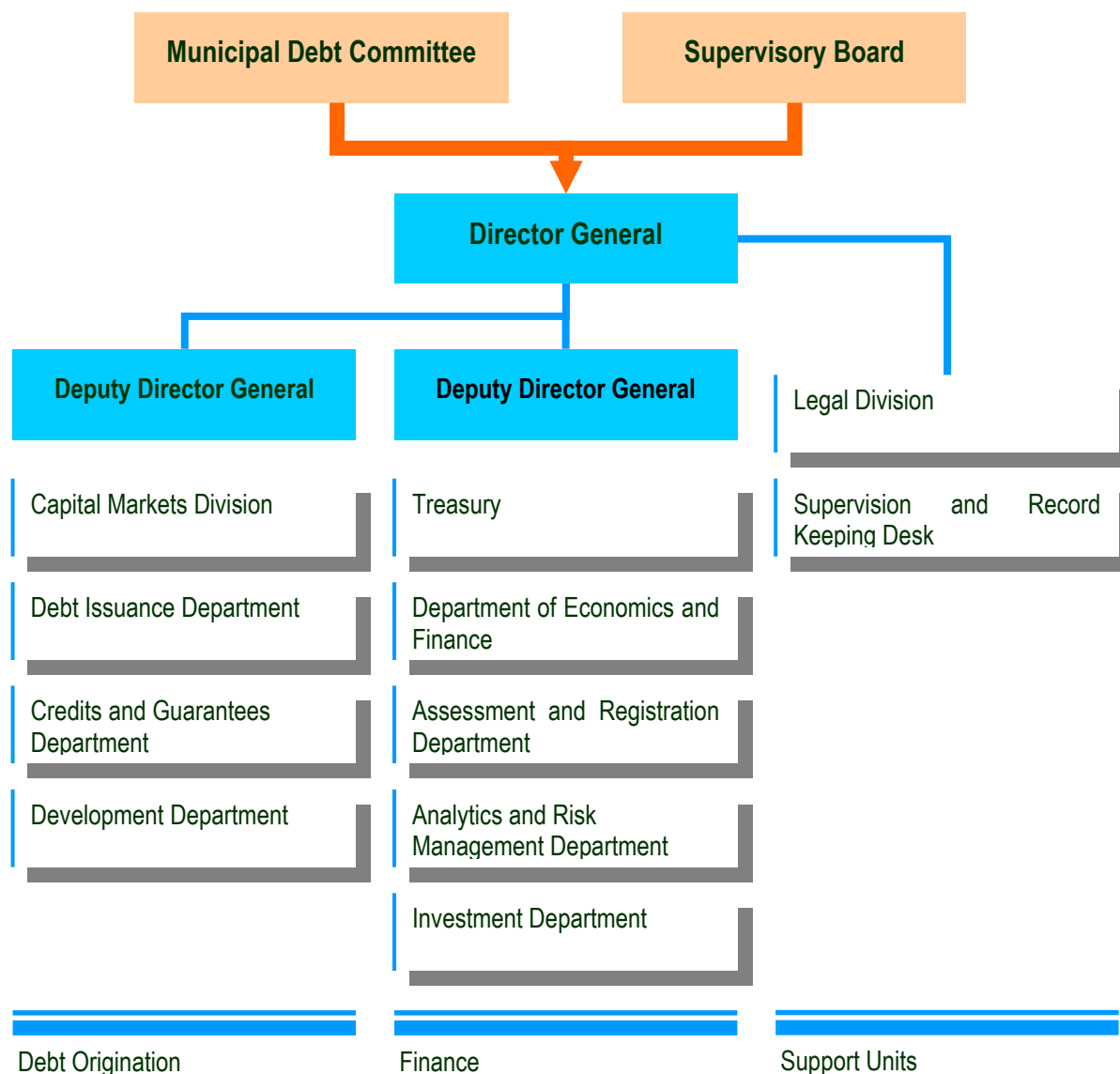


The Debt Management System was formed within the framework of this structure and in accordance with the legal requirements regarding the debt issuance procedure in the City of Moscow. The structure of the city's Debt Management System is shown in the following diagram:



The key element in the diagram is the Specialized State Unitary Enterprise "Financial Agency of the City of Moscow" (SSUE "MosFinAgency") – an organization acting as the City of Moscow's debt management agency.

The internal structure of “MosFinAgency” is shown in the diagram below:



“MosFinAgency” is subordinate to the Committee of Municipal Debt, Securities and Capital Market. Development of the Government of the City of Moscow. Its activities are controlled by the Supervisory Board, which consists of representatives of the management of other related authorities of the City of Moscow Government.

The Agency has two main divisions – the financial division and the division responsible for debt origination. It also has several support departments.

“MosFinAgency” can also be viewed as a back office of the Moscow Municipal Debt

Committee, with the following functions and powers:

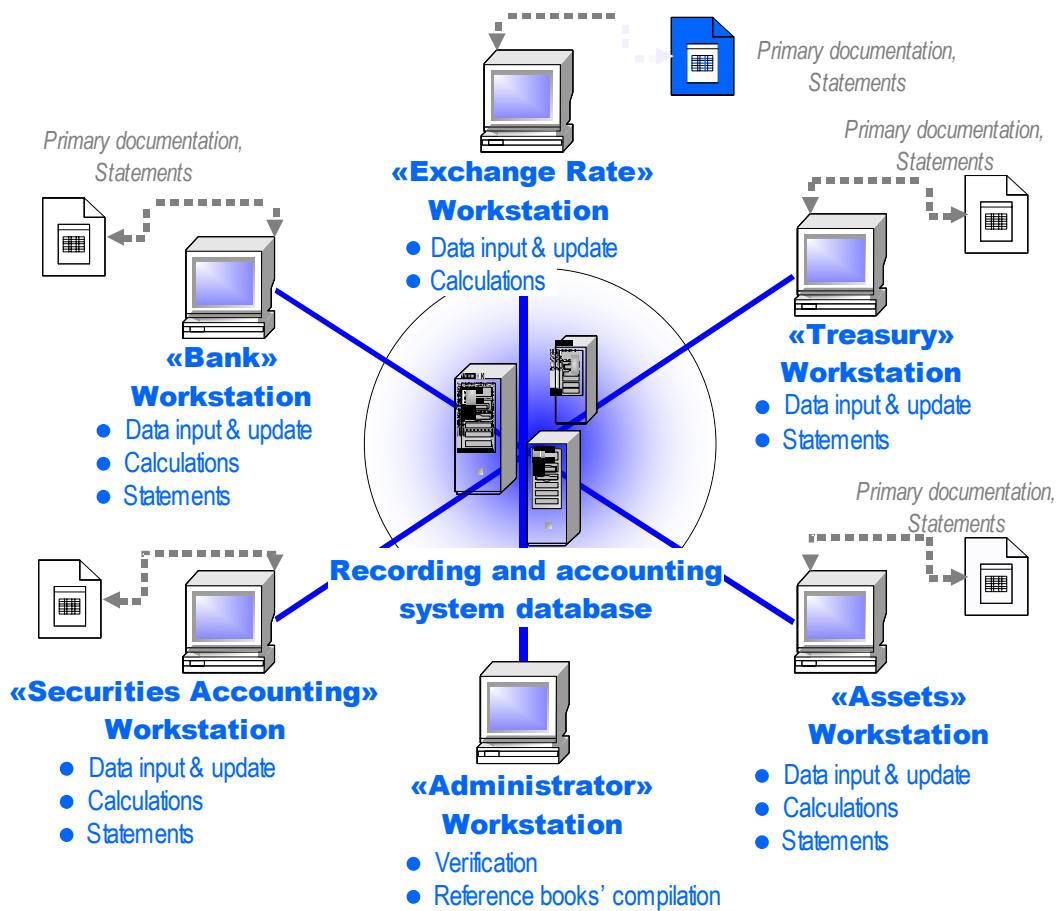
- Participation in development of the Debt Issuance Programme and key budgetary indicators related to the City’s debt;
- Development of terms and conditions for bonds, and bonds placement with market participants;
- Recommendations on debt management strategy;
- Development of tactical debt management solutions and their implementation; and

- Carrying out of all operations related to domestic debt origination, its circulation and redemption.

Performance by the “MosFinAgency” staff of the above-mentioned tasks does not depend solely on their professional skills. A specially designed system makes it possible to carry out

computerized debt management, including accounting for all types of the City’s debt obligations, daily debt balance and profile, scheduling of future debt payments, planning and forecasting of key debt indicators, and automatic compilation of operating and analytical reports.

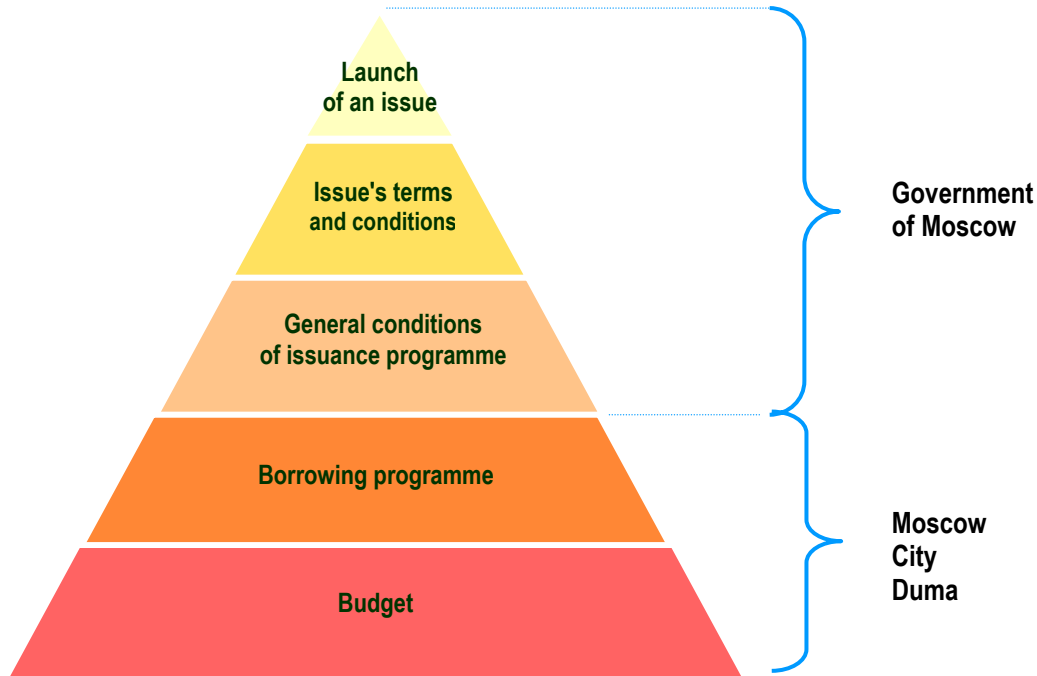
The structure of the computerised debt recording and accounting system is shown below:



The spreadsheets of this system contain all records on bonds placed and loans raised, as well as all on operations with securities. There are 122 entry forms. The entered data is stored and used as the basis for further calculations, analysis and compilation of financial statements. Over 140 types of financial statements can be produced using this computerized debt recording and accounting system.

Decision-making procedure for the City of Moscow debt issuance

The decision-making procedure for the City of Moscow debt issuance can be represented by the following diagram:



The principal decisions in respect of debt origination for the current year are taken by the Moscow City Duma – a representative chamber consisting of 35 deputies, directly elected by the electorate of Moscow in accordance with the City's laws. These decisions are reflected in the City's main financial document – the budget for the current year. The City of Moscow Debt Issuance Programme is an annex to the budget.

In accordance with the terms and conditions of the City of Moscow Debt Issuance Programme, the City Government develops and approves the general terms and conditions of an issue and then the terms and conditions of each particular issue. A decision on the issuance of particular bonds is then taken.

II. MAIN DECISIONS IN 1998–2001 (1998–1999) SUCCESSFULLY OVERCOMING THE 1998 FINANCIAL CRISIS

After the 1998 crisis the City of Moscow had the following options:

- To stop payments on its debt obligations and start negotiations with investors on debt restructuring; and
- To continue payments, but simultaneously to initiate talks on debt restructuring.

The City Government immediately rejected the first and the second options, notwithstanding the fact that they were chosen by many Russian issuers.

Instead, it chose an approach in accordance with the City's debt management strategy, namely to honour unconditionally all its debt obligations

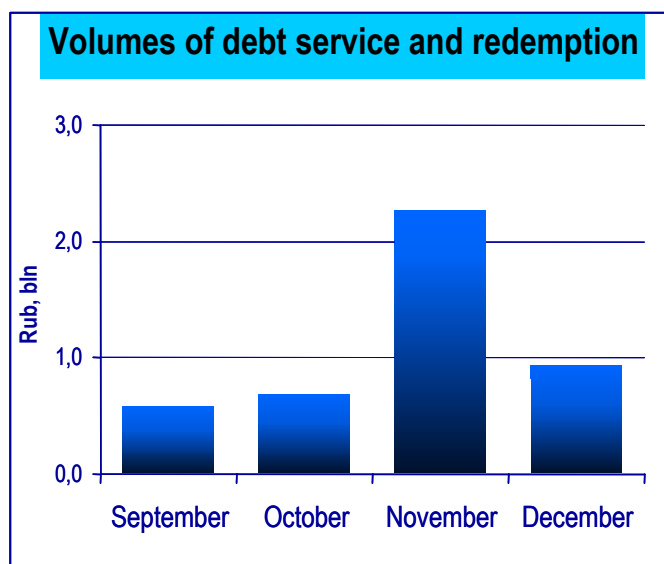
III. HONOURING UNCONDITIONALLY ALL ITS DEBT OBLIGATIONS

At the time of the crisis Moscow did not disrupt debt service and redemption by taking the following measures:

- Introduction of Emergency Budget for 1998, fourth quarter;
 - Mobilization of additional budgetary and extrabudgetary resources;
 - Partial and voluntary restructuring of existing rouble debt into securities of different tranches;
 - Partial and voluntary bond redemption via property swap;
 - Offsets with bonds for tax arrears; and
 - Full and timely external debt repayment.
- Cash redemption (88 per cent);
 - Tax offsets (5 per cent);
 - Restructuring into other securities (2 per cent); and
 - Redemption by property (5 per cent).

At that time the most difficult period for the City of Moscow was the end of 1998, which was characterized by a drastic decrease in tax revenue in the budget and scheduled repayments on a number of loans. The volumes of debt service and redemption for the end of the year are shown in the following graph:

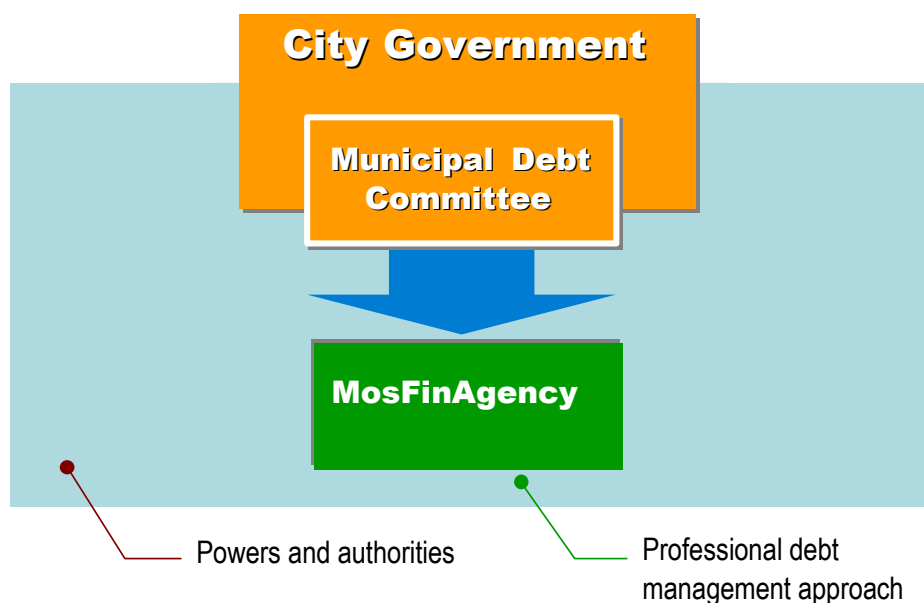
Debt service and redemption were effected from the following sources:



- All the debt obligations were repaid in full and on time, largely because Moscow had put in place the conditions guaranteeing the stability of the City's Investment-Borrowing System;
- Borrowed funds were invested in real sector of the economy (the City's capital development programme, investment in project finance);
- The Investment-Borrowing System was initially based on the principle of balance between the debt obligations and budget revenue (payments on debt service and redemption could not exceed 15 per cent of the budget expenditure; the net annual increase in debt could not exceed 30 per cent of the budget revenue; the level of consolidated debt could not exceed 100 per cent of the budget revenue);
- Strict registration of debt incurred by the City of Moscow in the Unified Debt Register of Moscow; and
- Efficient debt management policy.

Reform of debt management system using international expertise (1999)

In 1999, taking into account the accumulated experience acquired in running the City of Moscow Borrowing System, the debt management reform was launched. The new Debt Management System can be summarized in the following diagram:



The key elements of the new system were as follows:

- The borrowing function was concentrated with the Municipal Debt Committee; and
- MosFinAgency was established and organized as professional back-office for the Municipal Debt Committee.

Establishment of the State Specialized Debt Management Agency of the City of Moscow made it possible:

- To employ highly professional experts in debt management;
- To increase efficiency through linking the process of making strategic decisions with their implementation;
- To centralize management of the City's debt; and
- To apply the management system commonly used in the private banking sector and to increase the motivation and responsibility of employees, which cannot be achieved in the public sector.

(1999–2000) Prevention of liquidity crisis in 2000 through active liabilities management. Reserves building. Repayment of US\$ 500 million Eurobond

In the middle of 2000 the debt repayment schedule was characterized by “peaks” of repayments and that is why many analysts predicted the City of Moscow default, assuming

that the City would not be able to accumulate the substantial funds necessary for its debt repayment. The liquidity crisis could arise owing to the 1998 denomination and the subsequent increase in the rouble equivalent of the City of Moscow external debt.

The City was taking all necessary steps to prevent default:

- Allocating budgetary funds sufficient for debt service and redemption;
- Creating hard currency reserves using budgetary surplus and project finance revenues;
- Currency reserves cash management;
- External debt repurchase and cancellation; and
- Active debt management.

As a result of those steps the payments were distributed more evenly throughout the years 1999–2000, allowing the City's successful and timely debt repayments.

The lessons of the 1998–1999 crisis led to the following important strategic decisions:

- Unconditional and timely debt service and debt repayment are always essential;
- Debt size to be kept within managed limits, allowing full and timely debt service;
- Diversification of debt portfolio in terms of debt type and debt maturity;

- Full information transparency on the City's economy and finance, including debt obligations; and
- Efficient debt management. Proactive position on domestic capital market.

IV. RATIONAL BORROWING POLICY

- Cash flow planning for the life cycle of the City debt;
- Debt Issuance Programme is developed annually and included in the City Budget Law approved by the Moscow City legislature;

- Moscow's debt is fully accounted for by the City budget; federal control over budgetary deficit, debt service and debt size;
- Optimization of debt through its day-to-day management;
- Liquidity risk management through planning of maturities; and
- Debt instruments are diversified to meet financing needs of Moscow and market conditions.

(2001) Active liabilities management. Reserves building. Repayment of DM 500 million and Lit 400 billion. First return in Russia to international capital markets since 1998 crisis.

V. RESULTS OF DEBT MANAGEMENT SYSTEM IMPLEMENTATION

In 2000 the City faced a number of problems, which were successfully solved through the new Debt Management System:

| | |
|---|---|
| • Short-term debt maturity | Solved |
| • Poor debt portfolio: excess of bank loans | Solved |
| • Low liquidity of the domestic municipal bond market | Solved |
| • Large peak payments | Solved; steps have been taken to further smooth peak payments |
| • Currency risks and difficulties with mid- and long-term planning of debt service and debt repayment | Steps have been taken to reduce risks and to improve planning |

VI. MAIN RESULTS OF DEBT MANAGEMENT IN 2000–2001

Moscow was the first and the only Russian region to repay large Eurobonds on time in 2000 and 2001 without bonds restructuring and payments deferral. External debt payments exceeded US\$ 1 billion on Eurobonds only. Total expenditure on international debt service and redemption exceeded US\$ 1.8 billion.

Debt size, which as the result of the 1998 crisis increased to over 90 per cent of budget revenues, was gradually reduced to Rub 45 billion (as at 1 December 2001), or 21 per cent of budget revenues.

The average debt duration increased to 3.1 years.

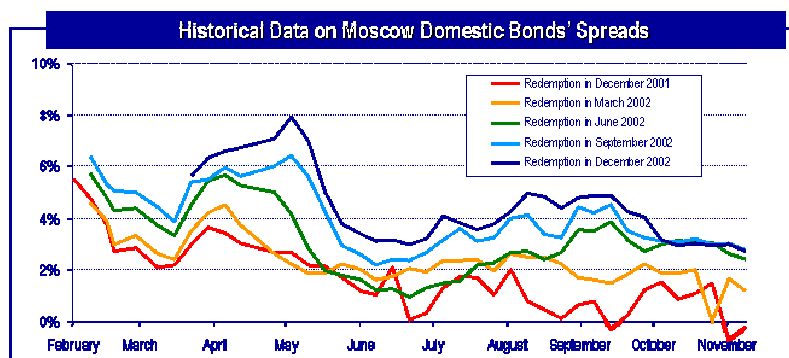
The liquid domestic bond market, which had been destroyed in 1998, was rebuilt. Borrowing amounted to Rub 9.83 billion.

Active participation in the market made it possible to reduce debt service and debt repayment expenditure by Rub 1.37 billion.

Domestic municipal bond market in 2001

One of the main results of the Debt Management System was the appearance of a liquid domestic bonds market in the post-crisis Russian Federation. Several of the characteristics of the domestic municipal debt market in 2001 are as follows:

- Average daily turnover of domestic municipal bonds equals Rub 32.1 million;
- Average daily turnover to total bonds in circulation is no less than other Russian bonds' average (0.5 –1.5 per cent)



VII. EXTERNAL BORROWINGS OF THE CITY OF MOSCOW IN 2001

One of the important achievements of the City of Moscow in its borrowing activity was the placement in 2001 of two issues of Loan Participation Notes for a total amount of euro 700 million. Moscow was the first administrative division of the Russian Federation to enter the

international capital markets after the 1998 crisis. The successful placement of the Loan Participation Notes was proof of the City's impeccable credit history and the trust shown by foreign investors.

Main parameters of the City of Moscow new debt obligations:

| | | |
|-------------------|-----------------------------------|------------------------------------|
| Issue date: | 25 October 2001 | 28 November 2001 |
| Obligor/borrower: | City of Moscow | City of Moscow |
| Structure: | Loan Participation Notes | Loan Participation Notes |
| Rating: | B/B2 | B/B2 |
| Amount: | 300 million | 400 million |
| Currency: | Euro | Euro |
| Tenor: | 3 years | 4 years, 5 months |
| Coupon: | 10¼ % | 10.95 % |
| Form: | Reg S global bearer notes | Reg S global bearer notes |
| Lender: | BHF-BANK AG (limited recourse) | JP Morgan AG (limited recourse) |
| Lead managers: | ING Barings/ UBS Warburg | JP Morgan/ BNP Paribas |
| Listing: | Luxembourg | Luxembourg |
| Clearing: | Euroclear/Clearstream | Euroclear/Clearstream |

The current goals of the City of Moscow in debt management are as follows:

- A simultaneous increase in debt size and reduction of debt service pressure on the City's budget;
- A planned and controlled stream of debt payments to eliminate the liquidity peak strain on the City's budget;
- A further increase in the rouble-denominated bonds share in the debt portfolio;
- Development of domestic debt capital market.

VIII. DEBT OBLIGATIONS OF THE CITY OF MOSCOW ON THE INTERNET

Information on the debt obligations of the City of Moscow can be found on the web at:
<http://www.moscowdebt.ru/>

DETERMINANTS AND CONSEQUENCES OF BAILING OUT STATES: THE CASE OF MEXICO

*Fausto Hernández Trillo*¹

I. INTRODUCTION

Sub-national government (SNG) debt bailouts occur from time to time in countries in which local governments have autonomy regarding the amount they want to borrow. When a SNG is unable to meet its debt payment obligations without drastically cutting its expenditure, like other sovereign borrowers, it faces the dilemma of affecting its creditors and its future access to borrowing, of reducing the level of services that it provides to its constituency, or increasing local taxes. The difference in the case of a SNG and a country is that the former affects other levels of government that could also be responsible for the well-being of the constituency, for example the federal government. The federal government, even if it did not create the conditions for the crisis, has to face the consequences of cutting local services, or increasing taxes, or – if there is no payment – of affecting the financial system or access to the credit market of that or other local governments. That is, the typical dilemma of a sovereign borrower is passed on from the SNG that took the debt to the higher authority (see Eichengreen and von Hagen, 1996; and Goldstein and Woglom, 1992). A typical response of the higher level of government that has more access to financial sources is to bail out the indebted entity. The problem with this behaviour is that it provides incentives for the SNG to acquire unsustainable levels of debt in the future.

Mexico is no exception. One such episode occurred in the aftermath of the so-called *tequila* crisis. The 1995 financial crises of Mexico came after a period of reckless credit expansion and with a sharp increase in interest rates. This combination left many SNGs with heavy debt loads and huge payment obligations that the federal government eased through extraordinary transfers and debt rescheduling programmes. This was certainly not the first SNG bailout by

the federal government, but this episode provides us with the only direct evidence of financial transfers by the federal government to rescue SNGs. Previous bailouts took place without leaving actual data that could be analysed in a systematic way.

In this paper, we use the available data of the generalized *tequila* crisis bailout to evaluate several questions of the logic behind bailouts in an effort to draw lessons so as to prevent future bailouts. The results of this paper suggest that the size of the constituency is important in explaining bailouts. This is in accordance with the *too-big-to-fail* hypothesis. On the other hand, the total dependence of the SNGs on federal transfers (vertical fiscal imbalance) is also an important determinant of a financial rescue. It is also shown that fiscal indiscipline may pay off (that is, the local deficit is associated with a larger transfer). Surprisingly, political variables do not appear to determine whether a state is bailed out.

It is also shown that the excessive indebtedness of many states may have equity implications as well: bailouts tend to be highly regressive, because the poorer – low-debt states – received fewer extraordinary resources.

In addition, we argue that the explicit generalized bailout carried out by the federal government in Mexico in 1995 may have created a moral hazard problem. Another result of the analysis is that the existing institutional and legal framework is not adequate, since it provides incentives for states to borrow and for banks to lend without evaluating the risk of the project.

Section II defines the concept of bailout in a federal system. Section III presents an overview of Mexican fiscal federalism, and also examines the evolution of state debt, while section IV explores the possible *ex ante* explanations for

¹ This paper is largely based on a previous paper "Fiscal decentralization in Mexico: The bailout problem", written with Alberto Díaz and Rafael Gamboa and sponsored by the Inter-American Development Bank. It was published by the *Eastern Economic Journal* in January 2002.

past bailouts. Empirical analysis is carried out in section V, while section VI examines the consequences of this generalized bailout. Section VII explores possible hidden bailouts. Finally, section VIII draws some conclusions and provides some policy lessons.

II. DEFINITION OF BAILOUT

A bailout occurs when a higher-level government assumes the obligations of a lower-level one because of the latter's inability or unwillingness to meet those obligations. But this definition is not restricted to financial obligations. In our study we attempt to identify hidden bailouts. One can think of a lower-level government providing a service with important externalities, which is then provided by the central government, even though the responsibility for the provision lies with the lower level of government.

We also recognize in bailout processes an element of time inconsistency. Even if the higher-level government knows perfectly well that the lower-level government caused its own financial distress by irresponsible behaviour, it may be willing to provide a bailout for many reasons – for example, because the central government cares about the welfare of the citizens of the jurisdiction in question, or because it benefits politically from extending the bailout, or because in the absence of bailout there would be negative externalities for the rest of the country.

In this sense it is important to identify the potential determinants of a bailout decision. We use the well-known lender-of-last-resort literature to identify these because it is a helpful analogy (see Bordo, 1990, and Goodhart, 1987). However, before doing this for the case of Mexico, we shall briefly review Mexican fiscal intergovernmental relations.

III. MEXICAN INTERGOVERNMENTAL FISCAL RELATIONS

Mexico is a federal republic made up of three levels of government: the central government, 32 local entities (which include 31 states and a federal district) and 2,477 municipalities.

The country is characterized by strong regional disparities. While the Federal District, and the two largest states produce about 40 per cent of total GDP (their GDP per capita is around \$4,000 a year), the poorest four account for only 7 per cent of total GDP (with \$1100 of GDP per capita). Fiscal intergovernmental relations in Mexico have been regulated through the National System of Fiscal Coordination (NSFC) since 1980, which is a revenue-sharing system, where states share the revenues coming from the Federal Government (main taxes).

The Federal Government collects the main taxes: the value-added, corporate, and personal income taxes. The main direct sources of revenue of the lower levels of Government are property taxes, payroll taxes and fees, and they represent less than 4 per cent of the country's total tax revenues.

Federal sources of revenue (including oil-related income) accounted for an average of 96 per cent of the public sector's income between 1992 and 1995. Even after the 1995–1998 process of decentralization, fiscal assignment remained unbalanced because decentralization did not give back any tax powers; it only included matching and conditional transfers (see Hernández, 1998). The result is a high level of vertical imbalance.

Although the NSFC is its best-known feature, Mexican intergovernmental fiscal relations are more complex than that. It may seem that fiscal intergovernmental relations are documented and regulated solely by the NSFC. In fact, most authors (see Arellano, 1994) suggest so. When these relations are analysed it has to be borne in mind that Mexico has a long history of centralization. Direct federal expenditures in the states and the municipalities are an important part of the overall picture.

The current distribution of responsibilities among the three levels of government, including those that are shared, is shown in table 1. The number of shared responsibilities (financed by the Federal Government but provided by SNGs) has increased since 1995 when the Federal Government began a significant decentralization effort – during the Zedillo administration.

Table 1. Responsibility Assignment

| Sources of revenues | Responsibilities |
|--|---|
| <p>Federal Government Taxes</p> <p>Corporate Income Tax Personal Income Tax Tax on assets of enterprises Value Added Tax Duty on oil extraction Oil export tax Tax on production and services (excises) Tax on new vehicles Tax on the ownership of vehicles Import duties Miscellaneous</p> <p>Shared Taxes</p> <p>Income taxes Value added tax Excises Oil export duties* Import duties Tax on ownership of vehicles** Tax on new cars**</p> <p>State Government taxes</p> <p>State payroll tax Real state transfer tax Tax on motor vehicles older than 10 years Tax on the use of land Education tax Indirect taxes on industry and commerce Fees and licenses for some public services</p> <p>Municipal Government Taxes</p> <p>Local Property Tax Real State Transfer Tax Water fees Other local fees and licenses Residential development Other indirect taxes on agriculture, industry and commerce</p> | <p>Federal expenditures</p> <p>Service of Domestic and Foreign Debt Defense Post and Telecommunications External affairs Irrigation Foreign Trade Railways, highways, airways, and shipping Federal and Border police</p> <p>Shared Expenditures</p> <p>Health Education Specific purpose grant program Solidaridad Single development Agreements Special Police National Parks</p> <p>State Expenditures</p> <p>State Administration State infrastructures State public order and safety Sanitation and water supply Service of state debt Public Libraries</p> <p>Municipal Expenditures</p> <p>Local Administration Local public order and safety Local transportation Local infrastructure including water supply and sanitation Local Transit Waste Disposal and street lighting Slaughter, cementeries, and parks</p> |

Source: Amieva (1997)

The Federal Government funds most of these shared activities through conditional transfers. The way in which these transfers are distributed has been the subject of intense debate. Until recently, much discretion by the Federal Government determined the assignment of transfers. Direct federal public investments in the states and extraordinary transfers were mainly assigned in a discretionary way.

To provide an example of the degree of discretionality in the allocation of federal funds (other than the revenue-sharing formula) during the years before the decentralization process, we estimated the average coefficient of variation of the per capita federal public investment in the states for the period 1989–1997.² This turned out to be 1.13, which suggests that the dispersion was quite high, compared with the mean. That is, per capita federal investment has been unequally distributed among states.

This structure of intergovernmental fiscal relations leaves the states with little flexibility for responding to external shocks (see Díaz Cayeros and McLure, 2000; and Courchene and Díaz Cayeros, 2000). This is where sub-national debt enters the picture. Sub-national government borrowing is regulated mainly by the National Constitution, which states that SNGs can borrow only for productive investments. In accordance with the benefit principle of public finance, to the extent that benefits from local public investment projects accrue over a number of years into the future (which is the case with productive projects such as infrastructure), it is both fair and efficient for future generations to share the cost of financing such projects. Borrowing for local capital development projects thus has a sound conceptual rationale.

However, debt has a special way of being guaranteed: states can use their block transfers (coming from the revenue-sharing system). The mechanism is as follows. In case of arrears or a threat of default, on behalf of creditors, the Federal Government deducted debt service payments (on registered debt) from revenue-sharing transfers before the funds were transferred to

² The data source is the Ministry of Finance (Secretariat de Hacienda). We compute this figure using real federal public investment in each state. We use the *state GDP deflator* to deflate, which is provided by INEGI (National Institute of Statistics, Geography and Informatics). It is useful to point out that we first obtain the average of the per capita federal investment in each state and then compute the coefficient of variation.

states. This amount, in turn, was paid to the creditor bank.

Evolution of state debt

To understand the 1994–1995 bailout in Mexico, it is worth examining the evolution of the SNGs' debt in the 1990s. As we will show in this section, the debt problem does not yet pose a macroeconomic problem; however, it represents a burden for many individual states and may give rise to future macroeconomic problems.

In contrast to other Latin American countries such as Argentina and Brazil, Mexico's SNG debt has not yet affected its macroeconomic performance. Total SNG debt (excluding the Federal District) reached \$4.5 billion by 1994, or 1.8 per cent of GDP, and about 6 per cent of total public sector debt. However, it is important to note that the accumulation of state debt in the period 1988–1993 rose at an annual rate of 62 per cent (see Gamboa, 1998). SNG debt grew by another 8 per cent in real terms from 1994 to 1995, mainly because of the increase in interest rates caused by the financial crisis.

By 1995, SNG's debt burden represented a fiscal problem for most of the states, in part because they had so little disposable income with which to service it. The average ratio of total debt to disposable income was around 80 per cent³, which shows an important degree of financial vulnerability. In addition, this vulnerability was increased by the limited ability of states to raise additional revenues, because of the centralization of the tax system, and by the high degree of unadjustable expenditure.

IV. DETERMINANTS OF BAILOUTS

In this section we attempt to determine the *ex ante* reasons for the bailout. We consider two different types of bailout. The first one is the **open bailout** that took place as a result of the *tequila* crisis, when the Federal Government had to rescue virtually all states. We also attempt to identify other possible forms of bailouts, which will be called **hidden bailouts**, which we associate with discrepancies between decreases in levels of debt and fiscal balances. These figures

³ Net disposable income is defined as total revenue, less municipal transfers and educational transfers.

may reflect a hidden bailout; for example, how else to explain a situation where a State with a primary fiscal deficit also reports a reduction in its debt level?

The (open) generalized bailout

As noted previously, by 1994 many states were highly indebted. On average, total debt represented 80 per cent of the total disposable annual income of the states. When the financial crisis of December 1994 erupted, interest rates multiplied by more than five, from 13.8 to 74.8 per cent, and SNGs simply could not keep servicing their debts. At the same time, commercial banks were experiencing liquidity and capitalization problems.⁴

For these reasons, the Federal Government came under pressure from the States and commercial banks to provide a major bailout. Even though the bailout was generalized to almost all SNGs, the size of the transfer, and the year in which it was provided to each of the States provide relevant information on the Federal Government's reason for providing discretionary help. This variation is shown in Figure 1, using official government data. We will now proceed to study the causes of these differences.

Possible explanations of the generalized bailout

Several potential determinants of a bailout decision can be identified, including the following.

- (a) *Vertical fiscal imbalance.* As discussed earlier, the Federal Government collects the richer tax bases – the value-added and the corporate and personal income taxes – and the main source of revenue for states and municipalities is net block transfers. Thus, the SNGs have little flexibility to absorb a macroeconomic shock since these transfers are highly pro-cyclical. We may conclude that the vertical imbalance determinant is potentially important in explaining the generalized bailout of 1995, as states cannot levy taxes to absorb shocks. Econometric analysis will attempt to verify this hypothesis.
- (b) *The institutional and legal design.* Having the block transfers as collateral, in an envi-

ronment where SNGs have to tighten their responsibilities, has two implications. First, banks had incentives to make loans to SNGs, as the Federal Government indirectly guaranteed repayment. Second, states had incentives to borrow because, under the above conditions, there was a high probability that the Federal Government would bail them out.

A bailout was more likely under this institutional framework because State and local Governments spent nearly 75 per cent of their total budgets on current expenditures such as the salaries of teachers, State police, doctors and so on, which are difficult to adjust. This reduces the flexibility to manage the budget adequately.

Thus, if their net block transfers had been seized to pay their debts, they would not have been able to meet their current expenditure obligations, since on average net block transfers account for nearly 80 per cent of total revenue. Failure by the SNGs to meet such obligations has high political costs for themselves and the Federal Government.⁵ Consequently, the Federal Government has no alternative but to bail them out.

The two points above could account for at least part of the over-borrowing in sub-national credit markets, and the lack of explicit local regulations for borrowing and of any obligation to present and/or publish financial statements. This would obviously make project evaluation very difficult for lending institutions. These institutions rarely make the evaluation, as the risk they face is passed on to the federal government.

- (c) *The too-big-to-fail hypothesis and the political factor.* There is ample evidence in the banking literature that size matters when it comes to bailing out an entity. In line with this reasoning, the size of the State could also be important in explaining the bailout. This is known as the *too-big-to-fail* hypothesis. When bailing out a particular State, this hypothesis may be present for several reasons. For example, a very populous State may be important because of the impact it may have on national elections. Second, from an economic point of

⁴ See Hernández and Billagómez (2000).

⁵ It is very common to see state workers, such as teachers, demonstrating in both the state capital and the Federal District.

view, a strong State (with high GDP) may also be important because a reduction in its growth rate may affect the national rate of growth. In addition, a financial crisis in an important state may lead to a loss of confidence among foreign investors in the country.

- (d) *Political factor.* Along with the *too-big-to-fail* factor there may be a political element. This factor can be of importance particularly in Mexico, given its existing system. Mexico has been going through a political transformation in recent years. Parallel processes of democratization have dramatically reshaped intergovernmental relations. From a disciplined system long dominated by one political party at all levels of government, Mexico is moving to a highly competitive, complex configuration of local political profiles where it is increasingly common to find divided local governments (where the legislature is fragmented or controlled by a party different from that of the governor) or municipalities that are governed by parties different from those governing the local or the federal executive. The federal executive under the Institutional Revolutionary Party has repeatedly been accused of manipulating financial instruments in order to produce favourable political cycles (Ames, 1989; Weldon and Molinar, 1994; Lamoyi and Leyva, 1998). But the erosion of federal authority is evident in many spheres. In fact, the main contenders in the presidential race of 2000 were all governors, while in the past presidential candidates always came from the president's cabinet. Thus, the relative importance of local politicians, especially governors, has reshaped the financial relationship between the federal and state governments, making local fiscal discipline less strong and federal bailouts more likely (see Kraemer, 1997). For this reason electoral variables are included in the analysis.

V. EMPIRICAL ANALYSIS

In this section we test the different hypotheses discussed above. First, we define our variables (both dependent and independent); then the model is estimated and, finally, we discuss the empirical results.

The data and variable definitions

The National Institute of Statistics, Geography and Informatics (INEGI) brings out an annual publication containing all states' financial statements. This publication also lists all federal investments that each state receives every year. Unfortunately, these data are sometimes inconsistent across years and states for two reasons. First, until 1995, each state had different methodologies for collecting data. Second, this information was provided by the states, which had incentives to provide the wrong information in order to put pressure on the federal government for extraordinary grants. Instead, we use the information that the states provide to the Federal Government. Thus, our source is the Secretaría de Hacienda (Ministry of Finance).

As a first measure of bailout we use extraordinary transfers as a proportion of total revenues (ET) documented between 1994 and 1998. The hidden forms of bailouts will be defined later in the paper.

For the independent variables, we include as a measure for the vertical fiscal imbalance the proportion of own revenues to total revenues, and proxies for the size of the state known as the *too-big-to-fail* hypothesis and political factors, as well as some other control variables. In our econometric test, we include several indicators that proxy the size of the bailout as a function of the importance of the State, the political situation of the state, and its fiscal flexibility. As the fiscal rules that determine state government access to credit are basically the same for each state, *ex-ante* circumstances that allow bailouts are not included.

Thus we include the ratio of "own revenues" to total revenues (VERT) for vertical fiscal imbalance, net of municipal transfers. The lower this variable is, the more dependent the state is on federal transfers, which may suggest that states have low tax capabilities for collecting revenues. The primary deficit (PRIM) is included to proxy for fiscal imbalance.

The importance of the state is not an observable variable either. We use as proxies the number of formal workers in the state (FORMAL). We consider this a good proxy because they can exert political pressure in different forms, such as strikes. We also include population (POP) because a heavily populated state has

a greater impact on federal elections. The higher this variable is, the more the chances are that the large states will be financially rescued.

Finally, two variables are used to represent political pressures in bailing out local governments. The first variable is a dummy that takes the value of one when there are municipal elections in the state in the year of the bailout (MUN). The second is a dummy that takes the value of one when there is an election for governor in that year (GOV).

Results

Table 2 presents the results of the regression when the dependent variable is the generalized bailout measured as extraordinary transfers from the federal government to the state (this was run considering fixed effects by year⁶ as a proportion of its total revenue.⁷ The period of this exercise is 1994–1998.

Results suggest that the *too-big-to-fail* hypothesis is valid for the generalized bailout carried out in Mexico in the aftermath of the *tequila* crisis. As can be seen in table 2, the sign of the coefficient of number of workers in the formal sector (FORMAL) is positive and statistically significant at the standard significance levels. When the number of formal workers is substituted for population (POP) the coefficient remains positive and statistically significant. This means that the size measured in these terms matters when deciding by how much to bail out a state.

The coefficient of the level of vertical fiscal imbalance (VERT) is also positive and statistically significant. However, our hypothesis was that it would be negative, since the more the state depends on its own sources of income, the

fewer extraordinary transfers the state needs. Thus, vertical fiscal imbalance does not appear to be associated with larger generalized bailouts.

The sign of the coefficient of the variable representing the size of fiscal deficit excluding extraordinary transfers (PRIM) is also positive and significant. This coefficient has to be interpreted cautiously because, on the one hand, it may suggest that lack of fiscal discipline pays. On the other hand, it may suggest that states incur a deficit because they do not have enough sources of income to meet their expenditure obligations. Perhaps it is an indication of the existing inflexibility in recurring to additional revenue sources. It is worth pointing out that a problem of endogeneity may be present since it is not clear whether extraordinary transfers cause primary deficit, or the converse. From our earlier discussion, it seems that former follows the latter.

The political variables election for either governor or municipal president, GOV and MUN, respectively, turned out to be statistically insignificant.

The GDP per capita was also included for each regression as a control variable. The coefficient was positive and statistically significant. This can be interpreted as evidence that the bailouts have a regressive distributional effect, i.e. the richer the state, the greater the size of the bailout. The next section deals with this effect.

⁶ Coefficients for each year are not reported in the table.

⁷ The regression was run with this dependent variable because it provides the best measure of the importance of the bailout for the state government. The two variables that measure state government fiscal flexibility are presented as a fraction of total expenditure.

Table 2. Bailout determinants

| Dependent variables EXTRA | | | | | |
|---------------------------|-------------|-------------|-------------|-------------|-------------|
| Fixed effects by year | | | | | |
| | Coefficient | Coefficient | Coefficient | Coefficient | Coefficient |
| POP | 0.021814 | | 0.01945 | | 0.0194 |
| | 5.290918 | | 4.703969 | | 4.7 |
| FORMAL | | 0.252027 | | 0.251365 | |
| | | 5.482098 | | 5.462125 | |
| PRIM | 0.186335 | 0.180147 | 0.184617 | 6.178191 | 0.1831 |
| | 5.142153 | 4.630784 | 4.94723 | 4.59922 | 4.8625 |
| VERT | 179610.9 | 26808.9 | 188954.1 | 30890.69 | 190579.2 |
| | 2.19847 | 0.35876 | 2.26082 | 6.404606 | 2.239 |
| GDP PERC | 3084763 | 186529 | | | |
| | 3.9091 | 2.584499 | | | |
| GOV | | | | -5919.87 | -4198 |
| | | | | -0.2162 | -0.2076 |
| MUN | | | | -3973.92 | -4664.631 |
| | | | | -0.2666 | -0.29924 |
| R2 | 0.3388 | 0.369851 | 0.302201 | | |
| DW | 2.0299 | 2.035954 | 2.0117 | | |

VI. CONSEQUENCES OF THE GENERALIZED BAILOUT

This section identifies two important consequences of the generalized bailout, namely its distributional effects and the moral hazard problem.

Distributional effects of the generalized bailout

The econometric results above suggest that bailouts may present distributional effects. It was shown that higher per capita extraordinary transfers were made to states with higher per capita GDP.

As can be seen in Figure 1, per capita extraordinary transfers show a high degree of variation, with a coefficient of variation reaching 1.1522. Furthermore, bailouts of SNGs may have equity implications. The most indebted states are those with a high per capita GDP. That is, rich states have higher revenues per capita, and thus higher debt per capita, because there is a perception that they are more credit-worthy. Since states with more debt and importance receive bailouts, these tend to be highly regressive, as the poorer – low-debt – states receive less in extraordinary transfers. This can be appreciated by looking at Figure 2, which shows the relationship between GDP per capita (hori-

zontal axis) and extraordinary transfers per capita (vertical axis). This relation is clearly positive and significant with a correlation coefficient of 0.473298703.

It is difficult to evaluate *ex ante* the reasons why the federal government apparently favoured some states. The question one would need to answer here is, why do poorer states borrow little? Even though the results suggest that the size of the state matters, the answer to this question is beyond the scope of this study. For our purposes, it is important to note that it has some degree of regressiveness as most of the beneficiary states have high GDP per capita.

Further information about inequality and dispersion can be obtained by looking at the Gini and Theil coefficients. The Gini coefficient of the distribution of federal funds is extremely high at 0.5131, which reveals high dispersion; and a similarly high level of dispersion is found for the GDP-weighted Gini coefficient, which takes a value of 0.4665. Similar results are obtained for subsequent years. In 1996 and 1997 the allocation of extraordinary transfers became even more dispersed, exhibiting population-weighted Gini coefficients of 0.5581 and 0.6523 respectively. The Theil entropy index of 1.2779 better suggests the unequal distribution of extraordinary resources.

Figure 1. Extraordinary transfers per capita (1995-1997)

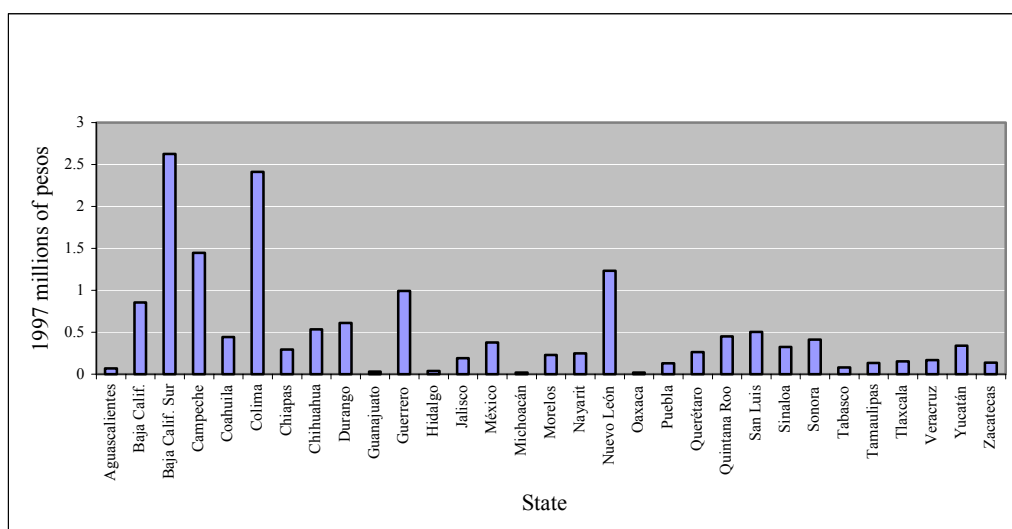
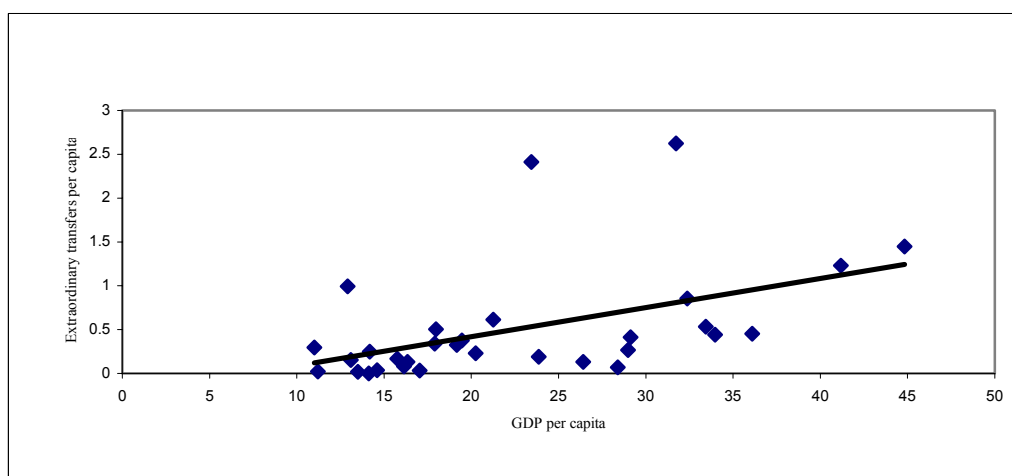


Figure 2. Relationship between GDP per capita and extraordinary transfers per capita (in thousands)



Has the bailout created a moral hazard problem?

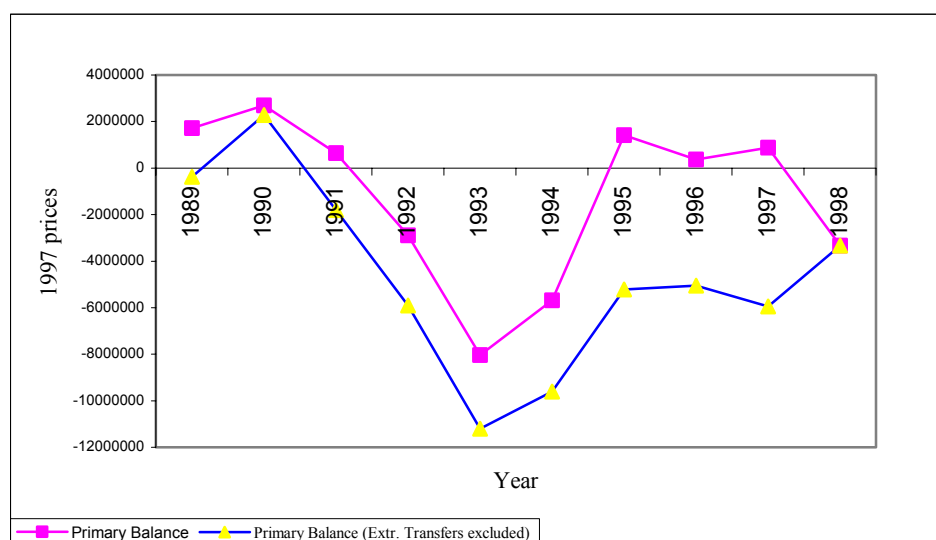
The stock of debt and the degree of indebtedness examined above are not enough to reveal the full extent of the financial weaknesses of Mexican states. In fact, the outstanding debt of the SNGs in Mexico is rather small compared with what it would be if their past fiscal deficits were capitalized. The reason for this discrepancy is that a substantial part of the fiscal deficits of the SNGs has been repeatedly shouldered by the federal government through extraordinary, discretionary transfers (to cover non-anticipated wage increases, investment expansion etc.) and other forms of bailouts (e.g. the 1995 ad hoc transfers).

Figure 3 shows the evolution of states' primary balance and its financing. It can be observed that states' fiscal situation experienced a serious deterioration until 1993 (when the aggregate primary deficit reached 0.4 per cent of national GDP). Since 1994 the situation apparently changed, and the statistics show even a primary surplus as of 1995. However, a closer look at the data reveals that the apparent surplus between 1995 and 1997 was the result of extraordinary transfers being treated as revenues. They should have been treated as a financing item (and should have been recorded below the line). Also, the primary deficit continued deteriorating after 1995, because debt restructuring did not lead in most cases to any effective adjustment in States' budget flows.

The financial deal involved basically a debt stock relief and did not resolve the structural fiscal imbalances. As a consequence, the current fiscal situation of the states is **not sustainable**, and without serious fiscal adjustment another bailout will soon be required in order to make them solvent again. The difference between the real primary balance and real primary balance

excluding extraordinary transfers shows the size of the 1995–1998 bailout. Figure 3 also suggests the persistence of the moral hazard problem. Even though states and municipalities have experienced an increase in federal transfers (both block and conditional), they continue to incur deficits because they expect to be bailed out.

Figure 3. Mexico aggregate SNGs fiscal deficit, 1989-1997



VII. HIDDEN BAILOUTS

Other forms of bailouts may exist that are less explicit than extraordinary transfers; to detect possible hidden forms of bailout, we use two alternative approaches in this section. On the basis of the hypothesis that some federal bailouts took the form of secret transfers, which were not registered as state revenues, we analyse reductions in debt stocks that are unmatched by state government surpluses. That is, when we find that a state government experiences a reduction in its stock of debt, in real terms, and this decrease is not explained by a surplus in its financial balance (measured on an income/expenditure basis), we suspect that a bailout occurred. The interviews carried out with former state finance secretaries and development bank authorities left us with the impression that most hidden bailouts were the result of debt renegotiations with development banks. These renegotiations resulted in softer conditions, including lower interest rates and debt forgiveness, which, given the absence of official information, validate our approach through debt reductions. For this section, the information on debt stocks and public finances comes from different

sources (the first one from the banking system and the second from the State Governments⁸; therefore, cross-checking this information seems like a good way of finding hidden practices for the period 1995–1997.

We define two dependent variables, each one representing a possible definition of a hidden bailout. The first one (HIDDEN) uses the definition of debt reductions that are unmatched by fiscal state government surpluses. That is, when a SNG presents a fiscal deficit and still reduces the level of outstanding debt, this might be an indication of a hidden bailout. The second variable uses the variation in interest rates (CARGA), which reflects the differences in interest rates before and after debt renegotiations.⁹ As independent variables we included those of the previous analysis for the generalized bailout.

⁸ Source: Banco de México. We use an alternative source (with respect to the generalized bailout analysis) to cross-check information and detect possible hidden bailouts.

⁹ This may be important as an indication of a hidden bailout since interest rates negotiated after the crisis varied among states. This may suggest discrimination among States. Our data source for this is Banco de México public finance statistics.

The results are presented in tables 3 and 4 respectively. In the estimation process we use fixed effects by year.

As can be observed in table 3, the *too-big-to-fail* hypothesis (FORMAL) holds for the first definition of hidden bailout (HIDDEN): the sign of the coefficient is positive and statistically significant. With respect to vertical fiscal imbalance, the coefficient of the ratio of own revenues to total revenue (VERT) which represent it is negative and statistically significant, which suggests that the greater the vertical imbalance, the greater the hidden bailout. The coefficient of the

primary deficit (PRIM) and the GDP per capita is negative and not statistically significant.

In table 4 we present the results of the alternative definition of hidden bailout, namely the variation in interest rates (CARGA). In this case, the *too-big-to-fail* hypothesis (FORMAL) still holds. The GDP per capita is also positive and significant, suggesting that this type of bailout is regressive. Finally, in this regression, the political variable is not important in explaining this type of hidden bailout.

Table 3. Hidden bailout (discrepancy between PRIM and level of debt)

| Dependent variable HIDDEN | | | |
|---------------------------|--------------------------|----------------------------|-----------------------------|
| Fixed effects by year | | | |
| | Coefficient | Coefficient | Coefficient |
| POP | 0.069038 <i>3.086</i> | 0.06903 <i>3.08004</i> | |
| FORMAL | | | 0.517604 <i>2.433616</i> |
| PRIM. | 1.22123 <i>9.0147</i> | 1.231078 <i>9.0227</i> | 1.241404 <i>8.079054</i> |
| VERT. | 1654.82 <i>0.0118</i> | -15.029 <i>-0.10908</i> | 252254.4 <i>1.10653</i> |
| GDP PERC. | 330372 <i>2.2355</i> | 342729 <i>2.3338</i> | 781017.9 <i>2.68075</i> |
| GOV | | 51044.4 <i>1.2327</i> | |
| MUN | | -18358.6 <i>-0.5343</i> | |
| R2 | 0.680835 | 0.682068 | 0.623586 |
| DW | 2.316431 | 2.2862 | 2.271641 |

t-statistic in italics below the coefficient

Table 4. Hidden bailout – Debt renegotiation with Development Bank

| Dependent variable CARGA | | | |
|--------------------------|--------------------------------|------------------------------|--------------------------------|
| Fixed effects by year | | | |
| | Coefficient | Coefficient | Coefficient |
| POP | 2.13 E-04 <i>2.59058</i> | | 2.13 E-14 <i>2.5794</i> |
| FORMAL | | 2.48 E-13 3.167 | |
| PRIM. | -5.33 E-05 <i>-0.187994</i> | -3.21 E-15 <i>0.1276</i> | -1.45 E-14 <i>-0.45411</i> |
| VERT. | -3.49 E-07 <i>-1.842984</i> | -2.56 E-07 <i>-1.3797</i> | -3.37 E-07 <i>-1.762086</i> |
| GDP PERC. | 4.65 E-06 <i>2.336095</i> | 6.43 E-06 <i>2.9713</i> | 4.74 E-06 <i>2.463911</i> |
| GOV | | | -3.75 E-08 <i>-1.286915</i> |
| MUN | | | -4.24 E-09 <i>-0.121236</i> |
| R2 | 0.501812 | 6.50696 | 0.518481 |
| DW | 2.131461 | 2.171915 | 2.138079 |

t-statistic in italics below the coefficient

Potential form of hidden bailout: Development bank debt

Allowing SNGs to borrow to cover current expenditures contradicts the existing rules and can be interpreted as a formal bailout. This section examines that issue. The gearing effect of borrowing should in principle allow local governments to achieve a higher level of investment than that which could be supported by their current resources, thus helping to accelerate the pace of local development. We test this hypothesis (that the debt should be invested in projects). This is important for the Mexican case, because it can help to identify channels of hidden bailouts. This is because, as we have already mentioned, the Mexican law was designed under these basic principles of public finance. That is, state and local governments can only borrow to finance investment projects. If this

were the case, one would expect an increase in debt ratios to be associated to increases in local investment.

We ran a cross-section regression for the period 1994–1998. The dependent variable is the change in investment with the rate of change of debt contracted with both commercial and development banks as independent variables. Results are presented in table 5. These are striking. The coefficient of commercial bank debt is positive and statistically significant in relation to investment, while the coefficient of development bank debt is negative and statistically significant.

This result is especially important because it could indicate that the Federal Government indirectly bails out States through development banks; this suggests possible hidden bailouts.

Table 5. Regression between investment and stock of State debt

| Variable | Coefficient | Standard error | t-Statistic | Probability |
|------------------|-------------|----------------|-------------|-------------|
| Development bank | -0.164259 | 0.072336 | -2.270773 | 0.0243 |
| Commercial bank | 0.129623 | 0.053009 | 2.445323 | 0.0154 |
| R-squared | 0.839965 | | | |
| Durbin-Watson | 2.019115 | | | |

Pooled LS // Dependent Variable is INV
Sample: 1992 1996
Included observations: 5
Total panel observations 154

VIII. CONCLUSIONS

This paper has documented and analysed bailouts by the Mexican Federal Government of a number of States. In particular, we studied the generalized bailout carried out by the Federal Government as a result of the *tequila crisis*. Our study suggests that this bailout took two forms: an explicit bailout and a hidden one, both of which we analysed. We then proceeded to test several hypotheses.

First, the *too-big-to-fail* hypothesis turned out to be important in explaining bailouts, regardless of the definition we used. Second, vertical fiscal imbalance was not important in explaining this bailout. The other important variable was fiscal indiscipline – that is, when the state government was incapable of adjusting its expenditure, the extraordinary transfer followed. Also, bailouts proceeded after high fiscal deficits. That is, it pays to misbehave. Political variables were not important in explaining bailouts. These results also hold for hidden bailouts. We also found evidence that the development bank has lent for poor projects.

We also show that the generalized bailout created a moral hazard problem. It is clear from the analysis that states over-borrow because it is a way to obtain additional extraordinary funds. Another result of the analysis is that the existing institutional and legal framework is not adequate, since it provides incentives for states to borrow and banks to lend without evaluating the risk of the project.

Furthermore, the excessive indebtedness of local entities may have equity implications: bailouts tend to be highly regressive, as the poorer – low-debt – states receive much less in extraordinary resources.

Looking at how the money borrowed has been spent, our results suggest that, during the period under study, the debt incurred by the local governments with development banks has not been used to finance investment projects.

In terms of policy lessons, we suggest that the rules-based approach for the case of Mexico is adequate at least in the short to medium term, but additional action should be taken to try to replicate more closely the conditions of market discipline.¹⁰ The great advantage of using the rules-based system to check excessive SNG indebtedness is that it is transparent and impartial, qualities that help minimize political bargains and discretionality. A possible disadvantage is that the inflexibility inherent in such a system tends to limit productive financing and to encourage local entities to try all possible devices to circumvent the rules. Another disadvantage is that such a system does not automatically adapt to changing circumstances (for details, see Ter-Minassian, 1996).

¹⁰ Bayoumi, Goldstein and Woglom (1995) study this issue for the case of the United States.

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EVOLUTION AND CONTROL OF SUB-NATIONAL PUBLIC DEBT IN BRAZIL

Cláudio Gontijo

I. INTRODUCTION

The Russian moratorium in August 1998 and, more recently, the Argentine compulsory debt restructuring have called attention to the indebtedness of the public sector of emerging countries. Although Brazil is not experiencing a crisis of confidence, the growth rate of its public debt indicates that it is not far from it: the net debt/gross domestic product (GDP) ratio increased from 28.5 per cent in 1994 to 54.8 per cent last September (figure 1). Thanks to privatization, all levels of the Brazilian public sector, with the exception of the State-owned companies, have taken part in this process. At constant September prices, the Federal Government and Central Bank's net debt increased from \$ 117.4 billion (12.3 per cent of GDP) in December 1994 to more than \$ 332.0 billion (34.1 per cent of GDP) last September. During the same period, the net debt of the sub-national public sector rose from \$ 91.1 billion (9.5 per cent of GDP) to \$ 188.5 billion (18.37 per cent of GDP). Because of privatization, only the net debt of the State-owned companies alone decreased from \$ 64.6 billion (6.7 per cent of GDP) to \$ 27.4 billion (2.3 per cent of GDP).

Paradoxically, although Brazil did not set up an independent debt management office as recommended by the International Monetary Fund (IMF) and the United Nations Conference on Trade and Development (UNCTAD) (see Ricupero, 1997, p. 2; Tricárico and Nastri, 1997; Borresen and Cosio-Pascal E, 2000; IMF and World Bank, 2000), there has been a great effort to control the growth of public debt, particularly at the sub-national level, through restrictive legislation and institutional actions (table 1).

The purpose of this paper is to discuss the process of indebtedness of the Brazilian public sector, particularly at the sub-national level, and the efforts that have been made to control it. Emphasis is placed on the regulatory apparatus that has been set up to avoid excessive indebtedness and the reason of its apparent failure.

Section II contains a discussion about the size of the public debt. The origin, evolution and control of the Brazilian public debt at the

sub-national level are described in section III. Section IV discusses the relationship between macroeconomic dynamics, interest rate and public debt in Brazil in the recent period, while section V summarizes the conclusions.

II. THE SIZE OF THE PUBLIC DEBT

The importance of avoiding excessive indebtedness in the public sector has been extensively analysed and written about. Alesina, Prati and Tabellini (1990) stressed that financial crises could be caused by investors' reluctance to renew their credit to the government. To avoid crises, they recommended that debt be long-term instead of short-term, and that its payment schedule be evenly distributed over time since, under such conditions the monetary impact of the investors' refusal to renew lending would be minimal. A similar approach was adopted by Giavazzi and Pegano (1990, p.26), who stated that "in a situation where the stock of debt is high, the average maturity is short and maturing debt is concentrated at a few dates, the Treasury has to borrow huge amounts from the market at those dates. If on one of those dates a confidence crisis occurs, the Treasury finds itself in the critical situation of refinancing a large portion of its debt on unfavourable terms." On that basis, they recommended that the period of the debt be lengthened and that its payments be smoothed over time.

Although the damage caused by a crisis of confidence is minimized when the debt is long-term and evenly distributed over time, it should be stressed (see Dornbush and Dragui, 1990, p. 120) that these circumstances do not prevent such crises, which are not a problem of flow, but of stock. In other words, an excessive debt can result in investors' refusal to lend to the government even when the public debt is well structured in terms of time.

Obviously, public debt is not low or high in itself, except if parameters, such as fiscal balance, interest rate, current account and exchange rate are taken into account. Indeed, by definition, the real variation of the public net debt in period t ($\Delta D_t = D_t - D_{t-1}$) is equal to the opera-

tional deficit (financial needs of the public sector, FNPSop), which is also equal to primary deficit (FNPSpr) plus real interests paid on public debt. Since primary deficit is also the difference between non-financial expenses of the public sector (G) and its net receipts (T), it follows that the operational deficit equals this difference plus interests paid on public debt:

$$\begin{aligned} \text{FNPSop} &= \Delta D_t = D_t - D_{t-1} = \text{FNPSpr} + i D_{t-1} \\ &= G - T + i D_{t-1} \end{aligned} \quad (1)$$

where i stands for interest rate.

From this can be derived the ratio between operational deficit and gross domestic product (GDP) in period t (d_t):

$$d_t = (D_t - D_{t-1})/Y_t = (G - T)/Y_t + i D_{t-1}/Y_t$$

Setting y as the rate of economic growth ($y = Y_t/Y_{t-1} - 1$), g as the ratio between non-financial expenses of the public sector, and t as the ratio between its net receipts and GDP (the “fiscal burden”), we have:

$$d_t = \frac{i D_{t-1}}{(1 + y) Y_{t-1}} - (t - g)$$

or

$$d_t = [i/(1 + y)] \delta_{t-1} - (t - g) \quad (2)$$

where $(t - g)$ means the ratio between the primary surplus and GDP and δ is the debt/GDP ratio.

On the basis of identity (2), it may be said that the public debt is high if the evolution of the debt/GDP ratio becomes crucially dependent on the ratio between the real interest rate and the rate of economic growth and less sensitive to the primary surplus/GDP ratio. Under these circumstances, the debt/GDP ratio may increase, even if there is a huge primary surplus, and the inves-

tors may become increasingly unwilling to lend money to the public sector. Now, if it is considered that the interest rate is sensitive to the investors’ mood and to the current account, the logic of a crisis of confidence can be easily understood: the increasing debt/GDP ratio or persistent primary deficits may convince investors that lending to the public sector is becoming a risky business. As a result, they demand an increase in interest rates to renew the public debt, which worsens the situation until it develops into a crisis of confidence.

III. ORIGIN, EVOLUTION AND CONTROL OF THE BRAZILIAN SUB-NATIONAL PUBLIC DEBT

Public debt became an effective instrument of long-term financing in Brazil only after the institution of indexation in the 1960s, through the *Obrigações Reajustáveis do Tesouro Nacional* (ORTNs), a bond issued by the National Treasury. Previously, the combination of high inflation with the so-called Usury Law, which forbade the lending of money at a nominal interest rate above 12 per cent a year, prevented the development of long-term financing. At the same time, Law 4131 and the Central Bank’s Resolution 63/67 instituted the legal framework for capturing resources in the international market.

The Brazilian public debt grew rapidly during the 1970s, but it was only after the international debt crisis that followed Mexico’s moratorium in September 1982 that it became a problem. Nevertheless, the concern regarding the process of indebtedness of states and municipalities led the Brazilian Senate to enact several resolutions to control it. During the period 1968–1975, Senate Resolution 58/68 prohibited states and municipalities from issuing bonds of any kind, but permitted them to contract some credit operations, particularly the so-called advances of fiscal revenue (AROs). Senate Resolutions 62/75 and 93/76 put a ceiling on the internal debt, issuing of bonds, debt service and ordinary credit operations, but did not control the external debt nor credit from governmental banks (Caixa Econômica Federal, BNDE, etc.).

**Table 1. Limits to state debt : main Senate resolutions
(Brazil, 1975–1995)**

| Subject | Resolution | | | | |
|-----------------------------------|-------------------------------------|---|---------------------------------------|---|---|
| | 62/1975 and 93/1976 | 94/1989 | 58/1990 | 11/1994 | 69/1995 |
| Total Debt | | | | | |
| 1 Internal debt | 70% of net revenue ⁽¹⁾ | | | | |
| 2 Growth of real internal debt | 20% of the increment of net revenue | | | | |
| 3 Debt service | 15% of net revenue | Margin of real savings (MRS) ⁽²⁾ | Margin of real savings ⁽³⁾ | MRS (2) or 15% of net revenue ⁽⁴⁾ | MRS ⁽²⁾ or 16% of net revenue ⁽⁴⁾ |
| 4 Credit operations | | Capital expenditures Debt service + 10% of net revenue | Capital expenditures Debt service | Capital expenditures Debt service or 27% of net revenue ⁽⁴⁾ | Capital expenditures Debt service or 27% of net revenue ⁽⁴⁾ |
| Advances of fiscal revenue | | | | | |
| 1 Amount | 25% of total revenue | 25% of total revenue | 25% of total revenue | 15% of estimated net revenue ⁽⁵⁾ | |
| 2 Service | 5% of total revenue | 7% of total revenue | 7% of total revenue | 7% of estimated net revenue ⁽⁵⁾ | |
| Bonds | | | | | |
| | 35% of total revenue | | | | |

Source: Almeida (1996, p. 10)

Notes: ⁽¹⁾ Net from credit operations;

⁽²⁾ Net revenue minus current expenses plus debt service;

⁽³⁾ Net revenue minus current expenses;

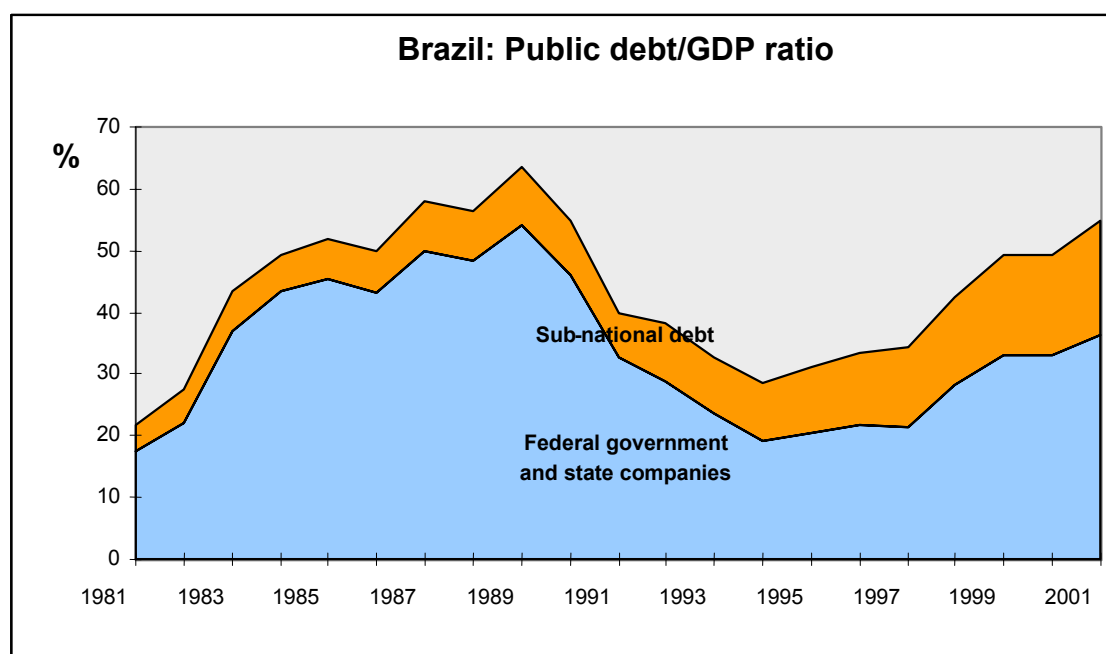
⁽⁴⁾ Total revenue minus capital receipts and transfers to municipalities;

⁽⁵⁾ Expected net revenue.

After the external debt crisis of 1981/1982, the Brazilian Government agreed in accordance with the recommendation of the International Monetary Fund (IMF), to implement adjustment programmes based on a tax increase, expenditure cutting and other measures to cut domestic absorption. The Brazilian Central Bank and the Senate, in a joint effort, passed a number of resolutions to restrict states' and municipalities' indebtedness. The Central Bank's Resolution 831/83 imposed restricted credit limits on states, municipalities and state companies, forcing them

to amortize part of their debt. However, they resorted to triangular operations to circumvent the restrictions (Oliveira, 1995). But the resulting fall in the share of states and municipalities in public debt during the 1980s did not prevent the worsening of their fiscal situation, with a concentration of debt in the short run and an increase in overdue payments. The fiscal deterioration of the Brazilian states affected their banks, which were used to carry state bonds, making them almost insolvent.

Figure 1.



Source: Central Bank of Brazil.

Under these circumstances, the federal government lent money to states ("Avisos" GB-588/67, MF-30 and MF-09) to enable them to honour their debt payments. On the basis of Law 7614 and National Monetary Council Votes Nos. 340 and 548, the Federal Government refinanced state debts for four years at low interest rates, opened new credit lines for them to cover their budget deficits, and created a programme for restructuring state banks that were close to insolvency because they were carrying state bonds. However, as these measures did not solve the problem, the Federal Government was forced to adopt a more comprehensive approach. While the Central Bank's Resolution 1469/88 limited the credits granted by financial institutions to the non-financial public sector to the

real value of their positions on 31 December 1987 and the Senate Resolution 94/89 adopted the concept of "real savings margin" instead of "net revenue", the amount of credit operations took the place of the amount of debt as the variable to be controlled and the short term and the external debt were included in the Resolution. Once, in accordance with Law 7614, the grace period ended, the National Monetary Council (Vote 128/89) granted the states an additional six months and, before this period expired, Law 7976/89 extended the period to 20 years.

The reasons for the failure of the attempts to control the sub-national debt during the 1980s are not difficult to identify:

- (i) The lack of fiscal state resources in the face of a high debt;
- (ii) The lack of efficient debt control instruments, mainly before 1987, when the states could borrow out of the limits imposed by the Senate and Central Bank resolutions;
- (iii) The absence of a comprehensive treatment of the question;
- (iv) The federal government's decision to honour external debt without renegotiating its terms; and
- (v) The lack of counterpart from the states that had their debt partially assumed by the federal government and did not take effective measures to adjust their budget.

The implementation of the Collor Plan in March 1991 – which froze financial assets, imposed a tax of 8 per cent on net financial wealth and corrected the nominal value of the frozen assets below the inflation index – caused a sharp devaluation of public debt at all government levels. Simultaneously, the Brazilian Federal Government started to treat state indebtedness from a comprehensive perspective. With the same conditions as Law 8388/91, which was not enforced, Law 8727/93 authorized the Federal Government to assume the states and municipalities' debt to Federal Banks and Agencies (BNH, FNDU, FAS, etc.), scheduled for a 20-year period and with moderate interest rates. The limit of debt service was 9 per cent, in 1994 and 11 per cent for the subsequent years. According to Lacerda (1997, p 5), 24 states and 111 municipalities joined the programme and four years later (August 1997), the amount of the refinanced debt was close to \$ 41.1 billion.

From 1991 to 1993, the emergence of a fiscal surplus caused by the fall in the debt service, privatization and the increase in the fiscal receipts/GDP ratio contributed to the fall of the debt/GDP ratio for the public sector as a whole. Nevertheless, the debt/GDP ratio rose at the sub-national level from 7.1 per cent to 9.3 per cent, while the participation of states and municipalities in public debt rose from 17.9 per cent to 28.2 per cent in the same period. Since the primary balance of states and municipalities showed a primary surplus, the explanation of the apparent paradox was the high rate of interest that prevailed during the period. To prevent a further deterioration of the fiscal situation, the Brazilian Congress approved the Constitutional

Amendment No. 3/93, which prohibited the states from issuing bonds until 31 December 1999, allowing them to refinance the principal and obtain resources to cover compensation payments under judicial mandates.

With the end of the high inflation resulting from the implementation of the Real Plan, in July 1994 Brazil reached a situation of macroeconomic equilibrium, characterized by primary (5.1 per cent of GDP) and operational (1.3 per cent of GDP) fiscal surplus, surplus in international trade (\$ 10 billion), virtual equilibrium in the current account (deficit of only US\$ 1.7 billion), low external debt (\$ 148.3 billion) and low public debt/GDP ratio (28.5 per cent). However, the fiscal equilibrium did not extend to the sub-national levels: states and municipalities showed a primary surplus of almost 0.9 per cent of GDP, and presented a small operational deficit (0.6 per cent of GDP).

The Brazilian macroeconomic situation changed completely after 1994, as a result of the combination of commercial and financial liberalization, overvaluation of the national currency and the high interest rate. The logic of the process was as follows. As a result of the adoption of a free trade regime in a context of rapid economic growth and an overvalued currency, the trade balance became negative, while the policy of attracting foreign capital increased the interest payments on the external debt and remittances of profits abroad. The emergence of current account deficits was concomitant with the deterioration of the international situation caused by the Mexican crisis, forcing the Brazilian Central Bank to maintain high interest rates to attract international capital, so as to avoid currency devaluation. The high interest rate hampered economic growth and caused a rapid expansion of public debt. When Brazil adopted a "dirty" floating exchange rate regime on January 1999 the debt/GDP ratio was already high (42.6 per cent).

During that period there were several attempts to control the sub-national public debt. Following Constitutional Amendment No. 3/93, Senate Resolutions 11/94 and 69/95 set 9 per cent of net real revenue as the ceiling of state debt service for 1994 and 11 per cent for the subsequent years. The states had to offer their part in federal taxes (Fundo de Participação dos Estados) as a guarantee to the Federal Govern-

ment.² Monetary Council Vote 165/95 authorized the states to borrow from federal credit agencies for covering state obligations with operations of advances of fiscal revenue, and to finance a programme for voluntary resignation of public servants, among others, including the rescue of state banks. However, these measures were not sufficient to curb the process of state indebtedness, since the securities debt was not refinanced by the Federal Government, although article 6 of Law 8727 (see table 2) provides for definition of criteria and mechanisms for it. In addition, there was no provision regarding any adjustment programme by the states' and municipalities' beneficiaries.

At the beginning of 1997, the fiscal and indebtedness situation of most Brazilian states and some municipalities (São Paulo and Rio de Janeiro) was quite serious. As can be seen in Table 3, the North region had the lowest debt/revenue ratio (94.6 per cent), although in some cases (Roraima, Acre and Rondônia), this ratio was very high. For all other regions, the debt/revenue ratio was greater than one, which means that the amount of debt was greater than the value of annual net revenue receipts. With the exception of Roraima, Alagoas, Maranhão, Piauí, Goiás, Mato Grosso and Mato Grosso do Sul, the states in the worst situation were the more developed ones: São Paulo (debt/revenue ratio of 278.1 per cent), Rio de Janeiro (202.6 per cent), Minas Gerais (228.1 per cent), and Rio Grande do Sul (277.2 per cent).

To face this situation, a whole set of measures was taken. Law 9496 of 11 September 1997 authorized the Union to refinance not only state debts in bonds but also those that were contracted under Vote 162/95, as well as other debts to be defined in the negotiation process between the state and the Federal Government (Lacerda, 1997). The term of the operation was 30 years, extended to an additional 10 years; the real interest rate was set at 6.0 per cent for those states that redeemed 20 per cent of their debt with the proceeds of the privatization of public companies and 7.5 per cent for those that redeemed only 10 per cent. The ceiling for the debt service was set at 13.5% of the net revenue receipts. In addition, the states that signed the accord had to implement an adjustment programme whose goal was to make their debt equal to their net revenue receipts. Without underestimating the importance of other instruments of debt control such as the Ministry of Finance's Decree 289/97, which defined the states' and municipalities' ability to pay, it may be said that the most important piece of legislation in recent years was the so-called Law on Fiscal Responsibility (Complementary Law No. 14,062/01), which imposes a fiscal adjustment to the Brazilian sub-national public sector.

² The limits set by these Resolutions do not include: (a) payments regarding debt contracts signed before 30 September 1991; (b) obligations in favour of the Brazilian Social Security Agency (INSS); or (c) debts refinanced through Law 7976. If the debt service was below the limit, the difference had to be used to pay off the obligations renegotiated under Law 8727; if the debt service were higher than the limit, the difference would be refinanced for an additional period of 10 years.

Table 2. Stages, instruments, and conditions of state debt renegotiation with the federal government

| Year | Instrument | Refinancing/rescue | Conditions |
|-------------|------------------------------|---|--|
| 1983 | “Avisos” Mf-30,09 and others | External debt (contractual) | |
| 1987 | Law 7614 (MNC Vote 340/87) | Debt rolling and “net money” | Term: 4 years; grace period: 18 months; charges: 10% p.a. + indexation |
| 1987 | Law 7614 (MNC Vote 548/87) | Refinancing for restructuring 10 state banks | Term: 15 years; grace period: 18 months; charges: SELIC cost |
| 1989 | Law 7976 | Debts outstanding "Avisos" MF-30/87 and others | Term: 20 years; grace period: 5 years; charges: exchange indexation and the LIBOR + 13/16 p.a. |
| 1989 | E.C. | Debts contracted under National Monetary Council Votes 340 and 548/87 | Term.: 20 years; grace period: 5 years; charges: TR + interest of 10% and 12% p.a. respectively |
| 1989 | | Restructuring of external debt contracted up to 1983 | Benefits passed on to borrowers which became debtors the National Treasury of Bonuses named BIB, BEA and DMLP |
| 1993 | Law 8727 | Debts to the Union-controlled agencies and entities | Term: 20 years, postponable for 10 more years; charges: weighted average of original charges; monthly instalments up to the limit of 11% of net real revenue |
| 1995 | NMC Vote 162/95 | Payment of unpostponable commitments (13o. salary); voluntary resign program (PED); acquisition of AROs | Term: December 1998; charges: average of CEF’s funding, CEF + 0.5% p.m. |

Source: Federal Senate and Central Bank of Brazil.

Table 3. Brazilian states: debt and net revenue receipts
Position on 30 June 1997
 (US\$ billion at constant prices of June, 2001)

| Region/state | Total debt | Net revenue receipts | Debt/revenue (%) |
|--------------------|------------|----------------------|------------------|
| North | 5 667.7 | 5 993.7 | 94.6 |
| Acre | 684.8 | 484.3 | 141.4 |
| Amapá | 86.2 | 546.0 | 15.8 |
| Pará | 1 485.9 | 1 735.4 | 85.6 |
| Rondônia | 1 034.1 | 652.5 | 158.5 |
| Roraima | 153.4 | 27.6 | 555.2 |
| Tocantins | 340.3 | 726.7 | 46.8 |
| North-East | 24 821.0 | 15 346.6 | 161.7 |
| Alagoas | 2 353.7 | 859.7 | 273.8 |
| Bahia | 6 350.5 | 4 262.2 | 149.0 |
| Ceará | 2 573.1 | 2 439.7 | 105.5 |
| Maranhão | 3 405.2 | 1 454.6 | 234.1 |
| Paraíba | 2 270.7 | 1 219.9 | 186.1 |
| Pernambuco | 3 437.1 | 2 499.9 | 137.5 |
| Piauí | 2 151.6 | 972.9 | 221.2 |
| R.G. Norte | 983.1 | 833.0 | 118.0 |
| Centre-West | 14 254.8 | 8 609.2 | 165.6 |
| Distrito Federal | 986.9 | 4 400.1 | 22.4 |
| Goiás | 6 536.5 | 1 955.1 | 334.3 |
| Mato Grosso | 3 950.7 | 1 380.5 | 286.2 |
| M. Grosso Sul | 2 780.5 | 873.5 | 318.3 |
| Southeast | 106 884.2 | 43 368.6 | 246.5 |
| Minas Gerais | 17 382.6 | 7 620.6 | 228.1 |
| Espírito Santo | 1 585.1 | 2 095.6 | 75.6 |
| São Paulo | 72 679.6 | 26 131.8 | 278.1 |
| Rio de Janeiro | 15 238.1 | 7 520.6 | 202.6 |
| South | 25 420.0 | 11 867.9 | 214.2 |
| Paraná | 4 107.8 | 3 397.6 | 120.9 |
| Rio G. do Sul | 16 223.0 | 5 852.3 | 277.2 |
| Santa Catarina | 5 041.7 | 2 618.0 | 192.6 |
| All states | 177 047.6 | 85 186.1 | 207.8 |

Source: Secretaria do Tesouro Nacional. Folha de São Paulo, 20 January 1998.

Note: ⁽¹⁾ Using the exchange rate purchasing power parity.

Inspired by New Zealand's legislation, the Law on Fiscal Responsibility imposes budget balancing a goal for public administration, restricting its non-financial expenses and limiting public debt, although this represents an usurpation of a Senate constitutional power. It embraces all levels of the Brazilian public sector, including the Federal Government, states, municipalities and "dependent" public enterprises. Failure to comply with its provisions is a criminal offence, subjecting the offender to many different penalties, including

ferent penalties, including imprisonment. The limits on expenditures in terms of personal, social security and other current expenses are set as proportions to the fiscal revenue. If some of these limits, mainly the debt ceiling, are exceeded, the public entity must cut its non-financial expenses, dismissing personnel, and cutting wages and other current expenditures. In addition, a federal finance agency such as Banco do Brasil is entitled to control its cash flow until the debt is under its limit once again. No fiscal

incentive is allowed unless there is a compensatory increase in revenue receipts or a decrease in other non-financial expenditures; all public credit operations must have the Central Bank's approval; credit operations are tied to capital expenditures; the financial surplus cannot be used for financing current expenses; and public entities cannot borrow from state enterprises.

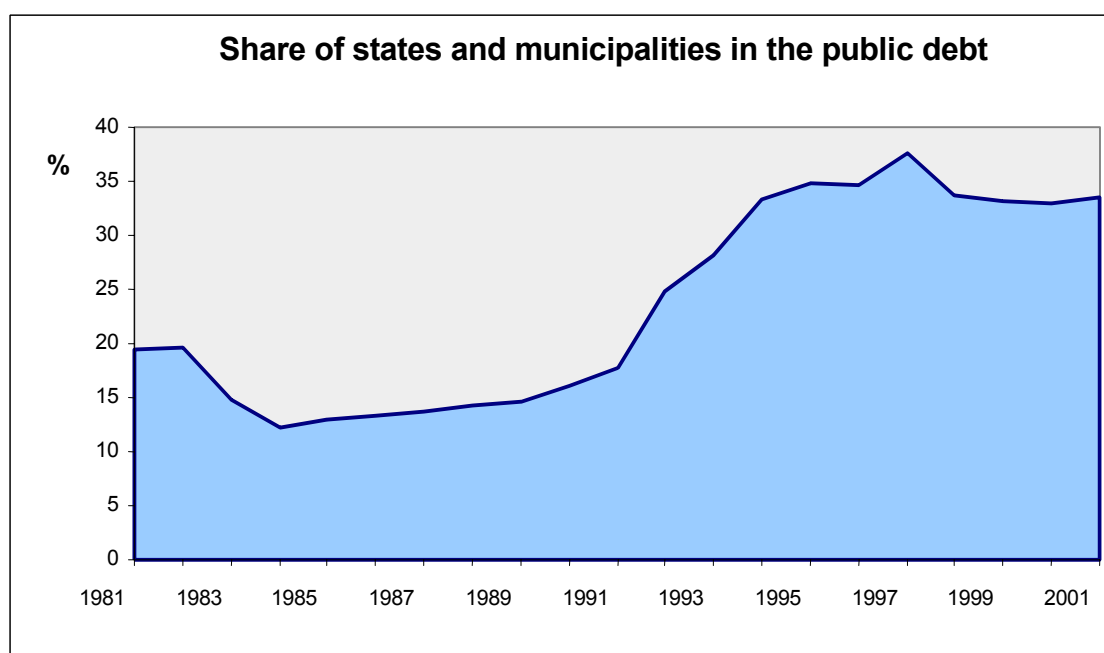
IV. MACROECONOMIC DYNAMICS, INTEREST RATE, AND THE PUBLIC DEBT

Although it could be said that there has not been enough time for the Law on Fiscal Responsibility to do its work, the rapid growth of public debt seems to indicate that the complex and very restrictive Brazilian legislation regarding debt and fiscal control has failed so far. In the last

three years the public debt increased by 12.2 per cent of GDP and the operational deficit reached 5.52 per cent of GDP in the 12 previous months to last September.

It is clear that the reason for this failure does not lie in any inability to control the non-financial public expenditures, since the magnitude of the primary surplus has been above 3.2 per cent of GDP since 1998, and the states and local government have contributed to it (in the 12 months to last September, the fiscal balance of states and municipalities showed a primary surplus of more than 0.8 per cent of GDP). The success of the Debt Accord of 1987 signed between the states and the Federal Government and the restrictive Brazilian legislation seem to have curbed the increase in the states' and municipalities' share in the public debt, interrupting a historical trend (figure 2).

Figure 2.



Source: Central Bank of Brazil.

Since there has been an impressive primary surplus, it seems quite obvious that the heavy debt service has to be blamed for the operational deficit: in the last four years the average interest burden has been above 7 per cent of GDP. In

turn, the explanation for the heavy debt service can be found in the interest rate, whose average has been much higher than the rate of economic growth and profit rate since 1988 (table 4).

**Table 4. Fiscal and other variables
Brazil, 1993 – September 2001**

| Year | Net public debt/GDP ⁽¹⁾ | Real interest rate ⁽³⁾ | Profit rate ⁽⁴⁾ | Rate of economic growth | Fiscal revenue/GDP | Non-financial Expenditures /GDP | % |
|---------------------|------------------------------------|-----------------------------------|----------------------------|-------------------------|--------------------|---------------------------------|---|
| 1993 | 32.8 | 12.45 | 1.13 | 4.9 | 25.8 | 23.7 | |
| 1994 | 28.5 | 24.22 | 5.05 | 5.9 | 29.8 | 24.7 | |
| 1995 | 31.2 | 33.37 | 1.55 | 4.2 | 29.4 | 29.1 | |
| 1996 | 33.3 | 16.65 | 1.61 | 2.7 | 29.1 | 29.0 | |
| 1997 | 34.5 | 16.08 | 2.78 | 3.3 | 29.6 | 30.6 | |
| 1998 | 42.6 | 26.63 | 3.70 | 0.2 | 29.6 | 29.6 | |
| 1999 | 49.4 | 4.67 | -0.55 | 0.8 | 31.6 | 28.4 | |
| 2000 | 49.3 | 6.94 | 5.41 | 4.5 | 32.6 | 29.1 | |
| 2001 ⁽²⁾ | 54.8 | 4.25 | --- | 1.8 | --- | --- | |

Source: Central Bank of Brazil; *Conjuntura Econômica*.

Notes ⁽¹⁾ Position on 31 December.

⁽²⁾ Overnight.

⁽³⁾ 500 larger non-financial corporations.

⁽⁴⁾ Net Public Debt: position on September 30th; real interest rate: average of the last 12 months; economic growth and fiscal revenue: expected for 2001

Actually, from identity (2) it can be seen that, for a fiscal burden of 32 per cent and a non-financial expenditures/GDP ratio of 29 per cent, the real interest rate must be 6.1 per cent to keep the debt/GDP ratio at around 50 per cent, assuming that the rate of economic growth is 1.8 per cent. This would cause no trouble if the external situation was under control or the public debt in foreign currency was low. However, the public non-financial external debt is \$ 92.1 billion, and 31.4 per cent of the Brazilian public debt in securities is now indexed to the United States dollar, whose value rose by about 30 per cent only this year; owing to the pressure in the exchange market caused by the disequilibrium in the balance of payments, the average rate of interest on public bonds is higher than 13 per cent. In other words, unless the Brazilian authorities are able to stabilize the exchange rate, any attempt to stop the growth of the public debt will not succeed. Considering that the value of the exchange rate has more than doubled since December 1998, and the deficit in the current account amounts to 5.0 per cent of GDP, this would be a hard task indeed. The irony is that the main instrument that the Brazilian Government has for controlling the exchange rate – increasing the interest rate – is the one that can be blamed for the expansion of its public debt!

V. CONCLUSIONS

It can be concluded that the worsening of the Brazilian fiscal situation and the systematic growth of Brazil's public debt in recent times have not been caused by any inability to control non-financial public expenditures (tables 5 and 6). Brazil now has comprehensive, complex and very restrictive legislation regarding debt and fiscal control covering all levels of government. Furthermore, it has been able to produce impressive primary surpluses. The reason for its failure lies in its inability to control the real interest rate, which has been suffering the pressures on the exchange market due to Brazil's balance-of-payments disequilibrium. In other words, Brazil has fallen into an interest rate trap, characterized by a situation where the debt/GDP ratio has become dependent on the ratio between the interest rate and the rate of economic growth, and less sensitive to the primary surplus/GDP ratio. Under these circumstances, unless Brazil controls the exchange rate and, at the same time, is able to maintain a low real interest rate, a crisis of confidence may develop in the future.

**Table 5. Net debt of public sector/GDP
Brazil, 1981 – September 2001**

| Items | % GDP | | | | | | | | | |
|-------------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| | Years | | | | | | | | | |
| | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 |
| Total net debt | 21.58 | 27.53 | 43.27 | 49.32 | 51.96 | 49.89 | 57.93 | 56.37 | 63.59 | 54.85 |
| Federal Government and Central Bank | 12.94 | 15.87 | 30.23 | 19.25 | 18.84 | 19.98 | 23.20 | 22.67 | 30.46 | 22.93 |
| States and municipalities | 4.20 | 5.40 | 6.40 | 6.02 | 6.73 | 6.68 | 7.98 | 8.00 | 9.36 | 8.86 |
| State companies | 4.44 | 6.26 | 6.64 | 24.05 | 26.39 | 23.24 | 26.76 | 25.69 | 23.78 | 23.06 |
| Internal net debt | 8.78 | 12.47 | 15.63 | 19.53 | 21.16 | 20.40 | 22.89 | 25.49 | 33.82 | 24.13 |
| Federal Government and Central Bank | 1.59 | 2.59 | 4.96 | 7.05 | 7.46 | 6.22 | 4.16 | 4.82 | 12.01 | 3.87 |
| States and municipalities | 2.84 | 3.76 | 4.07 | 4.37 | 4.65 | 4.77 | 6.11 | 6.31 | 7.96 | 7.43 |
| State companies | 4.35 | 6.11 | 6.82 | 8.11 | 9.05 | 9.41 | 12.62 | 14.35 | 13.85 | 12.84 |
| External net debt | 12.80 | 15.06 | 27.64 | 29.79 | 30.80 | 29.49 | 35.05 | 30.88 | 29.77 | 30.72 |
| Federal Government and Central Bank | 11.36 | 13.28 | 25.28 | 12.20 | 11.39 | 13.75 | 19.04 | 17.85 | 18.45 | 19.07 |
| States and municipalities | 1.36 | 1.64 | 2.33 | 1.65 | 2.08 | 1.91 | 1.87 | 1.69 | 1.39 | 1.43 |
| State companies | 0.09 | 0.14 | -0.18 | 15.95 | 17.33 | 13.83 | 14.14 | 11.34 | 9.93 | 10.22 |

Source: Central Bank of Brazil.

**Table 5. (continued) Net debt of public sector/GDP
Brazil, 1981 – September 2001**

| Items | % GDP | | | | | | | | | | |
|-------------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| | 1991 | 1992 | 1993 | 1994 | 1995 | Year 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
| Total net debt | 39.72 | 38.13 | 32.83 | 28.49 | 31.19 | 33.26 | 34.48 | 42.60 | 49.39 | 49.29 | 54.82 |
| Federal Government and Central Bank | 13.48 | 12.49 | 9.63 | 12.25 | 13.54 | 15.87 | 18.75 | 25.34 | 30.23 | 30.89 | 34.14 |
| States and municipalities | 7.09 | 9.45 | 9.27 | 9.50 | 10.85 | 11.53 | 12.96 | 14.35 | 16.33 | 16.22 | 18.37 |
| State companies | 19.15 | 16.20 | 13.94 | 6.74 | 6.81 | 5.86 | 2.77 | 2.90 | 2.83 | 2.18 | 2.31 |
| Internal net debt | 14.89 | 18.95 | 18.46 | 20.24 | 25.49 | 29.36 | 30.16 | 36.02 | 38.99 | 39.55 | 43.21 |
| Federal Government and Central Bank | -2.13 | 0.84 | 1.83 | 6.21 | 9.99 | 14.30 | 16.80 | 21.09 | 22.28 | 23.42 | 25.20 |
| States and municipalities | 6.38 | 8.38 | 8.26 | 9.17 | 10.51 | 11.16 | 12.47 | 13.67 | 15.43 | 15.25 | 17.19 |
| State companies | 10.64 | 9.73 | 8.37 | 4.86 | 4.99 | 3.90 | 0.89 | 1.26 | 1.28 | 0.88 | 0.82 |
| External net debt | 25.53 | 19.24 | 14.37 | 8.25 | 5.71 | 3.90 | 4.31 | 6.57 | 10.40 | 9.74 | 11.61 |
| Federal Government and Central Bank | 15.60 | 11.64 | 7.79 | 6.03 | 3.55 | 1.57 | 1.95 | 4.25 | 7.95 | 7.47 | 8.94 |
| States and municipalities | 1.42 | 1.12 | 1.01 | 0.34 | 0.34 | 0.37 | 0.48 | 0.67 | 0.90 | 0.97 | 1.18 |
| State companies | 8.51 | 6.47 | 5.57 | 1.88 | 1.82 | 1.97 | 1.88 | 1.65 | 1.55 | 1.30 | 1.49 |

Source: Central Bank of Brazil.

**Table 6. Financial needs of public sector/GDP
Brazil, 1983 – September 2001**

| Items | % GDP | | | | | | | |
|-------------------------------------|-------------|-------------|--------------|--------------|-------------|--------------|-------------|--------------|
| | Year | | | | | | | |
| | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 |
| Primary needs | ... | ... | -2.60 | -2.14 | 0.80 | -0.39 | 0.25 | -2.23 |
| Federal Government and Central Bank | ... | ... | -1.60 | -0.93 | 1.61 | 1.50 | 0.71 | -1.46 |
| States and municipalities | ... | ... | -0.10 | 0.10 | 0.60 | -0.50 | -0.30 | -0.33 |
| State companies | ... | ... | -0.90 | -1.31 | -1.41 | -1.39 | -0.16 | -0.44 |
| Real interests | ... | ... | 7.00 | 5.76 | 4.85 | 5.21 | 6.60 | 0.90 |
| Federal Government and Central Bank | ... | ... | 2.70 | 2.26 | 1.57 | 1.95 | 3.22 | -0.87 |
| States and municipalities | ... | ... | 1.10 | 0.80 | 1.00 | 0.90 | 0.86 | 0.72 |
| State companies | ... | ... | 3.20 | 2.70 | 2.28 | 2.37 | 2.52 | 1.05 |
| Operational needs | 3.00 | 1.60 | 4.40 | 3.62 | 5.65 | 4.82 | 6.85 | -1.33 |
| Federal Government and Central Bank | -0.10 | 0.50 | 1.10 | 1.33 | 3.18 | 3.45 | 3.93 | -2.33 |
| States and municipalities | 0.30 | -0.40 | 1.00 | 0.90 | 1.60 | 0.40 | 0.56 | 0.39 |
| State companies | 2.90 | 1.50 | 2.30 | 1.39 | 0.87 | 0.97 | 2.36 | 0.61 |

Source: Central Bank of Brazil.

**Table 6. (continued) Net debt of public sector/GDP
Brazil, 1983 – September 2001**

| Items | % GDP | | | | | | | | | | |
|-------------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|-------------|--------------|--------------|--------------|--------------|
| | 1991 | 1992 | 1993 | 1994 | 1995 | Year 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
| Primary needs | -2.77 | -1.77 | -2.10 | -5.09 | -0.26 | -0.11 | 1.02 | -0.01 | -3.24 | -3.50 | -3.79 |
| Federal Government and Central Bank | -1.17 | -1.36 | -0.90 | -3.05 | -0.50 | -0.31 | 0.33 | -0.56 | -2.36 | -1.88 | -1.99 |
| States and municipalities | -1.25 | -0.13 | -0.80 | -0.85 | 0.18 | 0.19 | 0.74 | 0.19 | -0.22 | -0.55 | -0.83 |
| State companies | -0.35 | -0.28 | -0.40 | -1.19 | 0.06 | 0.01 | -0.06 | 0.35 | -0.66 | -1.07 | -0.97 |
| Real interests | 2.80 | 3.36 | 2.60 | 3.77 | 5.17 | 0.39 | 3.31 | 7.51 | 6.66 | 4.67 | 9.31 |
| Federal Government and Central Bank | 1.06 | 1.72 | 1.30 | 1.48 | 2.22 | 0.16 | 1.44 | 5.76 | 5.54 | 3.18 | 5.23 |
| States and municipalities | 0.61 | 0.76 | 0.60 | 1.41 | 2.15 | 0.23 | 1.53 | 1.61 | 0.72 | 1.25 | 2.98 |
| State companies | 1.13 | 0.88 | 0.70 | 0.88 | 0.79 | 0.01 | 0.35 | 0.14 | 0.40 | 0.24 | 1.10 |
| Operational needs | 0.03 | 1.59 | 0.50 | -1.32 | 4.90 | 0.28 | 4.33 | 7.50 | 3.42 | 1.17 | 5.52 |
| Federal Government and Central Bank | -0.11 | 0.36 | 0.40 | -1.57 | 1.72 | -0.16 | 1.77 | 5.20 | 3.18 | 1.31 | 3.24 |
| States and municipalities | -0.64 | 0.63 | -0.20 | 0.56 | 2.33 | 0.42 | 2.27 | 1.80 | 0.50 | 0.69 | 2.15 |
| State companies | 0.78 | 0.60 | 0.30 | -0.31 | 0.85 | 0.02 | 0.29 | 0.50 | -0.26 | -0.83 | 0.13 |

Source: Central Bank of Brazil.

**Table 7. Some economic variables
Brazil, 1994 – September 2001**

| Year | Economic growth | Rate of inflation | Rate of open unemployment⁽¹⁾ | Trade balance⁽¹⁾ | Current balance⁽¹⁾ | International reserves⁽¹⁾ | External debt⁽¹⁾ | Net public debt/GDP⁽¹⁾ |
|---------------------------|------------------------|--------------------------|--|------------------------------------|--------------------------------------|---|------------------------------------|--|
| | (%) | (%) | (%) | (US\$ billion) | (US\$ billion) | (US\$ billion) | (US\$ billion) | (%) |
| 1993 | 4.9 | 2 708.6 | 4.39 | 4 093 | -592 | 32 211 | 145 726 | 32.8 |
| 1994 | 5.9 | 909.6 | 3.42 | 405 | -1 689 | 38 806 | 148 295 | 28.5 |
| 1995 | 4.2 | 14.8 | 4.44 | -17 310 | -17 972 | 51 840 | 159 256 | 31.2 |
| 1996 | 2.7 | 9.3 | 3.82 | -22 598 | -23 502 | 60 110 | 179 935 | 33.3 |
| 1997 | 3.3 | 7.5 | 4.84 | -27 880 | -30 791 | 52 173 | 199 998 | 34.5 |
| 1998 | 0.2 | 1.7 | 6.32 | -26 263 | -33 445 | 44 556 | 241 644 | 42.6 |
| 1999 | 0.8 | 20.0 | 6.28 | -14 734 | -25 396 | 36 342 | 241 468 | 49.4 |
| 2000 | 4.5 | 9.8 | 4.83 | -15 300 | -24 637 | 33 011 | 236 151 | 49.3 |
| 2001⁽²⁾ | 1.8 ⁽³⁾ | 9.5 | 6.18 ⁽⁴⁾ | -151 | -26 438 | 40 054 | 224 025 ⁽⁵⁾ | 54.8 |

Source: Central Bank of Brazil.

- Notes :
- ⁽¹⁾ Position at 31 December
 - ⁽²⁾ Position at 30 September, or values accumulated in the previous 12 months.
 - ⁽³⁾ Estimated by the IMF.
 - ⁽⁴⁾ Position in August.
 - ⁽⁵⁾ Position in June.

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SUB-NATIONAL DEBT MANAGEMENT IN INDIA: AN OVERVIEW

Sudhir G. Shrivastava

I. INDIAN FEDERAL STRUCTURE

India has 28 States (Provinces) and seven Union territories (sub-national entities administered by the Union Government). Each State has its own Legislature, and the division of legislative powers between the Union Legislature and the State Legislatures is defined in the Constitution.

II. INDIAN FEDERAL STRUCTURE

Schedule-7 to the Constitution lists the fields of legislation for the Union Legislature and the State Legislatures.

List-1 is the Union List, List-2 is the State List and List-3 is the Concurrent List.

The residual legislative powers vest with the Union Legislature. In matters included in the Concurrent List the State Legislatures can exercise powers within the ambit laid down by the Union Legislature.

III. FEDERAL FISCAL STRUCTURE

Taxation powers are divided between the Union Legislature and the State Legislatures.

Income tax (including corporate income tax), excise duties and customs duties are important areas of taxation for the Central Government.

Sales tax, profession Tax, registration fees, excise on alcohol and transport taxes are major areas of taxation for State Governments.

Taxes on services are not specifically listed and services are taxed under the residuary powers of the Union Legislature.

A statutorily constituted quinquennial Finance Commission decides the share of the States in central taxes and also the horizontal distribution of this share amongst the States. Currently, 29 per cent of the taxes comprising income tax and union excise duties are the States' share in central taxes.

Loans and grants are also provided by the Central Government to State Governments for capital expenditure/expansion of existing services or setting up of new services on the recommendations of the Planning Commission. These come as block assistance and also as tied assistance for the Central programmes.

Borrowings by States: Constitutional provisions

Article 293(1): "Subject to the provisions of this article, the executive power of a State extends to borrowing within the territory of India upon the security of the Consolidated Fund of the State within such limits, if any, and may from time to time be fixed by the Legislature of such State by law and to the giving of guarantees within such limits, if any, as may be so fixed".

Article 293(3): "A State may not, without the consent of the Government of India, raise any loan if there is still outstanding any part of a loan which has been made to the State by the Government of India or by its predecessor Government, or in".

IV. SOURCES OF BORROWINGS FOR STATE GOVERNMENTS

The only sources for borrowings by State Governments are:

- Borrowings from the Central Government;
- Borrowings by flotation of State Government securities in the market; and
- Borrowings from the "Public Account".

V. LOANS FROM CENTRAL GOVERNMENT

There are two types of loans from the Central Government:

The Central Government markets retail non-transferable instruments to promote financial savings. It also collects contractual savings in the form of the Public Provident Fund. The Central Government provides, as a loan to State Governments, 80 per cent of the amount so collected

within the respective States. These are untied loans.

As a part of the Plan, the Central Government provides loans for designated purposes to State Governments.

Assistance from external agencies such as the World Bank is passed on to State Governments as Additional Central Assistance, 70 per cent of which is a loan. The exchange rate risk is borne by the Union Government.

VI. FLOTATION OF GOVERNMENT SECURITIES

The extent of borrowings of State Governments in the market is decided by the Union Finance Ministry in consultation with the Planning Commission and the Reserve Bank of India (R.B.I.).

The R.B.I acts as the Debt Manager for State Governments.

Borrowings from the Public Account

The transactions relating to the deposit-taking activity of Governments are shown in the Public Account section of the Annual Financial Statement of the Governments. Typically, the amount credited to the Public Account is used as captive borrowings by the State Governments. The Provident Fund contributions of their employees form the bulk of such deposits.

VII. WHAT DO THE DATA SHOW?

The combined fiscal deficit of States as a percentage to GDP has increased from 3.3 per cent to 4.1 per cent during the period from 1990–1991 to 2000–2001.

The debt to GDP ratio has increased from 19.4 per cent to 22.9 per cent for States as a whole.

The Central Government has been the major source of the States' borrowings. The exposure of the banking sector to the States is not substantial. The reliance of States on Public Account borrowings has been substantial, and this causes some unpredictability in the States' resource position.

The real deterioration has been in revenue deficit, which rose as a percentage of the fiscal deficit from 28.3 per cent in 1990–1991 to 50.7 per cent in 2000–2001.

The increase in the revenue deficit has been substantially driven by an increase in the interest rates as the financial sector was liberalized after 1990–1991.

A substantial rise in salary expenditure since 1998–1999 has also put pressure on the revenue deficit.

The “hard budget constraint” and the increasing revenue deficits have resulted in a squeeze on capital expenditure.

States have tried to maintain capital expenditure by setting up Special Purpose Vehicles, the borrowings of which almost fully devolve on the Government Budget. Data for all States are not readily available. However, these borrowings were mainly for power and other infrastructure sectors.

Such off-budget borrowings were possible because after financial sector liberalization, banks often had ample liquidity.

The squeeze on capital expenditure has created a huge overhang of unfinished work.

VIII. STEPS FOR FISCAL REFORMS

The Central Government is providing States with incentives to undertake fiscal reforms. A Fiscal Reforms Facility Fund has been set up.

The Central Government has brought off-budget borrowings within the ambit of Article 293(3) of the Constitution.

State Governments are to draw up a Medium-Term Fiscal Reform Programme to reduce the fiscal deficit according to a defined path.

“Right sizing” of government, capping of subsidies, reform of parastatals, improved public expenditure management and improved governance are key components of the programme.

States are considering fiscal responsibility legislation

PROVINCE OF RÍO NEGRO

PUBLIC DEBT MANAGEMENT IN THE CONTEXT OF THE PROVINCIAL REFORMS

Ricardo E. Gutiérrez

I. THE 1990S. STRUCTURAL IMBALANCES

The decade of the 1990s saw Argentina trying to overcome the macroeconomic traumas left to it by the hyperinflation of the late 1980s. The “conversion” scheme¹ along with a favourable global financial climate foresaw the conditions for high economic growth; nevertheless, some issues remained unresolved (i.e. “fiscal convertibility”), the effects of which would be increasingly felt during the second half of the decade, with the advent of financial turbulence caused by the *tequila* crisis in Mexico and thereafter from developments in Asia, Russia and Brazil. The Province of Río Negro, not immune to the effects of such turbulence, failed to show by the end of the first half of the 1990s any progress in the required reforms, and, faced with a troubled economic climate, its deficit exceeded its budget by over 30 per cent. The financial effects had marked repercussions for the national finances and for the Province and led to a context of credit restrictions and high rates that further aggravated the deficit.

II. INITIAL REFORMS

The first-generation reforms implemented in Argentina, namely privatization, deregulation and liberalization, were followed by reforms in the Province of Río Negro. Beginning in 1996, they mainly encompassed the privatisation of loss-making public enterprises, such as the provincial bank (BPRN) and the electric power supply enterprise (ERSA), the licensing of provincial casinos; the transfer of the social insurance fund to the State, and the liquidation of the provincial airline (SAPSE). These reforms were carried out in conjunction with the application of strict wage-reduction measures and the passing of a new Civil Service Act based on an agreement with the main State unions for cost-containment measures both in the central administration and in the decentralized bodies. All

these reforms eventually enabled the deficit to be reduced by 65 per cent.

III. STRUCTURAL REFORMS

Towards 1996, the process of implementing second-generation reforms was started, based on subsidiary agreements signed with the Argentine National Government. The reform programmes, financed by the World Bank² and the Inter-American Development Bank,³ instituted reforms in the health, education, pension and land holding sectors, with regard to housing policy, and the strengthening of municipal institutions, among others. However, this process took on particular relevance and began to become particularly intensive towards the end of the 1990s in response to the introduction of new tools for the monitoring and recording of information.

IV. THE INFORMATION REVOLUTION

Of all the reforms implemented or under way, perhaps the most ambitious are those designed to achieve greater efficiency in information management. The Province of Río Negro has been able to implement both in the central administration and in the decentralized and independent entities an integrated financial administration and monitoring system for the public sector (SAFyC)⁴. This system is currently being integrated with the legislative entity as well as the Attorney-General’s Office. Its implementation, which allows for the handling of information using modern data processing tools, is the most avant-garde venture of its sort in any of the 23 Argentine provinces. The system consists of four essential elements: the accounting module, the budget module, the treasury module and the public credit module. In particular, this latter module, owing to its critical importance,

¹ National Act No. 23928 – 28/3/91.

² PDP 1 and 2 and PREP programmes.

³ PRODYMS programme (Municipalities).

⁴ Provincial Act No. 3186 and Decrees Nos. 1198/98, 1737/98, 129/99, 516/99, 1494/99, 1642/99 and 343/99.

has received specific attention in regard to its management, analysis and computerization possibilities and is looked at in more detail further on in this text. This implementation has taken place within the scope of the provisions of Act No. 3186 concerning the financial administration and internal monitoring of the provincial public sector. Since 1999, the Office of the Secretary of State for Finance and the General Audit Office of the Province have been gradually moving ahead with major changes in the various agencies of the provincial public administration, in regard to both human and technological resources.

The Provincial Government, therefore, made a major financial investment for the acquisition of information technology, which has made the development of the integrated financial information system possible. It includes fibre-optic interconnections between most of the agencies which enable transactions to be recorded in real time and in an integrated way so that timely information can be obtained on budget performance. It therefore facilitates decision-making in the economic and financial spheres.

V. PUBLIC CREDIT MANAGEMENT

Context and strategy

Public debt management has been influenced by two perfectly verifiable factors.

First of all, endogenous factors associated with clear debt policy. Of prime importance is the reliability, timeliness, flexibility and transparency of information. The first measures taken in this area concerned the surveying and listing of the public debt stock, the costs associated therewith and their fiscal impact. Emphasis was given to the classification of non-financial debt (wages owed, enforceable court decisions, and debts owed to suppliers) with a consolidation strategy in mind. Particular emphasis was given to the rapid implementation of the new Financial Administration Act, of which public credit constitutes one of the principle modules. This module is supported by DMFAS, a computerized debt management and analysis system developed by the United Nations Conference on Trade and Development, and is already used at the national level.

Provincial policy regarding floating debt (suppliers, wages, court judgements) is based on public securities issuance strategy. This policy gives the process reliability by guaranteeing future payment for services, a secondary market that ensures liquidity and transparency in custody, registration and the settlement of services through the Securities Fund, while also promoting the creation of a secondary market through the listings on the Buenos Aires Commodities Exchange and the MAE (Electronic Open Market). A consolidation plan is accordingly being developed through public securities in order to correct budgetary imbalances associated with the factors described above, and to convert due and payable debt having no agreed timetable for refinancing into funded debt that will take into account not only the financial constraints of the Province but also the interests of creditors. So far, this has been carried out through a process of systematic negotiation with creditors, that has involved the transfer of more than 370 million pesos in provincial bonds. Such a policy has permitted financial relief through an extension in debt maturities and a reduction of the weighted average interest rate. This has been possible by the Government prioritising timely debt service payment and facilitating the creation of an attractive secondary market for bond holders to negotiate securities. To date, bonds valued at over 250 million pesos have been punctually redeemed, while at the same time transparency and market creation have been ensured through their registration in the main capital market institutions in Argentina.

Policy regarding bank and financial institutional debt, which accounts for 50 per cent of the total provincial debt, aims to develop permanent capital refinancing mechanisms. Here, the issuing agency (the Province) is dependent on the implementation of State reforms and their consequent impact on cash flows. It has thus been possible to reschedule terms and rates at competitive values thanks to, in 1997, the reorganization of the total debt stock with the Bank of Galicia for 200 million and the securing of fresh funds for 179 million with the participation of the Quilmes, Ciudad and Bansud banks as well as the bank of Galicia. This enabled the debt service to be released from 10-year loans with two grace years and a variable rate of 10.38%, a very competitive rate for the Argentine financial market. Added to the factors described below, this has resulted in one of the lowest rates of indebtedness for any province, since the

weighted average cost of the debt measured in interest rates did not exceed 9% throughout the period preceding the 2001 debt crisis.

On the strength of the progress made in fiscal reform, the Province was selected by the World Bank, jointly with three other provinces, for a programme of reforms⁵ covering the financial, educational and health sectors. The Government has broken new ground in negotiating this 75 million dollar programme as it concerns the first loan accorded by the World Bank involving monitoring and direct technical assistance to provincial states, and the Province of Río Negro is the only province to have received two of the three agreed loan tranches thanks to the reform progress made in all sectors. Provincial policy includes second-generation reforms that will enable the foundations to be laid for future development.

Secondly, the overall debt stock has been affected by external factors that have narrowed the scope for refinancing policies. These are the successive financial crises in Mexico, Asia, Russia and Brazil, and more recently problems in the Republic of Argentina. This situation resulted in a tight and costly credit supply – in particular from 1999 onwards – to which the Province avoided having recourse, adopting instead restrictive credit policies, borrowing on an ad-hoc basis and avoiding refinancing under global programmes that might be hiding, under an attractive “financial umbrella”, credit policies that are definitely undesirable from an economic perspective. Nevertheless, volatile external factors have strongly conditioned the financial situation of the Province, mainly due to the increased burden of interest payments, the need to draw up programmes for combating a deepening recession and the discontinuing of the ongoing policies for the refinancing of capital. They also take into account the important influence exerted by the global financial situation on the macroeconomic policies adopted in the 1990s by the country and in the Province, hence the urgent need to review the programmes hitherto adopted; in particular the goals agreed to with multinational credit agencies and those concerned with the public debt stock.

Limited access to efficient financing sources due to the above mentioned causes has affected the economic decisions taken by the

Provincial Government and explain why the National Government adopted fiscal and debt policies that were rational and applicable alike to all the provinces. These resulted in the signature of separate Federal Commitments of December 1999 and November 2000 with the individual provinces, and later in the signature of Financial Assistance Agreements with the Province of Río Negro.⁶

It must be emphasized that the Assistance Agreement with the National Government provides access to funds in order to service debt, having a 2000–2001 maturity date, with the best market terms but does not in itself involve a programme for public debt refinancing. Accordingly, and to follow the spirit and letter of the Federal Commitment, during the current fiscal year, and as requested by the National Government through the Trust Fund for Provincial Development,⁷ the Provincial Government has concentrated on the preparation of a global programme for the refinancing of public debt that will embody the following guiding principles (it is not foreseen that this programme will be ready until the last quarter of this year, as a result of the debt crisis of the whole Nation):

- To unblock revenue-sharing allocations and royalties;
- To reduce appreciably the public debt service burden, regarding credits with low average residual life, non-competitive rates and overvaluations;
- To adopt combined strategies for (a) re-scheduling loans with credit agencies through reduction of interest rates and lengthening of maturities and (b) obtaining financing on the capital markets by advance redemption of current loans; and
- To seek, concurrently with the underwriting of public debt on international capital markets, the intangible yields from this type of programme, which consist of bringing the Province into relationship with investors able to finance long-term investment projects relevant to the development of the Province's economy.

⁶ This refers to the Trust Fund for Provincial Development as a Credit Assistance Instrument.

⁷ Trust Fund created in 1995 under National Act No. 2441, initially for the privatisation of provincial banks.

⁵ PRL-2: Programme of reforms of the IBRD for the Province of Río Negro.

Management of the public debt

Change in public debt management in the Province of Río Negro falls under several stages.

First stage: Recognition of the problem and the need for specific management

It was not until 1996 that the Province of Río Negro, confronted with the financial difficulties mentioned above, undertook a thorough reassessment of its management need in critical areas. As such, that year, a new Ministries Act was approved, providing for the creation of a public debt area with the rank of sub-department within the then Ministry of Finance.

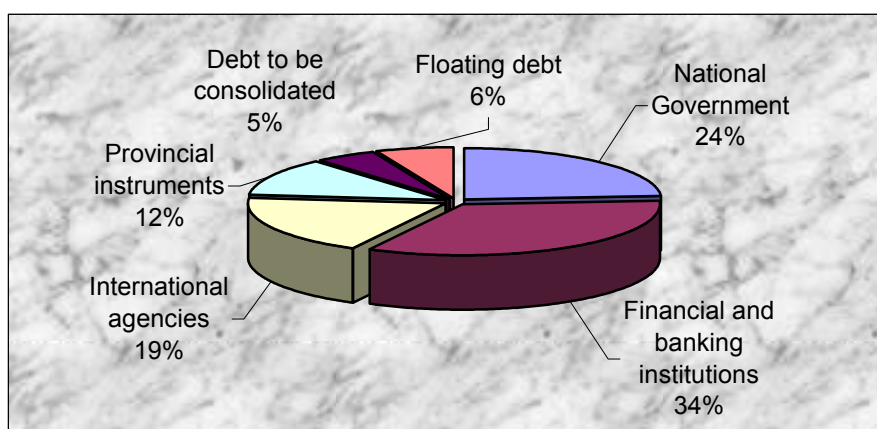
Second stage: Human resources and concentration of policies

It was decided to recruit manpower in gradual stages and progressively train a critical number of people in public debt. The first steps taken were aimed at obtaining reliable information on the current situation based on a detailed inventory of the debt. The Province assumed full and comprehensive responsibility for its public debt, which was surveyed at the end of 1996. At the end of the third quarter of 2001 the following profile by type of instrument applied:

Table 1. Provincial public debt on 30 September 2001

| Entity | Stock |
|------------------------------------|------------------|
| National Government | 285 325 |
| Financial and banking institutions | 410 156 |
| International agencies | 225 236 |
| Provincial instruments | 143 387 |
| Debt to be consolidated | 61 003 |
| Floating debt | 76 022 |
| TOTAL DEBT | 1 201 129 |

Figure 1. Debt stock as of 30 September 2001



Third stage: Public debt consolidation policies. The offices of administration, financing, registration and securities

Towards the last quarter of 1996, a mechanism for the general compilation of information on public accounts was put into operation, comprising a comprehensive listing of the provincial public debt, including the certificates already created and issued at that time: BOCON (Act No. 2545/92), CEDERN (Act No. 2931/95) and CEDEPIR (Act No. 2972/96).⁸

Once done, the Ministry's strategy was to unify policy on indebtedness, to which end the following steps were taken:

- (i) The Debt Consolidation Unit provided for in Act No. 2545 was again activated. For some time in the past no subscriptions had been opened for bonds to meet judicial debts;
- (ii) When difficulties were detected concerning the implementation of mechanisms for debt consolidation with creditors, the practice was to depart partially from the regulations in force (decrees and resolutions) prescribing their mode of operation and to seek a mechanism which would allow for, at the same time, rapid subscription, debt stock-listing and certificate issuance;
- (iii) The Ministry policy was to avoid indiscriminate use of the CEDERN bond (a registered bond freely transferable simply by assignment) for the payment of wage debts and debts with suppliers, because its interest rate and date profile were disadvantageous from the Province's perspective and because it consists virtually in another currency, which is conducive to its early redemption through various mechanisms; and
- (iv) The only debt stock listed but not covered by a consolidation instrument were those related to labour debts and court decisions with enforceable awards, essentially wage-related, against the Province. Thus, early in 1997, with the adoption of Decree Law 4/97, the RÍO 1 and 2 Certificate was created to address those categories of debt.

The Ministry of the Economy with clearly discernable objectives in view took all these steps into account:

- (i) To coordinate reconciliation with creditors and bridge the way to a solution on a consensual basis, while at the same time alleviate the serious financial situation of the Province. This latter meant that, among other things, some 47 debt suits with liabilities and representing about 80 per cent of all such debts, could be brought to a conclusion through the issue of RIO bonds, thus laying the groundwork for future agreements involving the RIO bond in approximately 100 further cases and the issue of RIO bonds to the entire body of wage creditors during the years 1997 to 1999.
- (ii) Close to 30 per cent of debt outstanding and disbursed was domestic. After determining this amount, it was necessary to consolidate it through the process of securitization. This was very important for the Province and is closely linked to its negotiating position with the World Bank and later with other banks.

This strategy was implemented through the creation of specific offices:

The directorate of public debt administration

Office responsible essentially for executing policies for consolidation of debts due and payable and without refinancing provisions, through the operation of securitization mechanisms elaborated beforehand by the sub-department.

This office has been entrusted mainly with calling upon suppliers for the recognition of their claims as creditors and for the issuance of the corresponding debt instruments. It has also put in place all the necessary mechanisms for consolidation as a result of enforceable court decisions and wage disputes.

The directorate of financing and indebtedness registration

This office has been given two areas of responsibility: first of all, to organize the raising of new credits with the financial sector in consideration of the need for annual financing; and secondly to deal with the tasks of debt registration and public debt reporting. This office is currently responsible for the processing of public debt and financing information using DMFAS.

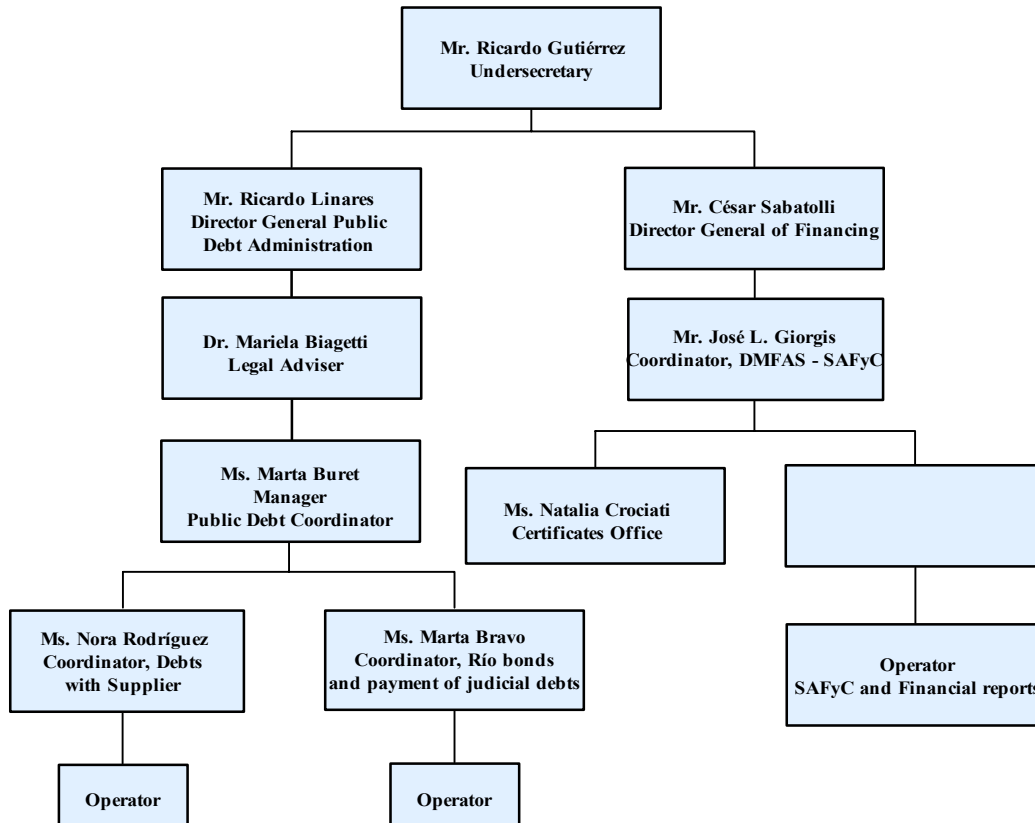
⁸ Laws on funding of debts predating convertibility, wages and providers respectively.

The securities office

This office is basically concerned with generating securities in the form of public debt certificates or bonds, through the provision of ongoing legal assistance, and is responsible for the execution of the corresponding services.

The organizational chart of the Sub-department of Financing of the Province of Río Negro is currently as follows:

Figure 2. Sub-department of Financing of the Province of Río Negro



Fourth and current stage: Rationalization of the financing and public debt processes

This stage was started in 1999 with the implementation of SAFyC, the public credit module and the installation of DMFAS as agreed with the National Government. First implemented in the Finance Department of the Ministry of Economy, a Financial Administration Committee⁹ was designated to oversee its management and has enabled computerization of the Audit, Budget, Treasury and Public Debt modules. In the specific case of DMFAS, the Financial Administration Committee has permitted a smoother interaction between the general system

and the specific system (DMFAS). The interface between the two systems is currently under development.

VI. PROVINCIAL DEBT MANAGEMENT AND FINANCIAL ANALYSIS SYSTEM (USING DMFAS)

During 2000, a joint implementation agreement was signed by the National Ministry of the Economy and the Provincial Government, strengthening the latter's involvement in the strengthening, management, registration and administration of the provincial public debt. This entails installing, training and putting into operation DMFAS in pursuance of the relevant agreement signed by the Argentine Republic and

⁹ With membership representing the General Audit Office, Budget, Treasury, Public Credit, and, as coordinator, the Department of Finance.

the United Nations Conference on Trade and Development.

It can be said here that, as a result of the efforts made to ensure the transparency, coherence and sound management of its public debt stock since the end of 1996, the Province of Río Negro is at an advanced stage of implementing an ambitious project that will enable it to be the first Argentine province to possess a state-of-the-art computer system meeting international standards.

Its main purpose is to provide precise and up-to-date information on public debt, in order to achieve its effective management. Technical staff from the National Ministry of the Economy currently work together with staff in the Ministry of the Economy of the Province. To date, DMFAS has been installed and the greater part of its training is completed. The various financial transactions have been loaded into the system and recently training in report issuance has been made. Also the timetable for implementation of the interface with SAFyC has been started, and to this end provision has been made for technical training for staff from the National Department of Finance during the month of December 2001.

It must be emphasized that both the National Government and the Government of the Province have insisted on the need to harmonize policies regarding indebtedness and the registration of public debt stock and they form part of the federal commitment entered into by both Governments.

In particular it has proven possible, at the explicit wish of the Provincial Government, to provide transparent and timely information and basically – through the installation of computer equipment and databases reflecting state-of-the-art technology – to equip present and future Government administrations with modern tools for better management.

At the beginning of 1991, after completion of the third phase of the financing policy through the implementation of the debt consolidation policies and the development of the offices of Administration, Financing, Registration and Instruments, the Subdepartment of Financing began to study the possibility of systematizing the procedure concerning indebtedness. Until then all processing and reporting had been

performed with non-integrated systems, with resulting disadvantages in terms of loss of time and errors. Thus the first contacts with the National Public Debt Office were made and formal arrangements were entered into in March 2000 with the signature of the relevant project.

The project “Strengthening of the public debt management capacity of the sub-national Governments of the Argentine Republic” and the Government of the Province of Río Negro

The purpose of the project is “to strengthen the capacity of the Subnational Governments in the management, registration and administration of the public debt, through the installation, training and putting into operation the computer system developed by UNCTAD and designated DMFAS, duly adapted to the circumstances and needs of the provinces, by incorporating into the database installed for that purpose the characteristics of the loans and the debt servicing timetables for outstanding loans.”

The project stresses the “duty of the National Government to coordinate its execution together with its technical supervision, through the carrying out of all such measures as will be conducive to attaining its objectives.” For its part the Province of Río Negro undertakes to create a working unit with suitable personnel and necessary equipment, and also to provide all information proved necessary for the loading of data as required for the operation of the system.¹⁰

Responsibility for the execution of the DMFAS project

The implementation of the project with the DMFAS programme is the responsibility of the Subdepartment of Finance within the Province’s Ministry of the Economy, with the Undersecretary for Financing, Mr. Ricardo Gutiérrez and the Director-General of Financing, Mr. César José María Sabattoli, as the directing authorities.

Activities to date

A first information collecting and training mission was carried out by officials of the National Department of Finance during October 2000. Later, in December 2000, the task of installing the system was undertaken and four staff

¹⁰ DMFAS Agreement between Nation and Province – 27/3/2000, Art. 1, paras. 4 and 5.

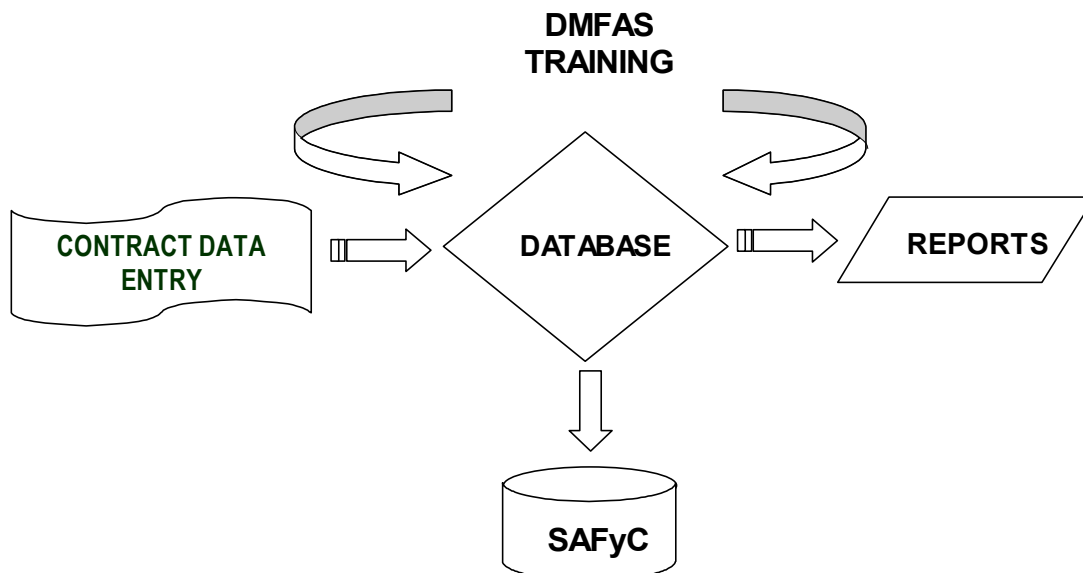
members from the area were trained. Next a staff member of the Directorate of Fiscal Coordination with the Provinces was assigned to give initial training to five operators of the system. At the same time, staff of the Department of Finance gave a conceptual presentation on DMFAS to future users. From then on the stage of inputting all the loans outstanding in the Province began.

As a result of the conclusions of the technical audit of the project, conducted by Mr. Gerard Teeling, UNCTAD staff member, in June 2001, the Province expedited the installation of equipment suited to the requirements of the system and arranged for the staff assigned to the Province to be put on call for longer periods. It should be emphasized that the referred to audit determined that the objectives to date had been satisfactorily attained. It also commended all these in the Province who had been involved with the system, for their motivation and for their thorough knowledge of the debt situation.

Following completion of the inputting of loans stage in August 2001, training was given in September on the reporting functions of the system. Emphasis is currently given to the utilization of reports on debt stock by type and origin of debt, by creditor, by contract and by currency. Reports are also available on trends in debt servicing, by amortization, interests and guarantees approved.

Progress has also been made in linking up with the integrated public sector financial administration and control system (SAFyC), which records all the financial transactions of the Province, making through its interaction with DMFAS an improved quality of information on public credit possible.

Figure 3.



VII. LEGAL PROVISIONS GOVERNING BORROWING BY THE PROVINCE

Public credit is subject to regulations at the national and provincial levels.

Federal regulations on public credit at the provincial level

At the national level, the regulations establish the duty to inform and accordingly evaluate the risk of indebtedness through compliance of

the Provinces with the provisions of Resolutions 1075/93 and 1090/98 of the National Ministry of the Economy.

Under these regulations the Provinces, with their agencies or enterprises, are subject to the supervision, coordination and approval of the National Ministry of the Economy with respect to any credit-related act, contract, arrangement or negotiation entered into that gives rise or may give rise to payment obligations in foreign currencies. The operations that may take place within the limits of this definition are: credits, issuance of public instruments (bonds, provincial treasury bills, debt certificates), and financial trust contracts.

Duty to inform¹¹

When a loan request is submitted on behalf of the Provinces, their municipalities, agencies or enterprises, a file is opened which must contain the following fiscal and financial information:

- Intended utilization of the loan;
- Law or ordinance under which the operation is authorized and resources allocated from the Federal Tax Revenue Sharing Scheme, and percentage available thereof;
- Budgetary performance for the current year;
- Debt stock and annual debt servicing costs;
- Federal tax share withheld in legal and real terms;
- Offer from bank or other institution with details of terms;
- Opinions of the Attorney-General's Office, Accounts Office and Legal Advisory Service of the Provincial Ministry of the Economy;
- Attestations of the Accountant-General on loans previously granted;
- Analysis of the percentage of servicing costs that the provincial constitution allows to be assigned from its resources; and
- Loan contract (mutual).

In light of the information provided by the legal authorities, the authorities of the National Ministry of the Economy decide as to the merits

of the proposed operation, reporting among other aspects on the amount and currency of the credit, the total life of the operation, the grace period for repayment of the capital, capital amortization, method of calculation, interest rate and details of guarantees.

Once the operation has been authorized by the National Ministry of the Economy, it will be for the Provinces, their agencies and enterprises as well as the municipalities to request a derogation from the provisions of Communication A-3054/99 of the Central Bank of the Argentine Republic.¹²

This regulation stipulates that financial institutions, including their branch and local offices or foreign subsidiaries, may not refinance or grant financial assistance to the non-financial public sector. This provision applies to the following operations: public and private credit instruments, loans, financial operations of all kinds executed by and/or through banks abroad, etc.

Thus, the Central Bank will consider requests for exemption from the limitation on granting of financial assistance provided that a number of requirements are met:

- That there exists an express authorization to undertake borrowing and to assign by way of guarantee federal resources under the revenue sharing arrangement and/or royalties for exploitation of natural resources;
- That the loan agreements entered into contain a clause authorizing the designated financial agents to effect transfers of the amount assigned as a guarantee to the accounts of the participating creditors;
- That there exists an authorization from the National Ministry of the Economy in accordance with the provisions of Resolution 1075/93; and
- That the regulations concerning information on credit bills from privatized public financial institutions are duly complied with.

At the provincial level, the regulatory provisions are those contained in Act 3186/98 on

¹¹ Ministry of the Economy Resolution No. 277/95 on mechanisms for obtaining authorizations.

¹² References and datings: Communication "A" 3063/00 and "A" 3144/00.

provincial financial administration, Title III, Articles 43 to 52 of which regulate the Public Credit Module.

In general, public credit is governed by Article 95 of the Provincial Constitution, Act 3186, with its implementing regulations, and rules issued by the coordinating body of the system, the Provincial Ministry of the Economy. The regulations define public credit as the competence possessed by the State to contract debts, for the purpose of obtaining means of financing for productive investments, for cases of evident need, for remodelling the organization of the Provincial Government and for refinancing its liabilities.¹³

Another important piece of legislation at the provincial level is the Fiscal Solvency Act.

The Fiscal Solvency Act

Monetary policy implemented in the Republic of Argentina regarding convertibility was complemented by a considerable strengthening of the technical aspects concerning its financial management system, especially after the Mexican devaluation of December 1994, which produced in 1995 the well-known *tequila* effect. Nevertheless, the country was far from renewing its efforts towards a true fiscal convertibility that would allow a closing of the State deficit gap and lead to a systematic effort extending to the monetary system. The first efforts date from the aftermath of the Russian crisis of 1998, but basically they began really to take shape with the Brazilian devaluation of 1999. In that context began the current period of the National Government, which is seeking to call a halt to the deficit in a situation of deepening recession.

Thus the year 2000 saw the prolongation of the national Fiscal Solvency Act, which was to obtain the legislative support of the Province of Río Negro.¹⁴ The Provincial Act, like the national one, establishes new parameters with regard to future provincial budgetary legislation, defining fiscal concepts such as primary fiscal result, net current result, and capital results, so as to avoid financing current expenses with non-renewable resources such as petroleum and natural gas royalties, without taking into account the amount of future debt interest.

It is worth noting that this legislation covers the preparation of long-term budgets, counter-cyclical funds, as well as specific fiscal and deficit-reduction goals. In particular it is emphasized that tax resources must constitute 6 per cent of the gross domestic product in the year 2005, and also that the primary result must show a surplus and an absorption of interests by the year 2005, while the public debt must not increase beyond the deficits authorized.

Obviously, however, in a context of acute recession that has lasted for more than three years, these measures will not suffice and the federal agreements of 1999 and 2000 will need to be strengthened.

VIII. FEDERAL AGREEMENTS AND THEIR IMPACT ON PUBLIC CREDIT IN THE PROVINCE

After implementation of the Convertibility Act, a series of reforms began involving deregulation, privatization and liberalization. These included a reform of the Retirement and Pension System, which replaced the current allocation system and of the Retirement Pension Fund Administration (AFJP). They led to the Federal Agreements of 1992 and 1993.¹⁵ Essentially these reforms instituted a system for the distribution of shared federal tax revenue between the National State and the Provinces, partially amending the provisions of Act 23548. While there was no special section in the Act on provincial indebtedness, the impact of the reforms on the provincial fiscal accounts and on its indebtedness were of major importance. It was proposed to institute under these agreements a tax reform committing the Provinces to eliminating taxes that distorted productive activity in exchange for acceptance of the provincial social insurance funds (retirement funds), most of which were in deficit. As such, the Province of Río Negro eliminated the provincial taxes affecting two main activities: tourism and the production of raw materials.

Furthermore, the Provinces agreed to national tax reforms that involved a smaller transfer of resources and took responsibility for national public hospitals and national primary and middle schools. This entire process made the financing of national insurance reforms possible

¹³ Act 3186, pp. 30 to 32.

¹⁴ Provincial Act No. 3502/01.

¹⁵ National Act No. 24130/92 – Provincial Act No. 2743/94.

at the cost of a considerable increase in the provincial debt. On that basis, the Province of Río Negro carried out a series of reforms that enabled the deficit to be reduced by 63 per cent between 1995 and 2000. During this same period primary expenditure fell by 9 per cent and at the same time interest payments on the debt increased by 65 million.

Concerning the Federal Agreements of 1999 and 2000¹⁶, the higher level of indebtedness taken on by the Provinces was offset by the conclusion of the Federal Compromise of 1999 signed with the National Government. Clause 7 notably recognizes, on behalf of the State, the difficulties in provincial jurisdictions, and provides (subject to commitment) for the implementation of a programme for the extend-

ing of time limits for debt redemption and for the obtaining of more favourable interest rates for these Provinces having major difficulties. This is subject to their previous signature of the commitments concerning the reduction of deficits, containment, efficiency and transparency in expenditure and the reorganization of provincial and municipal finances. Thus, through the Trust Fund for Provincial Development (FFDP), provision was made for the implementation of a programme to cope with debt maturities falling in the years 2000 and 2001.

The results of this programme for the eleven provinces that signed the Federal Commitment can be seen in the following table:

**Table 2. Stabilization Programme
(In millions of pesos)**

| Province | Result | | Goal |
|------------------|----------|--------|--------|
| | 1999 | 2000 | 2001 |
| Catamarca | -64.3 | -19.7 | -19.1 |
| Chaco | -218.7 | -153.1 | -128.1 |
| Chubut | -122.2 | -18.4 | -33.9 |
| Formosa | -159.2 | -88.3 | -70.0 |
| Jujuy | -177.7 | -77.1 | -57.7 |
| Neuguen | -291.1 | -98.9 | -79.0 |
| Río Negro | -129.7 | -87.0 | -66.0 |
| Tierra del Fuego | -32.6 | -2.4 | -29.7 |
| Tucumán | -130.1 | -18.5 | -35.4 |
| Misiones | -208.3 | -124.0 | -106.5 |
| San Juan | -61.5 | -146.3 | -68.3 |
| Total | -1 536.0 | -829.4 | -694.1 |

Source: Subdepartment of Relations with Provinces.

¹⁶ National Acts No. 25235/00 and No. 25400/01.

During 2000, the Government undertook orthodox adjustments in the hope of relaunching activities. Towards the end of the year, however, political problems arose that made it necessary to jointly undertake, with multilateral agencies, a financial rescue programme designated "shield",¹⁷ with revised goals. However, some measures were slow to be implemented, resulting in the resignation of the Ministry of the Economy, José L Machinea. Under the direction of Dr Domingo Cavallo who under the previous government was the "father" of convertibility, the Government is again attempting to obviate the effects on the fiscal situation of the enormous public debt accumulated, through the so-called *mega-swap*.¹⁸ Nevertheless, this too has failed to extricate the country from its enormous crisis, which at this point in time reflects the impact of loss in market confidence in terms of exceptional country risk figures, currently exceeding 3 000 basic points.¹⁹

Overtaken by the reality of the decline in public financing and the systematic fall in revenue collected, the Government is pursuing a *zero deficit* policy which obliges it to review amounts due and payment of public expenses, in particular payments to public officials, pensions and transfers to the Provinces.

This situation has led to the signing of the Independence Agreement by the Provinces with the Nation, making them subject to the zero deficit laws, and eventually to the approval of an addendum or annex setting out reforms to the Federal Commitment of 2000²⁰ modifying the system of transfers which under that agreement provided for a ceiling and a floor, until such time as revenue collection improves, in return for rescheduling of the provincial debts, which display dramatic features, with provinces showing arrears in salary payments, crises in the delivery of basic services such as hospitals and schools, and interest rates sometimes exceeding 30% annually.

We have thus achieved an interrelation between debt and deficit in the Provinces. The out-

come of successive Federal Agreements in the context of international financial crises is illustrated in the accompanying diagram (Figure 4). Account must be taken here of two series of agreements with the Provinces, the former of them immediate in their application to the validity of the Convertibility Act (1992-1993). They enabled budgetary imbalances at the national level to be offset through major reforms such as the new insurance system, the decentralization of hospitals and schools and the centralization of the provincial insurance funds. These agreements amended, through successive tax reforms, Act 23548 on Federal Tax Sharing which fixed the distribution of tax revenue between the Nation and the Provinces to the advantage of the former. The effects of this new tax system had an influence on the high rate of accumulation of provincial debt – about 22 billion pesos between 1991 and 2000²¹ – since the provincial states received 28 billion pesos less in primary revenue share. All these effects were felt in an unfavourable international financial climate, and had an impact on access to financing sources and on the cost of indebtedness.

After a lapse of eight years, and with five international crises in between, the two Federal Agreements of 1999 and 2000 came about. They sought inadequately to mitigate the effects of the financial crises on the Provinces and culminated in the need to sign an amendment to the Federal Agreement of 2000 in order to establish new rules in regard to transfers and, most importantly, to the rescheduling of debts, in a context of over three years of recession and consequently reduced activity. An important question for the Provinces is whether this national debt-restructuring plan will be sufficient to prevent the country from plunging into unprecedented chaos. On the positive side we can claim to have overcome the fiascoes of successive failed civil and military rulings and the systematic flouting of the National Constitution. We have gone through 19 years of democracy suspension, have overcome decades spent under the scourge of inflation, enjoyed ten years of monetary stability, and have strengthened our financial system like few countries in the world have been able to, thus enabling us to deal successfully with five worldwide financial crises. However, Argentina is currently facing perhaps its greatest challenge: to master for good its recurrent fiscal deficit and its unproductive public expenditure.

¹⁷ Agreement with IMF, IBRD, IDB, private banks and governments in the amount of 40 billion pesos for the implementation of a Fiscal Adjustment Programme.

¹⁸ Exchange of public for market instruments, which allows maturities to be postponed at the cost of better interest rates for creditors, and in some cases, allows fixed rates to be offered.

¹⁹ J.P. Morgan EMBI indicator for Argentina.

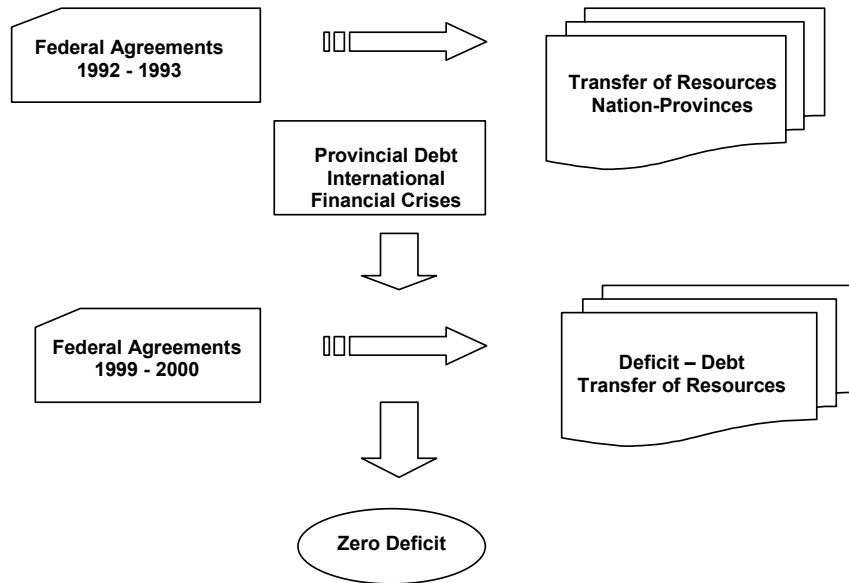
²⁰ Ratified by Provincial Act No. 3556/01.

²¹ Source: Economía y Regiones S.A.

The Argentine Provinces are solidly behind the new zero deficit plan, which will nonetheless necessitate sacrifices perhaps never before borne by this country. It may be that the prospect of

reaching our goal within a reasonable time will enable us to live up to the ideal that our ancestors cherished for our country.

Figure 4.



PART 3

PRIVATE SECTOR, AUDITING AND GENERAL GUIDELINES FOR DEBT MANAGEMENT

GUIDELINES FOR PUBLIC DEBT MANAGEMENT

*Fred Jensen*¹

I. WHAT IS PUBLIC DEBT MANAGEMENT AND WHY IS IT IMPORTANT?

Sovereign debt management is the process of establishing and executing a strategy for managing the government's debt in order to raise the required amount of funding, achieve its risk and cost objectives, and meet any other sovereign debt management goals which the government may have set, such as developing and maintaining an efficient market for government securities.

In a broader macroeconomic context for public policy, governments should seek to ensure that both the level and the rate of growth in their public debt are fundamentally sustainable, and can be serviced under a wide range of circumstances while meeting cost and risk objectives. Sovereign debt managers share fiscal and monetary policy advisers' concerns that public sector indebtedness remain on a sustainable path and that a credible strategy be in place to reduce excessive levels of debt. Debt managers should ensure that the fiscal authorities are aware of the impact of government financing requirements and debt levels on borrowing costs.² Examples of indicators that address the issue of debt sustainability include the public sector debt service ratio, and ratios of public debt to gross domestic product (GDP) and to tax revenue.

Poorly structured debt in terms of maturity, currency or interest rate composition and large and unfunded contingent liabilities have been important factors in inducing or propagating economic crises in many countries throughout history. For example, irrespective of the exchange rate regime, or whether domestic or foreign currency debt is involved, crises have often arisen because of an excessive focus by governments on possible cost savings associated with large volumes of short-term or floating rate debt.

This has left government budgets seriously exposed to changing financial market conditions, including changes in the country's creditworthiness, when this debt has to be rolled over. Foreign currency debt also poses particular risks, and excessive reliance on foreign currency debt can lead to exchange rate and/or monetary pressures if investors become reluctant to refinance the government's foreign currency debt. By reducing the risk that the government's own portfolio management will become a source of instability for the private sector, prudent government debt management, together with sound policies for managing contingent liabilities, can make countries less susceptible to contagion and financial risk.

A government's debt portfolio is usually the largest financial portfolio in the country. It often contains complex and risky financial structures, and can generate substantial risk to the government's balance sheet and to the country's financial stability. As noted by the Financial Stability Forum's Working Group on Capital Flows, "recent experience has highlighted the need for governments to limit the build up of liquidity exposures and other risks that make their economies especially vulnerable to external shocks".³ Therefore, sound risk management by the public sector is also essential for risk management by other sectors of the economy "because individual entities within the private sector typically are faced with enormous problems when inadequate sovereign risk management generates vulnerability to a liquidity crisis". Sound debt structures help governments reduce their exposure to interest rate, currency and other risks. Many governments seek to support these structures by establishing, where feasible, portfolio benchmarks related to the desired currency composition, duration and maturity structure of the debt to guide the future composition of the portfolio.

Several debt market crises have highlighted the importance of sound debt management practices and the need for an efficient and sound capital market. Although government debt man-

¹ Prepared by the Staffs of the International Monetary Fund and the World Bank

² Excessive levels of debt that result in higher interest rates can have adverse effects on real output. See, for example, Alesina A *et al.* Default Risk on Government Debt in OECD Countries. In: *Economic Policy: A European Forum*, 1992, 7(14): pp. 428-463.

³ Financial Stability Forum. *Report of the Working Group on Capital Flows*. 5 April 2000, p. 2.

agement policies may not have been the sole or even the main cause of these crises, the maturity structure, and interest rate and currency composition of the government's debt portfolio, together with substantial obligations in respect of contingent liabilities, have often contributed to the severity of the crisis. Even in situations where there are sound macroeconomic policy settings, risky debt management practices increase the vulnerability of the economy to economic and financial shocks. Sometimes these risks can be readily addressed by relatively straightforward measures, such as lengthening the maturities of borrowings and paying the associated higher debt servicing costs (assuming an upward-sloping yield curve), adjusting the amount, maturity and composition of foreign exchange reserves, and reviewing criteria and governance arrangements in respect of contingent liabilities.

Risky debt structures are often the consequence of inappropriate economic policies – fiscal, monetary and exchange rate – but the feedback effects undoubtedly go in both directions. However, there are limits to what sound debt management policies can deliver. Such policies are no panacea or substitute for sound fiscal and monetary management. If macroeconomic policy settings are poor, sound sovereign debt management may not by itself prevent any crisis. Such policies reduce susceptibility to contagion and financial risk by playing a catalytic role for broader financial market development and financial deepening. Experience supports the argument, for example, that developed domestic debt markets can substitute for bank financing (and vice versa) when this source dries up, helping economies to weather financial shocks.⁴

II. PURPOSE OF THE GUIDELINES

The Guidelines for public debt management, prepared jointly by the World Bank and the International Monetary Fund, are designed to assist policy makers in considering reforms to strengthen the quality of their public debt management and reduce their country's vulnerability to international financial shocks. Vulnerability is often greater for smaller and emerging market countries because their economies may be less

diversified, have a smaller base of domestic financial savings and less developed financial systems, and be more susceptible to financial contagion through the relative magnitudes of capital flows. As a result, the Guidelines should be considered within a broader context of the factors and forces affecting a government's liquidity more generally, and the management of its balance sheet.

Governments often manage large foreign exchange reserves portfolios, their fiscal positions are frequently subject to real and monetary shocks, and they can have large exposures to contingent liabilities and to the consequences of poor balance sheet management in the private sector. However, irrespective of whether financial shocks originate within the domestic banking sector or from global financial contagion, prudent government debt management policies, together along with sound macroeconomic and regulatory policies, are essential for containing the human and output costs associated with such shocks.

The Guidelines cover both domestic and external public debt and encompass a broad range of financial claims on the government. They seek to identify areas in which there is broad agreement on what generally constitutes sound practices in public debt management. They endeavour to focus on principles applicable to a broad range of countries at different stages of development and with various institutional structures of national debt management. They should not be viewed as a set of binding practices or mandatory standards or codes. Nor should they suggest that a unique set of sound practices or prescriptions exists, which would apply to all countries in all situations. Building capacity in sovereign debt management can take several years and country situations and needs vary widely. These Guidelines are mainly intended to assist policy makers by disseminating sound practices adopted by member countries in debt management strategy and operations. Their implementation will vary from country to country, depending on each country's circumstances, such as its state of financial development.

Each country's capacity-building needs in sovereign debt management are different. Their needs are shaped by the capital market constraints they face, the exchange rate regime, the quality of their macroeconomic and regulatory policies, the institutional capacity to design and

⁴ See, for example, Remarks by Chairman Alan Greenspan before the World Bank Group and the International Monetary Fund, Program of Seminars, Washington, D.C., 27 September 1999.

implement reforms, the country's credit standing, and its objectives for public debt management. Capacity building and technical assistance must therefore be carefully tailored to meet stated policy goals, while recognizing the policy settings, institutional framework and the technology and human and financial resources that are available. The Guidelines should assist policy advisers and decision-makers involved in designing debt management reforms as they raise public policy issues that are relevant for all countries. This is the case whether the public debt comprises marketable debt or debt from bilateral or multilateral official sources, although the specific measures to be taken will differ in order to take into account a country's circumstances.

Every government faces policy choices concerning debt management objectives, its preferred risk tolerance, which part of the government balance sheet those managing debt should be responsible for, how to manage contingent liabilities, and how to establish sound governance for public debt management. On many of these issues, there is increasing convergence on what are considered prudent sovereign debt management practices that can also reduce vulnerability to contagion and financial shocks. These include: recognition of the benefits of clear objectives for debt management; weighing risks against cost considerations; the separation and coordination of debt and monetary management objectives and accountabilities; a limit on debt expansion; the need to carefully manage refinancing and market risks and the interest costs of debt burdens; and the necessity to develop a sound institutional structure and policies for reducing operational risk, including clear delegation of responsibilities and associated accountabilities among government agencies involved in debt management.

Debt management needs to be linked to a clear macroeconomic framework, under which governments seek to ensure that the level and the rate of growth of public debt are sustainable. Public debt management problems often have their origins in the lack of attention paid by policy makers to the benefits of having a prudent debt management strategy and to the costs of weak macroeconomic management. In the first case, authorities should pay greater attention to the benefits of having a prudent debt management strategy, framework and policies that are coordinated with a sound macro policy frame-

work. In the second case, inappropriate fiscal, monetary or exchange rate policies generate uncertainty in financial markets regarding the future returns available on local currency-denominated investments, thereby inducing investors to demand higher risk premiums. Particularly in developing and emerging markets, borrowers and lenders alike may refrain from entering into longer-term commitments, which can stifle the development of domestic financial markets, and severely hinder debt managers' efforts to protect the government from excessive rollover and foreign exchange risk. A good track record of implementing sound macro policies can help to reduce this uncertainty. This should be combined with building appropriate technical infrastructure – such as a central registry and payments and settlement system – to facilitate the development of domestic financial markets.

III. SUMMARY OF THE PUBLIC DEBT MANAGEMENT GUIDELINES

A. Debt management objectives and coordination

1. Objectives

The main objective of public debt management is to ensure that the government's financing needs and its payment obligations are met at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk.

2. Scope

Debt management should encompass the main financial obligations over which the central government exercises control.

3. Coordination with monetary and fiscal policies

Debt managers, fiscal policy advisers and central bankers should share an understanding of the objectives of debt management, fiscal and monetary policies, given the interdependencies between their different policy instruments. Debt managers should convey to fiscal authorities their views on the costs and risks associated with government financing requirements and debt levels.

Where the level of financial development allows, there should be a separation of debt management and monetary policy objectives and accountabilities.

Debt management, fiscal and monetary authorities should share information on the government's current and future liquidity needs.

B. Transparency and accountability

1. Clarity of roles, responsibilities and objectives of financial agencies responsible for debt management

The allocation of responsibilities among the ministry of finance, the central bank or a separate debt management agency for debt management policy advice, and for undertaking primary debt issues, secondary market arrangements, depository facilities, and clearing and settlement arrangements for trade in government securities, should be publicly disclosed.

The objectives for debt management should be clearly defined and publicly disclosed, and the measures of cost and risk that are adopted should be explained.

2. Open process for formulating and reporting of debt management policies

Materially important aspects of debt management operations should be publicly disclosed.

3. Public availability of information on debt management policies

The public should be provided with information on the past, current and projected budgetary activity, including its financing, and the consolidated financial position of the government.

The government should regularly publish information on the stock and composition of its debt and financial assets, including their currency, maturity and interest rate structure.

4. Accountability and assurances of integrity by agencies responsible for debt management

Debt management activities should be audited annually by external auditors.

C. Institutional framework

1. Governance

The legal framework should clarify the authority to borrow and to issue new debt, invest and undertake transactions on the government's behalf.

The organizational framework for debt management should be well specified, and ensure that mandates and roles are well articulated.

2. Management of internal operations

Risks of government losses from inadequate operational controls should be managed according to sound business practices, including well-articulated responsibilities for staff, and clear monitoring and control policies and reporting arrangements.

Debt management activities should be supported by an accurate and comprehensive management information system with proper safeguards.

Staff involved in debt management should be subject to a code of conduct and conflict-of-interest guidelines regarding the management of their personal financial affairs.

Sound business recovery procedures should be in place to mitigate the risk that debt management activities might be severely disrupted by natural disasters, social unrest or acts of terrorism.

D. Debt management strategy

The risks inherent in the structure of the government's debt should be carefully monitored and evaluated. They should be mitigated to the extent feasible by modifying the debt structure, taking into account the cost of doing so.

In order to help guide borrowing decisions and reduce the government's risk, debt managers should consider the financial and other risk characteristics of the government's cash flows.

Debt managers should carefully assess and manage the risks associated with foreign currency and short-term or floating rate debt.

There should be cost-effective cash management policies in place to enable the authorities to meet with a high degree of certainty their financial obligations as they fall due.

E. Risk management framework

A framework should be developed to enable debt managers to identify and manage the trade-offs between expected cost and risk in the government debt portfolio.

To assess risk, debt managers should regularly conduct stress tests of the debt portfolio on the basis of the economic and financial shocks to which the government – and the country more generally – are potentially exposed.

1. Scope for active management

Debt managers who seek to manage actively the debt portfolio to profit from expectations of movements in interest rates and exchange rates, which differ from those implicit in current market prices, should be aware of the risks involved and accountable for their actions.

2. Contingent liabilities

Debt managers should consider the impact that contingent liabilities have on the government's financial position, including its overall liquidity, when making borrowing decisions.

F. Development and maintenance of an efficient market for government securities

In order to minimize cost and risk over the medium to long run, debt managers should ensure that their policies and operations are consistent with the development of an efficient government securities market.

1. Portfolio diversification and instruments

The government should strive to achieve a broad investor base for its domestic and foreign obligations, with due regard to cost and risk, and should treat investors equitably.

2. Primary market

Debt management operations in the primary market should be transparent and predictable. To the extent possible, debt issuance

should use market-based mechanisms, including competitive auctions and syndications.

3. Secondary market

Governments and central banks should promote the development of resilient secondary markets that can function effectively under a wide range of market conditions.

The systems used to settle and clear financial market transactions involving government securities should reflect sound practices.

IV. DISCUSSION OF THE GUIDELINES

A. Debt management objectives and coordination

1. Objectives

The main objective of public debt management is to ensure that the government's financing needs and its payment obligations are met at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk. Prudent risk management to avoid dangerous debt structures and strategies (including monetary financing of the government's debt) is crucial, given the severe macroeconomic consequences of sovereign debt default, and the magnitude of the ensuing output losses. These costs include business and banking insolvencies as well as the diminished long-term credibility and capability of the government to mobilize domestic and foreign savings. Box 1 provides a list of the main risks encountered in sovereign debt management.

Governments should try to minimize expected debt servicing costs and the cost of holding liquid assets, subject to an acceptable level of risk, over a medium- to long-term horizon.⁵ Minimizing cost, while ignoring risk, should not be an objective. Transactions that appear to lower debt servicing costs often embody significant risks for the government and can limit its capacity to repay lenders. Developed countries, which typically have deep and liquid markets for

⁵ In addition to their concerns about the real costs of financial crises, governments' desire to avoid excessively risky debt structures reflects their concern over the possible effects of losses on their fiscal position and access to capital, and the fact that losses could ultimately lead to higher tax burdens and political risks.

their government's securities, often focus primarily on market risk, and, together with stress tests, may use sophisticated portfolio models for measuring this risk. In contrast, emerging market countries, which have only limited (if any) access to foreign capital markets and which also have relatively undeveloped domestic debt markets, should give higher priority to rollover risk. Where appropriate, debt management policies to promote the development of the domestic debt market should also be included as a prominent government objective. This objective is particularly relevant for countries where market constraints are such that short term debt, floating rate debt and foreign currency debt may, in the short run at least, be the only viable alternatives to monetary financing.

2. *Scope*

Debt management should encompass the main financial obligations over which the central government exercises control. These obligations typically include both marketable debt and non-market debt, such as concessional financing obtained from bilateral and multilateral official sources. In a number of countries, the scope of debt management operations has broadened in

recent years. Nevertheless, the public sector debt, which is included in or excluded from the central government's mandate over debt management, will vary from country to country, depending on the nature of the political and institutional frameworks.⁶

Domestic and foreign currency borrowings are now typically coordinated. Moreover, debt management often encompasses the oversight of liquid financial assets and potential exposures due to off-balance sheet claims on the central government, including contingent liabilities such as state guarantees. In establishing and implementing a strategy for managing its debt in order to achieve its cost and risk objectives and any other sovereign debt management goals, the central government should monitor and review the potential exposures that may arise from guaranteeing the debts of sub-central governments and state-owned enterprises, and, whenever possible, be aware of the overall financial position of public- and private-sector borrowers. Furthermore, the borrowing calendars of the central and sub-central government borrowers may need to be coordinated to ensure that auctions of new issues are appropriately spaced.

⁶ These guidelines may also offer useful insights for other levels of government with debt management responsibilities.

Box 1. Risks encountered in sovereign debt management

| Risk | Description |
|------------------|---|
| Market risk | Refers to the risks associated with changes in market prices, such as interest rates, exchange rates and commodity prices, on the cost of the government's debt servicing. For both domestic and foreign currency debt, changes in interest rates affect debt servicing costs on new issues when fixed rate debt is refinanced, and on floating rate debt at the rate reset dates. Hence, short-duration debt (short-term or floating rate) is usually considered to be more risky than long-term, fixed rate debt. (Excessive concentration in very long-term, fixed rate debt can also be risky as future financing requirements are uncertain.) Debt denominated in or indexed to foreign currencies also adds volatility to debt servicing costs as measured in domestic currency owing to exchange rate movements. Bonds with embedded put options can exacerbate market and rollover risks. |
| Rollover risk | The risk that debt will have to be rolled over at an unusually high cost or, in extreme cases, cannot be rolled over at all. To the extent that rollover risk is limited to the risk that debt might have to be rolled over at higher interest rates, including changes in credit spreads, it may be considered a type of market risk. However, because the inability to roll over debt and/or exceptionally large increases in government funding costs can lead to, or exacerbate, a debt crisis and thereby cause real economic losses, in addition to the purely financial effects of higher interest rates, it is often treated separately. Managing this risk is particularly important for emerging market countries. |
| Liquidity risk | There are two types of liquidity risk. One refers to the cost or penalty that investors face in trying to exit a position when the number of transactors has markedly decreased or because of the lack of depth of a particular market. This risk is particularly relevant in cases where debt management includes the management of liquid assets or the use of derivatives contracts. The other form of liquidity risk, for a borrower, refers to a situation where the volume of liquid assets can diminish quickly in the face of unanticipated cash flow obligations and/or a possible difficulty in raising cash through borrowing in a short period of time. |
| Credit risk | The risk of non-performance by borrowers on loans or other financial assets or by a counter party on financial contracts. This risk is particularly relevant in cases where debt management includes the management of liquid assets. It may also be relevant in the acceptance of bids in auctions of securities issued by the government as well as in relation to contingent liabilities, and in derivative contracts entered into by the debt manager. |
| Settlement risk | Refers to the potential loss that the government, as a counter party, could suffer as a result of failure to settle, for whatever reason other than default, by another counter party. |
| Operational risk | This includes a range of different types of risks, including transaction errors in the various stages of executing and recording transactions; inadequacies or failures in internal controls, or in systems and services; reputation risk; legal risk; security breaches; or natural disasters that affect business activity. |

3. *Coordination with monetary and fiscal policies*

Debt managers, fiscal policy advisers and central bankers should share an understanding of the objectives of debt management, fiscal and monetary policies, given the interdependencies between their different policy instruments. Debt managers should convey to fiscal authorities their views on the costs and risks associated with government financing requirements and debt levels. Policy makers should understand the ways in which the different policy instruments operate, their potential to reinforce one another, and how policy tensions can arise.⁷ Prudent debt management, fiscal and monetary policies can reinforce one another in helping to lower the risk premiums in the structure of long-term interest rates. Monetary authorities should inform the fiscal authorities of the effects of government debt levels on the achievement of their monetary objectives. Borrowing limits and sound risk management practices can help to protect the government's balance sheet from debt servicing shocks. In some cases, conflicts between debt management and monetary policies can arise owing to the different purposes – debt management focuses on the cost/risk trade-off, while monetary policy is normally directed towards achieving price stability. For example, some central banks may prefer that the government issue inflation-indexed debt or borrow in foreign currency to bolster the credibility of monetary policy. Debt managers may believe that the market for such inflation-indexed debt has not been fully developed and that foreign currency debt introduces greater risk into the government's balance sheet. Also, conflicts can arise between debt managers and fiscal authorities, for example on the cash flows inherent in a given debt structure (e.g. issuing zero-coupon debt to transfer the debt burden to future generations). For this reason, it is important that coordination takes place in the context of a clear macroeconomic framework.

Where the level of financial development allows, there should be a separation of debt management and monetary policy objectives and accountabilities. Clarity in the roles and objectives for debt management and monetary policy minimizes potential conflicts. In countries with

well-developed financial markets, borrowing programmes are based on the economic and fiscal projections contained in the government budget, and monetary policy is carried out independently from debt management. This helps ensure that debt management decisions are not perceived to be influenced by inside information on interest rate decisions, and avoids perceptions of conflicts of interest in market operations. A goal of cost minimization over time for the government's debt, subject to a prudent level of risk, should not be viewed as a mandate to reduce interest rates or to influence domestic monetary conditions. Nor should the cost/risk objective be seen as a justification for the extension of low-cost central bank credit to the government. Moreover, monetary policy decisions should not be driven by debt management considerations.

Debt management, fiscal and monetary authorities should share information on the government's current and future liquidity needs. Since monetary operations are often conducted using government debt instruments and markets, the choice of monetary instruments and operating procedures can have an impact on the functioning of government debt markets, and potentially on the financial condition of dealers in those markets. By the same token, the efficient conduct of monetary policy requires a solid understanding of the government's short- and longer-term financial flows. As a result, debt management, fiscal and monetary officials often meet to discuss a wide range of policy issues. At the operational level, debt management, fiscal and monetary authorities generally share information on the government's current and future liquidity needs. They often coordinate their market operations so as to ensure that they are not operating in the same market segment at the same time. Nevertheless, achieving separation between debt management and monetary policy might be more difficult in countries with less-developed financial markets, since debt management operations may have correspondingly greater effects on the level of interest rates and the functioning of the local capital market. Consideration needs to be given to the sequencing of reforms to achieve this separation.

B. Transparency and accountability

As outlined in the Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles (MFP Transparency Code), the case for transparency in debt

⁷ For further information on coordination issues, see Sundarajan V, Dattels P and Blommestein H J, eds. *Coordinating Public Debt and Monetary Management*. Washington, DC, International Monetary Fund, 1997.

management operations is based on two main premises: first, their effectiveness can be strengthened if the goals and instruments of policy are known to the public (financial markets) and if the authorities can make a credible commitment to meeting them; second, transparency can enhance good governance through greater accountability of central banks, finance ministries and other public institutions involved in debt management.

1. *Clarity of roles, responsibilities and objectives of financial agencies responsible for debt management*

The allocation of responsibilities among the ministry of finance, the central bank or a separate debt management agency for debt management policy advice and for undertaking primary debt issues, secondary market arrangements, depository facilities, and clearing and settlement arrangements for trade in government securities, should be publicly disclosed.⁸ Transparency in the mandates and clear rules and procedures in the operations of the central bank and the ministry of finance can help resolve conflicts between monetary and debt management policies and operations. Transparency and simplicity in debt management operations and in the design of debt instruments can also help issuers reduce transaction costs and meet their portfolio objectives. They may also reduce uncertainty among investors, lower their transaction costs, encourage greater investor participation and over time help governments lower their debt servicing costs.

The objectives for debt management should be clearly defined and publicly disclosed, and the measures of cost and risk that are adopted should be explained.⁹ Some sovereign debt managers also publicly disclose their portfolio benchmarks for cost and risk, although this practice is not universal. Experience suggests that such disclosure enhances the credibility of the debt management programme and helps achieve debt management goals. Complementary objectives, such as domestic financial market development, should also be publicly disclosed. Their relationship with the primary objective should be clearly explained.

Clear debt management objectives are essential in order to reduce uncertainty as to the government's willingness to trade off cost and

risk. Unclear objectives often lead to poor decisions on how to manage the existing debt and what types of debt to issue, particularly during times of market instability, resulting in a potentially risky and expensive debt portfolio for the government and adding to its vulnerability to a crisis. Lack of clarity with respect to objectives also creates uncertainty within the financial community. This can increase government debt servicing costs because investors incur costs in attempting to monitor and interpret the government's objectives and policy framework, and may require higher risk premiums because of this uncertainty.

2. *Open process for formulating and reporting of debt management policies*

Materially important aspects of debt management operations should be publicly disclosed. The Code of Good Practices on Fiscal Transparency – Declaration on Principles highlights the importance of and need for a clear legal and administrative framework for debt management, including mechanisms for the coordination and management of budgetary and extrabudgetary activities.

Regulations and procedures for the primary distribution of government securities, including the auction format and rules for participation, bidding and allocation, should be clear to all participants. Rules covering the licensing of primary dealers (if engaged) and other officially designated intermediaries in government securities, including the criteria for their choice and their rights and obligations, should also be publicly disclosed.¹⁰ Regulations and procedures covering secondary market operations in government securities should be publicly disclosed, including any intervention undertaken by the central bank as agent for the government's debt management operations.¹¹

3. *Public availability of information on debt management policies*

The public should be provided with information on the past, current and projected budgetary activity, including its financing, and the consolidated financial position of the government. Disclosure of information on the flow and stock of government debt (if possible on a cash

⁸ See MFP Transparency Code, 1.2, 1.3 and 5.2.

⁹ See MFP Transparency Code, 1.3 and 5.1.

¹⁰ See MFP Transparency Code, 6.1.3.

¹¹ See MFP Transparency Code, 1.3.

and accrual basis) is important.¹² Liberalized capital markets react swiftly to new information and developments, and in the most efficient of these markets, participants react to information whether published or not. Market participants will attempt to infer information that is not disclosed, and there is probably no long-term advantage to the issuer from withholding materially important information on, for example, the estimated size and timing of new debt issuance. Most debt managers therefore regularly publish projected domestic borrowing programmes. Some adhere to set patterns of new issuance, while retaining flexibility to fix the amounts and maturities of instruments that will be auctioned until one or two weeks prior to the auction.

The government should regularly publish information on the stock and composition of its debt and financial assets, including their currency, maturity and interest rate structure.¹³ The financial position of the public sector should be regularly disclosed.¹⁴ Where contingent liabilities exist (for example, through explicit deposit insurance schemes sponsored by the government), information on their cost and risk aspects should be disclosed whenever possible in the public accounts.¹⁵ It is also important that the tax treatment of public securities be clearly disclosed when they are first issued. The objectives and fiscal costs of tax preferences, if any, for government securities should also be disclosed.

Transparency and sound policies can be seen as complements. The Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles recognizes, however, that there may exist circumstances under which it may be appropriate to limit the extent of such transparency.¹⁶ For example, a government may not wish to publicize its pricing strategy prior to debt repurchase operations in order to avoid having prices move against it. However, in general, such limitations would be

expected to apply on relatively few occasions with respect to debt management operations.

4. *Accountability and assurances of integrity by agencies responsible for debt management*

Debt management activities should be audited annually by external auditors. The accountability framework for debt management can be strengthened by public disclosure of audit reviews of debt management operations.¹⁷ Audits of government financial statements should be conducted regularly and publicly disclosed according to a pre-announced schedule, including information on the operating expenses and revenues.¹⁸ A national audit body, such as the agency responsible for auditing government operations, should provide timely reports on the financial integrity of the central government accounts. In addition, there should be regular audits of debt managers' performance, and of systems and control procedures.

C. Institutional framework

1. *Governance*

The legal framework should clarify the authority to borrow and to issue new debt, invest and undertake transactions on the government's behalf. The authority to borrow should be clearly defined in legislation.¹⁹ Sound governance practices are an important component of sovereign debt management, given the size of government debt portfolios.

The soundness and credibility of the financial system can be supported by assurances that the government debt portfolio is being managed prudently and efficiently. Moreover, counter parties need assurances that the sovereign debt managers have the legal authority to represent the government, and that the government stands behind any transactions its sovereign debt managers enter into. An important feature of the legal framework is the authority to issue new debt, which is normally stipulated in the form of either borrowing authority legislation with a pre-set limit or a debt ceiling.

¹² See FT Code, Section II, and MFP Code, Section VII.

¹³ See FT Code, 2.2.

¹⁴ See the IMF's *Government Finance Statistics Manual* (second edition, draft, December 2000) for details on how to present such information. In addition, the Inter-Agency Task Force on Finance Statistics (TFFS) is developing a framework for the presentation of external debt statistics. See *External Debt Statistics: Guide for Compilers and Users* (TFFS, March Draft 2000).

¹⁵ The disclosure of contingent liabilities is discussed further in section 5.2.

¹⁶ See MFP Transparency Code, Introduction.

¹⁷ See MFP Transparency Code, 1.2, 1.3, Sections IV and VIII.

¹⁸ The audit process may differ, depending on the institutional structure of debt management operations.

¹⁹ See also FT Code, 1.2.

The organizational framework for debt management should be well specified, and ensure that mandates and roles are well articulated.²⁰ Legal arrangements should be supported by delegation of appropriate authority to debt managers. Experience suggests that there is a range of institutional alternatives for locating the sovereign debt management functions across one or more agencies, including in one or more of the following: the ministry of finance, the central bank, the autonomous debt management agency and the central depository.²¹ Regardless of which approach is chosen, the key requirement is to ensure that the organizational framework surrounding debt management is clearly specified, that there is coordination and sharing of information, and that the mandates of the respective players are clear.²²

Many debt managers file an annual debt management report, which reviews the previous year's activities, and provides a broad overview of borrowing plans for the current year based on the annual budget projections. These reports increase the accountability of the government debt managers. They also assist financial markets by disclosing the criteria used to guide the debt programme, the assumptions and trade-offs underlying these criteria, and the managers' performance in meeting them.

2. *Management of internal operations*

Risks of government losses from inadequate operational controls should be managed according to sound business practices, including well-articulated responsibilities for staff, and clear monitoring and control policies and reporting arrangements. Operational risk, due to inadequate controls and policy breaches, can entail large losses to the government and tarnish the reputation of debt managers. Sound risk monitoring and control practices are essential for reducing operational risk.

Operational responsibility for debt management is generally separated into front and

back offices with distinct functions and accountabilities, and separate reporting lines. The front office is typically responsible for executing transactions in financial markets, including the management of auctions and other forms of borrowing, and all other funding operations. It is important to ensure that the individual executing a market transaction and the one responsible for entering the transaction into the accounting system are different people. The back office handles the settlement of transactions and the maintenance of the financial records. In a number of cases, a separate middle or risk management office has also been established to undertake risk analysis and monitor and report on portfolio-related risks, and to assess the performance of debt managers against any strategic benchmarks. This separation helps to promote the independence of those setting and monitoring the risk management framework and assessing performance from those responsible for executing market transactions. Where debt management services are provided by the central bank (e.g. registry and auction services) on behalf of the government's debt managers, the responsibilities and accountabilities of each party and agreement on service standards can be formalized through an agency agreement between the central bank and the government debt managers.

Government debt management requires staff with a combination of financial market skills (such as portfolio management and risk analysis) and public policy skills. Regardless of the institutional structure, the ability to attract and retain skilled debt management staff is crucial for mitigating operational risk. This can be a major challenge for many countries, especially where there is a high demand for such staff in the private sector, or an overall shortage of such skills generally. Investment in training can help alleviate these problems, but where large salary differentials persist between the public and private sector for such staff, government debt managers often find it difficult to retain these skills.

Debt management activities should be supported by an accurate and comprehensive management information system with proper safeguards. Countries that are beginning the process of building capacity in government debt management need to give high priority to developing accurate debt recording and reporting systems. This is required not only for producing debt data and ensuring timely payment of debt service, but also for improving the quality of budgetary re-

²⁰ See also Section 2.1 of the Guidelines, and MFP Transparency Code, 5.2.

²¹ A few countries have privatized elements of debt management within clearly defined limits, including, for example, some back-office functions and the management of the foreign currency debt stock.

²² If the central bank is charged with the primary responsibility for debt management, the clarity of, and separation between, debt management and monetary policy objectives particularly needs to be maintained.

porting and the transparency of government financial accounts. The management information system should capture all relevant cash flows, and should be fully integrated into the government's accounting system. While such systems are essential for debt management and risk analysis, their introduction often poses major challenges for debt managers in terms of expense and management time. However, the costs and complexities of the system should be appropriate to the organization's needs.

Staff involved in debt management should be subject to a code of conduct and conflict-of-interest guidelines regarding the management of their personal financial affairs. This will help to allay concerns that staff's personal financial interests may undermine sound debt management practices.

Sound business recovery procedures should be in place to mitigate the risk that debt management activities might be severely disrupted by natural disasters, social unrest or acts of terrorism. Given that government debt issuance is increasingly based on efficient and secure electronic book-entry systems, comprehensive business recovery procedures, including back-up systems and controls, are essential for ensuring the continuing operation of the government's debt management, maintaining the integrity of the ownership records and providing full confidence to debt holders about the safety of their investments.

D. Debt management strategy

The risks inherent in the government's debt structure should be carefully monitored and

evaluated. These risks should be mitigated to the extent feasible by modifying the debt structure, taking into account the cost of doing so. Box 2 summarizes some of the pitfalls encountered in sovereign debt management. A range of policies and instruments can be engaged to help manage these risks.

Identifying and managing market risk involves examining the financial characteristics of the revenues and other cash flows available to the government to service its borrowings, and choosing a portfolio of liabilities which matches these characteristics as much as possible. When they are available, hedging instruments can be used to move the cost and risk profile of the debt portfolio closer to the preferred portfolio composition.

Some emerging-market governments would be well served by accepting higher liquidity premiums to keep rollover risks under control, since concentrating the debt in benchmark issues at key points along the yield curve may increase rollover risk. On the other hand, reopening previously issued securities to build benchmark issues can enhance market liquidity, thereby reducing the liquidity risk premiums in the yields on government securities and lowering government debt service costs. Governments seeking to build benchmark issues often hold liquid financial assets, spread the maturity profile of the debt portfolio across the yield curve, and use domestic debt buy-backs, conversions or swaps of older issues with new issues to manage the associated rollover risks.

Box 2. Some pitfalls in debt management

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.*

Debt managers should avoid exposing their portfolios to risks of large or catastrophic losses, even with low probabilities, in an effort to capture marginal cost savings that would appear to be relatively "low risk".

- **Maturity structure.** A government faces an intertemporal trade-off between short-term and long-term costs that should be managed prudently. For example, excessive reliance on short-term or floating rate paper to take advantage of lower short-term interest rates may leave a government vulnerable to volatile and possibly increasing debt service costs if interest rates increase, and the risk of default in the event that it cannot roll over its debts at any cost. It could also affect the achievement of a central bank's monetary objectives.
- **Excessive unhedged foreign exchange exposures.** This can take many forms, but the predominant is directly issuing excessive amounts of foreign-currency-denominated debt and foreign-exchange-indexed debt. This practice may leave governments vulnerable to volatile and possibly increasing debt service costs if their exchange rates depreciate, and the risk of default if they cannot roll over their debts.
- **Debt with embedded put options.** If poorly managed, these increase uncertainty to the issuer, effectively shortening the portfolio duration and creating greater exposure to market/rollover risk.
- **Implicit contingent liabilities, such as implicit guarantees provided to financial institutions.** If poorly managed, they tend to be associated with significant moral hazard.

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

- **Debt collateralized by shares of state-owned enterprises or other assets.** In addition to understating the underlying interest cost, they may distort decisions regarding asset management.
- **Debt collateralized by specific sources of future tax revenue.** If a future stream of revenue is committed for specific debt payments, a government may be less willing to undertake changes, which affect this revenue, even if the changes would improve the tax system.
- **Tax-exempt or reduced tax debt.** This practice is used to encourage the placement of government debt. The impact on the deficit is ambiguous, since it will depend upon the taxation of competing assets and whether the after-tax rate of return on taxable and tax-exempt government paper are equalized.

3. *Misreporting of contingent or guaranteed debt liabilities.*

This may understate the actual level of the government's liabilities.

- **Inadequate coordination or procedures with regard to borrowings by lower levels of government, which may be guaranteed by the central government, or by state-owned enterprises.**
- **Repeated debt forgiveness for lower levels of government or for state-owned enterprises.**
- **Guaranteeing loans, which have a high probability of being called (without appropriate budgetary provisions).**

4. *Use of non-market financing channels.*

In some cases the practice can be unambiguously distortionary.

- **Special arrangements with the central bank for concessional credit, including zero-low-interest overdrafts or special treasury bills.**
- **Forced borrowing from suppliers either through expenditure arrears or through the issuance of promissory notes, and tied borrowing arrangements.** These practices tend to raise the price of government expenditures.
- **Creating a captive market for government securities.** For example, in some countries the government pension plan is required to buy government securities. In other cases, banks are required to acquire government debt against a certain percentage of their deposits. While some forms of liquid asset ratios can be a useful prudential tool for liquidity management, they can have distortionary effects on debt servicing costs, as well as on financial market development.

Box 2. Some pitfalls in debt management (continued)

5. *Improper oversight and/or recording of debt contracting and payment, and/or of debt holders.*

Government control over the tax base and/or the supply of outstanding debt is reduced.

- Failing to record implicit interest on zero-interest long-term debt. While helping the cash position of the government, if the implicit interest is not recorded, the true deficit is understated.
- Too broad an authority to incur debt. This can be due to the absence of parliamentary reporting requirements on debt incurred, or the absence of a borrowing limit or debt ceiling. However, the authority must ensure that existing debt service obligations are met.
- Inadequate controls regarding the amount of debt outstanding. In some countries a breakdown in internal operations and poor documentation led to more debt being issued than had been officially authorized.
- Onerous legal requirements with respect to certain forms of borrowing. In some countries, more onerous legal requirements with respect to long-maturity borrowings (relative to short-maturity borrowings) have led to disproportionate reliance on short-term borrowings, which compounds rollover risk.

Some debt managers also have treasury management responsibilities.²³ In countries where they are also responsible for managing liquid assets, debt managers have adopted a multi-pronged approach to the management of credit risk inherent in their investments in liquid financial assets, and financial derivatives transactions.²⁴ In countries where credit ratings are widely available, debt managers should limit investments to those that have credit ratings from independent credit rating agencies that meet a pre-set minimum requirement. All governments, however, should set exposure limits for individual counterparties that take account of the government's actual and contingent consolidated financial exposures to that counterparty arising from debt and foreign exchange reserves management operations. Credit risk can also be managed by holding a diversified portfolio across a number of acceptable financial counterparties and also through collateral agreements. Settlement risk is controlled by having clearly documented settlement procedures and responsibilities, and often placing limits on the size of payments flowing through any one settlement bank.

²³ In some countries debt managers also have responsibility for the management of some foreign exchange reserve assets.

²⁴ Financial derivatives most commonly used by debt managers include interest rate swaps and cross-currency swaps. Interest rate swaps allow debt managers to adjust the debt portfolio's exposure to interest rates, for example by synthetically converting a fixed rate obligation into a floating rate one. Similarly, a cross-currency swap can be used to synthetically change the currency exposure of a debt obligation. In addition, some countries have issued debt with embedded call or put options.

In order to help guide borrowing decisions and reduce the government's risk, debt managers should consider the financial and other risk characteristics of the government's cash flows. Rather than simply examining the debt structure in isolation, several governments have found it valuable to consider debt management within a broader framework of the government's balance sheet and the nature of its revenues and cash flows. Irrespective of whether governments publish a balance sheet, conceptually all governments have such a balance sheet, and consideration of the financial and other risks of the government's assets can provide the debt manager with important insights for managing the risks of the government's debt portfolio. For example, a conceptual analysis of the government's balance sheet may provide debt managers with useful insights about the extent to which the currency structure of the debt is consistent with the revenues and cash flows available to the government to service that debt. In most countries, these mainly comprise tax revenues, which are usually denominated in local currency. In this case, the government's balance sheet risk would be reduced by issuing debt primarily in long-term, fixed rate, domestic currency securities. For countries without well-developed domestic debt markets, this may not be feasible, and governments are often faced with a choice between issuing short-term or indexed domestic debt and issuing foreign currency debt. Issues such as crowding out of private sector borrowers and the difficulties of issuing domestic currency debt in highly dollarized economies should also be considered. But the financial analysis of the government's revenues and cash flows provides a sound basis for measuring the costs and risks

of the feasible strategies for managing the government's debt portfolio. The asset and liability management approach is summarized in box 3.

Some countries have extended this approach to include other government assets and liabilities. For example, in some countries where the foreign exchange reserves are funded by foreign currency borrowings, debt managers have reduced the government's balance sheet

risk by ensuring that the currency composition of the debt that backs the reserves, after taking account of derivatives and other hedging transactions, reflects the currency composition of the reserves. However, other countries have not adopted this practice because of considerations relating to exchange rate objectives and the institutional framework, including intervention and issues related to the role and independence of the central bank.

Box 3. Asset and liability management

Some governments are seeking to learn from companies that have successfully managed their core business and financial risks. Financial intermediaries, for example, seek to manage their business and financial risks by matching the financial characteristics of their liabilities to their assets (off- as well as on-balance sheet), given their core business objectives. This approach is known as asset and liability management (ALM). For example, a life insurance company is in the business of selling life insurance policies, which have a relatively stable expected long-term payment structure as determined by actuarial tables of expected mortality. To minimize its financial risk, a life insurance company will invest the proceeds of its policy sales in long-term assets to match the expected payout on its policies.

In some ways a government resembles a company. It receives revenues from taxpayers and other sources, and uses them to pay operating expenses, make transfer payments, purchase foreign exchange, invest in public infrastructure and state-owned enterprises, and meet debt-servicing costs. A government may also make loans and provide guarantees, both explicit and implicit. These various government operations may be undertaken to fulfil a broad range of macroeconomic, regulatory, national defence and social policy objectives. However, in the process a government incurs financial and credit risks, which can be managed by considering the types of risks associated with both its assets and its liabilities.

There are also important differences between the role of the government and that of private companies. While some governments have attempted to produce a balance sheet quantifying the value of their assets and liabilities, and more governments may attempt this in the future, this is not essential for the ALM approach. Instead, the objective of the ALM approach is to consider the various types of assets and obligations which the government manages and explore whether the financial characteristics associated with those assets can provide insights for managing the cost and risk of the government's liabilities. This analysis involves examining the financial characteristics of the asset cash flows, and selecting, to the extent possible, liabilities with matching characteristics in order to help smooth the budgetary impact of shocks on debt servicing costs. If full matching is not possible, or is too costly, the analysis of cash flows also provides a basis for measuring the risks of the liability portfolio and measuring cost/risk trade-offs.

Using a conceptual ALM framework for the debt management problem can be a useful approach for several reasons. At a minimum, it grounds the cost/risk analysis of the government's debt portfolio in an analysis of the government's revenues that will be used to service that debt, which in most cases are denominated by the government's tax revenues. It enables the government debt managers to consider the other types of assets and liability portfolios which the government manages, besides its tax revenues and direct debt portfolio. Assessing the main risks relating to these portfolios can help a government design a comprehensive strategy to help reduce the overall risk in its balance sheet. The ALM approach also provides a useful framework for considering governance arrangements for managing the government's balance sheet. This could, for example, involve deciding whether the government should maintain an ownership interest in producing particular goods and services, and the best organizational structure for managing the assets it wishes to retain.

The ALM approach to managing the government's exposure to financial risks is discussed in more detail in the forthcoming World Bank publication *Sound Practice in Sovereign Debt Management*.

Debt managers should carefully assess and manage the risks associated with foreign currency and short-term or floating rate debt. Debt management strategies that include an over-reliance on foreign currency or foreign-currency-indexed debt and short-term or floating rate debt are very risky. For example, while foreign currency debt may appear, *ex ante*, to be less expensive than domestic currency debt of the same maturity (given that the latter may include higher currency risk and liquidity premiums), it could prove to be costly in volatile capital markets or if the exchange rate depreciates. Debt managers should also be aware of the fact that the choice of exchange rate regime can affect the links between debt management and monetary policy. For example, foreign currency debt may appear to be cheaper in a fixed exchange rate regime because the regime caps exchange rate volatility. However, such debt can prove to be very risky if the exchange rate regime becomes untenable.

Short-term or floating rate debt (whether domestic or foreign-currency-denominated), which may appear, *ex ante*, to be less expensive over the long run in a positively sloped yield curve environment, can create substantial rollover risk for the government. It may also deter the central bank from raising interest rates to address inflation or support the exchange rate because of concerns about the short-term impact on the government's financial position. However, such actions might be appropriate from the viewpoint of macroeconomic management and, by lowering risk premiums, may help to achieve lower interest rates in the longer run. Macro-vulnerabilities could be exacerbated if there is a sudden shift in market sentiment as to the government's ability to repay, or when contagion effects from other countries lead to markedly higher interest rates. Many emerging market governments have too much short-term and floating rate debt. However, over-reliance on longer-term fixed rate financing also carries risks if, in some circumstances, it tempts governments to deflate the value of such debt in real terms by initiating surprise inflation.

Any such concerns would be reflected in current and future borrowing costs. Also, unexpected disinflation would increase the ex-post debt-servicing burden in real terms. This could create strains in countries which, because of an already heavy debt burden, have to pay a higher risk premium.

If a country lacks a well-developed market for domestic currency debt, a government may be unable to issue long-term, fixed rate domestic currency debt at a reasonable cost, and consequently must choose between risky short-term or floating rate domestic currency debt and longer-term, but also risky, foreign currency debt. Even so, given the potential for sizeable economic losses if a government cannot roll over its debt, rollover risk should be given particular emphasis, and this risk can be reduced by lengthening the maturity of new debt issues. Options to lengthen maturities include issuing floating rate debt, foreign currency or foreign-currency-indexed debt and inflation-indexed debt.²⁵ Over the medium term, a strategy for developing the domestic currency debt market can relieve this constraint and permit the issuance of a less risky debt structure, and this should be reflected in the overall debt management strategy. In this context, gradual increases in the maturity of new fixed rate domestic currency debt issues may raise cost in the short run, but they reduce rollover risk and often constitute important steps in developing domestic debt markets. However, debt structures which entail extremely "lumpy" cash flows should, to the extent possible, be avoided.

There should be cost-effective cash management policies in place to enable the authorities to meet their financial obligations with a high degree of certainty as they fall due. The need for cost-effective cash management recognizes that the window of opportunity for issuing new securities does not necessarily match the timing of planned expenditures. In particular, for governments lacking secure access to capital markets, liquid financial assets and contingent credit lines can provide flexibility in debt and cash management operations in the event of temporary financial market disturbances. They enable governments to honour their obligations, and provide flexibility to absorb shocks where access to borrowing in capital markets is temporarily curtailed or very costly. However, liquid assets are a more secure source of funds than unconditional, contingent credit lines, since financial institutions called upon to provide funds under these lines may attempt to prevent their exposures from expanding by withdrawing other lines from the government. On the other hand,

²⁵ While rollover risk can be reduced through such longer maturity instruments, the short *duration* of floating rate and indexed debt still exposes the issuer to potential variability in debt service costs.

some governments that do have secure access to capital markets prefer to minimize their holdings of liquid financial assets and instead rely on short-term borrowings and overdraft facilities to manage day-to-day fluctuations in their revenues and cash flows. Sound cash management needs to be supported by efficient infrastructure for payments and settlements, which are often based on dematerialized securities and a centralized, book-entry register.

Sound cash management by its very nature combines elements of debt management and monetary operations. Particularly in some developing countries where it is not given a high priority, poor or inadequate cash management practices have tended to hamper efficient debt management operations and the conduct of monetary policy.²⁶ Notwithstanding the desirability of a clear separation of debt management and monetary policy objectives and accountabilities, the search for liquidity creates a challenge for cash managers that might be more easily dealt with if debt and cash management functions are integrated in the same institution or work in close collaboration.²⁷ Where cash and debt management functions are separately managed, for example by the central bank and treasury or ministry of finance, respectively, close coordination and information flows, in both directions, are of paramount importance for avoiding short-run inconsistencies between debt and monetary operations. A clear delineation of institutional responsibilities, supported by a formal service agreement between the central bank, treasury and debt management officials, as appropriate, can further promote sound cash management practices.

Appropriate policies related to official foreign exchange reserves can also play a valuable role in increasing a government's room for manoeuvre in meeting its financial obligations in the face of economic and financial shocks. Box 4 summarizes some macroeconomic indicators that can be used as a starting point for assessing a country's external vulnerability.²⁸ More broadly, the level of foreign exchange reserves should be set in accordance with the govern-

ment's access to capital markets, the exchange rate regime, the country's economic fundamentals and its vulnerability to economic and financial shocks, the cost of carrying reserves, and the amount of short-term foreign currency debt outstanding. Governments lacking secure access to international capital markets could consider holding reserves that bear an appropriate relationship to their country's short-term external debt, regardless of whether that debt is held by residents or non-residents. In addition, there are some indicators specific to the government's debt situation that governments and debt managers need to consider. Ratios of debt to GDP and to tax revenue, for example, would seem to be very relevant for public debt management, as would indicators such as the debt service ratio, the average interest rate, various maturity indicators and indicators of the composition of the debt.

V. RISK MANAGEMENT FRAMEWORK

A framework should be developed to enable debt managers to identify and manage the trade-offs between expected cost and risk in the government debt portfolio. The cost of government debt includes two components: (a) the financial cost, which typically is considered to be the cost of servicing the debt over the medium to long run (and may be measured in terms of its impact on the government's fiscal position); and (b) the potential cost of real economic losses that may result from a financial crisis if a government has difficulty in rolling over its debt, or if it defaults.²⁹ To calculate the expected cost of debt under a particular strategy for managing the portfolio, debt servicing costs can be projected forward over the medium to long term, on the basis of assumptions of future interest and exchange rates and future borrowing needs. To minimize bias in choosing among different strategies, some governments use "market-neutral" assumptions of future interest and exchange rates – for example, based on market measures of forward rates, or on simple assump-

²⁶ Payment arrears are one common example of poor cash management—see box 2.

²⁷ See Guideline 1.3.

²⁸ Additional information on the motivations for holding foreign exchange reserves and factors influencing the adequacy of reserves under different exchange rate regimes can be found in "Debt- and Reserve-Related Indicators of External Vulnerability" (SM/00/65), IMF, 2000.

²⁹ Most countries measure the financial cost and risk of government debt over the medium to long run in terms of the future stream of nominal debt service costs. However, for countries that actively manage their debt portfolios to profit from expected movements in interest rates and exchange rates, which differ from those implicit in current market prices, the net returns on their trading positions are often measured in terms of changes in the market value of the trading portfolio, while risk is often measured in terms of the variance of these changes.

tions that rates will remain unchanged. The expected cost can be evaluated in terms of the projected financial impact on the government's budget or other measure of its fiscal position, as

well as for possible real costs if the projected debt service is potentially unsustainable in terms of its impact on future tax rates or government programmes, or if there is a potential for default.

Box 4. Overview of indicators of external vulnerability

| Indicators of reserve adequacy | Description |
|--|---|
| Ratio of reserves to short-term external debt | Single most important indicator of reserve adequacy in countries with significant but uncertain access to capital markets. Should be based on measure of reserves consistent with the <i>Balance of Payments Manual</i> , fifth edition, and operational guidelines for the <i>Special Data Dissemination Standard</i> reserves template, and a comprehensive measure of short-term debt of the public and private sectors on a remaining maturity basis. |
| Ratio of reserves to imports | Useful measure for reserve needs for countries with limited access to capital markets; effectively scales the level of reserves to the size and degree of openness of the economy. |
| Ratio of reserves to broad money | Measure of the potential impact of a loss of confidence in the domestic currency, leading to capital flight by residents. Particularly useful if the banking sector is weak and/or credibility of the exchange rate regime remains to be established. There are, however, other potential sources of capital flight as well. |
| Debt-related indicators | Debt-related indicators should generally be used in conjunction with medium-term scenarios, which permit the analysis of debt sustainability over time, and on a variety of alternative assumptions. |
| Ratio of external debt to exports | Useful indicator of trend in debt that is closely related to the repayment capacity of the country. |
| Ratio of external debt to GDP | Useful indicator for relating debt to resource base (reflecting the potential for shifting production to exports or import substitutes so as to enhance repayment capacity). |
| Average interest rate on external debt | Useful indicator of borrowing terms. In conjunction with debt/GDP and debt/export ratios and growth outlook, a key indicator for assessing debt sustainability. |
| Average maturity | Useful for homogeneous categories such as non-concessional public sector debt, to track shortening of maturities or efforts to limit future vulnerabilities. |
| Share of foreign currency external debt in total external debt | Useful indicator of the impact of exchange rate changes on debt (balance sheet effect), especially in conjunction with information on derivatives that transform the effective currency composition. |
| <i>Source:</i> "Debt- and Reserve-Related Indicators of External Vulnerability" (SM/00/65), IMF, 2000. | |

Market risk is then measured in terms of potential increases in debt servicing costs from changes in interest or exchange rates relative to the expected costs. The potential real economic losses that may result from such increases in costs or if the government cannot roll over its debt should also be considered. Sovereign debt managers typically manage several other types of risk, as summarized in box 1. An important role of the debt manager is to identify these risks, assess to the extent possible their magnitude, and develop a preferred strategy for managing the trade-off between expected cost and risk. Following government approval, the debt manager is also normally responsible for the implementation of the portfolio management and risk management policies. To carry out these responsibilities, debt managers should have access to a range of financial and macroeconomic projections. They should also have access to an accounting of official assets and liabilities on a cash or accrual basis, where this is available. Also, they require complete information on the schedule of future coupon and principal payments and other characteristics of the government's debt obligations, together with budget projections of future borrowing requirements.

To assess risk, debt managers should regularly conduct stress tests of the debt portfolio on the basis of the economic and financial shocks to which the government – and the country more generally – are potentially exposed. This assessment is often conducted using financial models ranging from simple scenario-based models to more complex models involving highly sophisticated statistical and simulation techniques.³⁰ When constructing such assessments, debt managers need to factor in the risk that the government will not be able to roll over its debt and be forced to default, which has costs that are broader than just to the government's budget. Moreover, debt managers should consider the interactions between the government's financial situation and those of the financial and non-financial sectors in times of stress in order to ensure that the government's debt management activities do not exacerbate risks in the

private sector.³¹ In general, models used should enable government debt managers to undertake the following types of risk analysis:

- Project expected future debt-servicing costs over a medium- to long-term horizon on the basis of assumptions regarding factors affecting debt-servicing capability, such as new financing requirements; the maturity profile of the debt stock; interest rate and currency characteristics of new debt; assumptions for future interest rates and exchange rates; and the behaviour of relevant non-financial variables (e.g. commodity prices for some countries);
- Generate a “debt profile”, consisting of key risk indicators of the existing and projected debt portfolio over the projected horizon;³²
- Calculate the risk of future debt-servicing costs in both financial and real terms by summarizing the results of stress tests that are formulated on the basis of the economic and financial shocks to which the government and the country more generally are potentially exposed. Risks are typically measured as the potential increase in debt-servicing costs according to the risk scenarios relative to the expected cost; and
- Summarize the costs and risks of alternative strategies for managing the government's debt portfolio as a basis for making informed decisions on future financing alternatives.

The appropriate strategy depends on the government's tolerance regarding risk. The degree of risk that a government is willing to take may evolve over time, depending on the size of the government debt portfolio, and the government's vulnerability to economic and financial shocks. In general, the larger the debt portfolio and the vulnerability of the country to economic shocks, the larger the potential risk of loss from financial crisis or government default, and the greater the emphasis should be on reducing risks rather than costs. Such strategies include selecting maturities, currencies and interest rate terms

³⁰ Complex simulation models should be used with caution. Data constraints may significantly impair the usefulness of these models, and the results obtained may be strongly model-dependent and sensitive to the parameters used. For example, some parameters may behave differently in extreme situations or be influenced by policy responses.

³¹ Of course, governments should also take corrective measures, such as eliminating policy biases that may encourage excessive risk-taking by the private sector.

³² A typical profile will include such indicators as the share of short-term to long-term debt, the share of foreign currency to domestic debt, the currency composition of the foreign currency debt, the average maturity of the debt and the profile of maturing debts.

to lower risk, as well as fiscal authorities placing more stringent limits on debt issuance. The latter approach may be the only option available to countries with limited access to market-based debt instruments, such as those that rely primarily on concessional financing from bilateral or multilateral creditors.

Debt managers in well-developed financial markets typically follow one of two courses: they periodically determine a desired debt structure to guide new debt issuance for the subsequent period, or set strategic benchmarks to guide the day-to-day management of the government's debt portfolio. Such portfolio benchmarks are typically expressed as numerical targets for key portfolio risk indicators, such as the share of short-term to long-term debt, and the desired currency composition and interest rate duration of the debt. The key distinction between these two approaches is the extent to which debt managers operate in financial markets on a regular basis to adhere to the "benchmark". However, the use of a strategic benchmark may be less applicable for countries with less-developed markets for their debt, since a lack of market liquidity may limit their opportunities to issue debt with the desired characteristics on a regular basis. Even so, many emerging-market countries have found it useful to establish somewhat less stringent "guidelines" for new debt in terms of the desired maturities, interest rate structure and currency composition. These guidelines often incorporate the government's strategy for developing the domestic debt market.

For those governments that frequently adjust their debt stock, strategic portfolio benchmarks can be powerful management tools because they represent the portfolio structure that the government would prefer to have, on the basis of its preferences with respect to expected cost and risk. As such, they can help guide sovereign debt managers in their portfolio and risk management decisions for example by requiring that debt management decisions move the actual portfolio closer to the strategic benchmark portfolio.³³ Governments should strive to ensure

that the design of their strategic portfolio benchmarks is supported by a risk management framework that ensures the risks are well specified and managed, and that the overall risk of their debt portfolios is within acceptable tolerances. Where markets are well developed, debt managers should try to ensure that their desired debt structures or strategic benchmarks are clear and consistent with the objectives for debt management, and publicly disclosed and explained.

A. Scope for active management

Debt managers who seek to manage the debt portfolio actively, so as to profit from expectations of movements in interest rates and exchange rates, which differ from those implicit in current market prices, should be aware of the risks involved and accountable for their actions. These risks include possible financial losses, as well as conflicts of interest, and adverse signaling with respect to monetary and fiscal policies. In order to be able to reduce borrowing costs without increasing risk by taking market views, debt managers require information or judgement that is superior to that of other market participants (and must also be able to transact in an efficient manner).

Debt managers may have better information on financial flows in the domestic market and the financial condition of market participants because of the government's privileged role as supervisor or regulator of the financial system. However, most governments consider it unwise and unethical to try to capitalize on such inside information, especially in the domestic market. In particular, debt managers and policy makers should not engage in tactical trading on the basis of inside information with respect to future fiscal or monetary policy actions. This is because the government is usually the dominant issuer of debt in the domestic market, and it risks being perceived as manipulating the market if it buys and sells its own securities or uses derivatives for the purpose of trying to generate additional income. Moreover, if the debt managers adopt interest rate or currency positions, their actions could also be interpreted as signaling a government view on the desired future direction of interest rates or the exchange rate, thereby making the central bank's task more difficult.

³³ However, debt managers should be mindful of the transaction costs associated with continuously rebalancing the debt portfolio to mirror the benchmark, as well as the costs associated with making a major shift in the structure of the portfolio over a short period of time. Common practice is therefore to express the benchmark characteristics as a range for currency composition, interest rate duration and level of refinancing.

In foreign capital markets, debt managers generally have little or no information on the nature of financial flows beyond that available in the market generally. Even so, some governments actively manage their foreign currency debt in the hope of generating risk-adjusted returns, or to enable their portfolio managers to accumulate greater market knowledge, in an attempt to generate cost savings on major borrowings. Many governments do not consider it appropriate to undertake such tactical trading. In cases where such trading is permitted, it should be conducted in accordance with clearly defined portfolio guidelines with respect to position and loss limits, compliance procedures and performance reporting. In countries where government debt managers undertake tactical trading, it normally comprises only a small fraction of a government's portfolio management activities.

B. Contingent liabilities

Debt managers should consider the impact that contingent liabilities have on the government's financial position, including its overall liquidity, when making borrowing decisions. Contingent liabilities represent potential financial claims against the government which have not yet materialized, but which could trigger a firm financial obligation or liability under certain circumstances. They may be explicit (such as government guarantees on foreign exchange borrowings by certain domestic borrowers, government insurance schemes with respect to crop failures or natural disasters, and instruments such as put options on government securities) or implicit, where the government does not have a contractual obligation to provide assistance, but (*ex post*) decides to do so because it believes the cost of not intervening is unacceptable. Examples of the latter could include possible bailouts of the financial sector, state-owned enterprises or sub-central governments. Unlike most government financial obligations, however, contingent liabilities have a degree of uncertainty – they may be exercised only if certain events occur, and the size of the fiscal payout depends on the structure of the undertaking. Experience indicates that these contingent liabilities can be very large, particularly when they involve recapitalization of the banking system by the government or government obligations that arise from poorly designed programmes for privatization of government assets. If structured without appropriate incentives or controls, contingent liabilities are often associated with moral hazard

for the government, since making allowances ahead of time can increase the probability of these liabilities being realized. As a result, governments need to balance the benefits of disclosure with the moral hazard consequences that may arise with respect to contingent liabilities.

Governments should monitor the risk exposures they are entering into through their explicit contingent liabilities, and ensure that they are well informed of the associated risks of such liabilities. They should also be conscious of the conditions that could trigger implicit contingent liabilities, such as policy distortions which can lead to poor asset and liability management practices in the banking sector. Some governments have found it useful to centralize this monitoring function. In all cases, the debt managers should be aware of the explicit contingent liabilities that the government has entered into.

The fiscal authorities should also consider making budget allowances for expected losses from explicit contingent liabilities. In cases where it is not possible to derive reliable cost estimates, the available information on the cost and risk of contingent liabilities or a liquidity drain can be summarized in the notes to the budget tables or the government's financial accounts, since contingent liabilities may represent a significant balance sheet risk for a government.

Governments can also do a great deal to reduce the risks associated with contingent liabilities by strengthening prudential supervision and regulation, introducing appropriate deposit insurance schemes, undertaking sound governance reforms of public sector enterprises, and improving the quality of their macroeconomic management and regulatory policies.

VI. DEVELOPMENT AND MAINTENANCE OF AN EFFICIENT MARKET FOR GOVERNMENT SECURITIES

In order to minimize cost and risk over the medium- to long run, debt managers should ensure that their policies and operations are consistent with the development of an efficient government securities market. An efficient market for securities provides the government with a mechanism to finance its expenditures in a way that alleviates the need to rely on the central bank to finance budget deficits. Moreover, by

promoting the development of a deep and liquid market for its securities, debt managers, in tandem with central banks and supervisors and regulators of financial institutions, and market participants (see box 5) can achieve lower debt service costs over the medium to long term as liquidity premiums embedded in the yields on government debt wane.³⁴ In addition, where they have low credit risks, the yields on government securities serve as a benchmark in pricing other financial assets, thereby serving as a catalyst for the development of deep and liquid money and bond markets generally. This helps to buffer the effects of domestic and international shocks on the economy by providing borrowers with readily accessible domestic financing, and it is especially valuable in times of global financial instability, when lower-quality credits may find it particularly difficult to obtain foreign funding. Governments should exercise particular care in borrowing in external markets.

Experience suggests that there is no single optimal approach for developing an efficient market for government securities. OECD countries, for example, have established government securities markets using a wide range of approaches involving different sequencing of reforms and speed of deregulation. But experiences in developing these markets in many countries demonstrate the importance of having a sound macroeconomic policy framework, well-designed reforms to adopt and develop market-based monetary policy instruments, and careful sequencing in removing regulations concerning the capital account.

A. Portfolio diversification and instruments

The government should strive to achieve a broad investor base for its domestic and foreign obligations, with due regard to cost and risk, and should treat investors equitably. Debt issuers can support this objective by diversifying the stock of debt across the yield curve or through a

range of market instruments. Such actions could be particularly beneficial to emerging market countries seeking to minimize rollover risk. At the same time, issuers need to be mindful of the cost of doing this and the market distortions that might arise, since investors may favour particular segments of the yield curve or specific types of instruments. And in less-developed markets, the nominal yield curve may extend only to relatively short-term securities. Attempting to extend the yield curve quickly beyond that point may be impractical or unfeasible. This has led some emerging market countries to issue large amounts of longer-term inflation-indexed debt and floating rate debt, since such debt may be attractive to investors in countries where government indebtedness is high, and the credibility of the monetary authorities is low.

As investors seek to diversify their risks through buying a range of securities and investments, debt managers should attempt to diversify the risks in their portfolios of liabilities by issuing securities at different points along the yield curve (different maturity dates), issuing securities at different points during the year (rather than issuing a large amount of securities in a single offering), offering securities with different cash flow characteristics (for example, fixed coupon or floating rate, nominal or indexed) and securities targeted at specific investors (for example, wholesale or retail investors, or in certain circumstances, domestic and foreign investors).³⁵ In so doing, debt managers should strive to treat investors equitably and, where possible, develop the overall liquidity of their debt instruments. This would increase their attractiveness to investors, and reduce the liquidity premium that investors demand, as well as reduce the risk that the pricing of government securities could be significantly affected by the actions of a small number of market participants. A well-balanced approach aimed at broadening the investor base and spreading rollover risks, while at the same time recognizing the benefits of building liquid benchmark issues, should contribute to the objective of lowering debt costs over the long run.

³⁴ Some governments are finding that declining government financing requirements have led to reduced liquidity in their government debt markets. This has triggered a debate regarding the benefits of rapidly paying down the debt stock. Partly as an alternative to extensive debt buy-backs, a few governments are continuing to issue some debt to build or maintain liquid financial markets. Similarly, the absence of sustained fiscal deficits in some countries has prevented the natural development of a government debt market. Some of them have nevertheless decided to issue debt to stimulate the development of a domestic fixed-income market.

³⁵ Some countries are considering attaching renegotiation or collective action clauses to their debt instruments, such as majority voting rules.

Box 5. Relevant conditions for developing an efficient government securities market

In most countries, the development of a government securities market has been pivotal in helping to create a liquid and efficient domestic debt market. Although countries have adopted different approaches in the timing and sequencing of measures to develop these markets, the main elements of many of these programmes are summarized below. One important prerequisite for building investor confidence is a track record of a sound macroeconomic environment. This includes implementing appropriate fiscal and monetary policies, coupled with a viable balance-of-payments position and exchange rate regime. In addition, developing a domestic securities market involves addressing, even in the nascent stages, securities market regulation, market infrastructure, the demand for securities and the supply of securities.

Early steps in developing *securities market regulation* to support the issuance and trading of government securities include:

- Establishing a legal framework for securities issuance;
- Developing a regulatory environment to foster market development and enable sound supervisory practices to be enforced; and
- Introducing appropriate accounting, auditing and disclosure practices for financial sector reporting.

Market infrastructure to help build market liquidity and reduce systemic risk can be developed over time by:

- Introducing trading arrangements suitable for the size of the market, which include efficient and safe custody, clearing and settlement procedures;
- Encouraging the development of a system of market makers to enable buyers and sellers to transact efficiently at prices reflecting fair value;
- Removing any tax or other regulatory impediments, which may hamper trading in government securities;
- Fostering, at a later stage, the scope for other money market and risk management instruments, such as repos and interest rate futures and swaps; and
- Central bank operations to manage market liquidity.

Strengthening *the demand* for government securities involves acting on a broad front to build the potential investor base through measures such as:

- Removing regulatory and fiscal distortions, which inhibit the development of institutional investors (e.g. pension reform);
- Eliminating below-market-rate funding through captive investor sources; and
- Implementing appropriate rules and regulatory regime affecting participation by foreign investors in the domestic market.

In developing *the supply* of government securities the key elements for establishing an efficient primary market include:

- Establishing clear objectives for security issuance and debt management;
- Developing basic projections of the government's liquidity needs;
- Creating safe and efficient channels for the distribution of securities (e.g. auctions, syndication, possible use of primary dealers) targeted to investor needs and thereby lowering transaction costs;
- Progressively extending the maturity of government securities;
- Consolidating the number of debt issues and creating standardized securities with conventional maturities with a view to eventually providing market benchmarks; and
- Moving towards a predictable and transparent debt management operation, for example with pre-announced issuance calendars, and greater disclosure of funding needs and auction outcomes.

The development of government securities markets is discussed in more detail in *Handbook on Development of Government Bond Markets*, which is to be published by the World Bank in cooperation with the International Monetary Fund.

Offering a range of debt management instruments with standardized features in the domestic market helps make financial markets more complete, which enables all participants to better hedge their financial commitments and exposures, thus contributing to reduced risks premiums and vulnerability in the economy more generally.

Where appropriate, issuing instruments with embedded options (such as savings bonds, which are redeemable by the bondholder on demand) may also contribute to instrument diversification. However, even where valid reasons exist for issuing such securities, debt managers should exercise considerable caution to ensure that the risks inherent in embedded options and other derivative instruments are integrated into the risk management framework, and that the instruments and risks are well understood by the issuer and other market participants.

B. Primary market

Debt management operations in the primary market should be transparent and predictable. Regardless of the mechanism used to raise funds, experience suggests that borrowing costs are typically minimized and the market functions most efficiently when government operations are transparent – for example, through the publication of borrowing plans well in advance and acting consistently when issuing new securities – and when the issuer creates a level playing field for investors. The terms and conditions of new issues should be publicly disclosed and clearly understood by investors. The rules governing new issues should treat investors equitably. And debt managers should maintain an ongoing dialogue with market participants and monitor market developments so that they are in a position to react quickly when circumstances require.

To the extent possible, debt issuance should use market-based mechanisms, including competitive auctions and syndications. In the primary market for government securities, best practice suggests that governments typically strive, where feasible, to use market-based mechanisms to raise funds. For domestic currency borrowings, this typically involves auctions of government securities, although syndications have been successfully used by borrowers that do not have a need to raise funds on a regular basis or are introducing a new instrument

to the market.³⁶ Governments should rarely cancel auctions because of market conditions, or cut off the amounts awarded below the pre-announced tender amount in order to achieve short-run debt service cost objectives. Experience has shown that such practices affect credibility and damage the integrity of the auction process, causing risk premiums to rise, hampering market development and causing long-run debt service costs to increase.

C. Secondary market

Governments and central banks should promote the development of resilient secondary markets that can function effectively under a wide range of market conditions. In many countries, debt managers and central banks work closely with financial sector regulators and market participants in this regard. This includes supporting market participants in their efforts to develop codes of conduct for trading participants, and working with them to ensure that trading practices and systems evolve continuously and reflect best practices. It can also include promoting the development of an active repo market in order to enhance liquidity in the underlying securities and minimize credit risk through collateralization.³⁷

A government can promote the development and maintenance of an efficient secondary market for its securities by removing both taxation and regulatory impediments that hinder investors' willingness to trade securities. These include removing possible regulations that provide captive funding from financial intermediaries to the government at low interest rates, and modifying tax policies that distort investment in and trading of financial and non-financial assets. In addition, government approaches to regulating financial markets and market participants often include a wide range of disclosure and supervision requirements to reduce the risk of fraud, and limit the risk that market participants

³⁶ Some governments have found that introducing a network of market makers can be a useful mechanism for distributing securities and fostering deep and liquid markets. Some countries have used primary dealers for this role, while others have sought to encourage a more open financial market place. Where primary dealers operate, the incentives and obligations, as well as eligibility criteria for becoming a primary dealer, need to be defined and disclosed.

³⁷ Committee on the Global Financial System, "How Should We Design Deep and Liquid Markets? The Case of Government Securities," Bank for International Settlements, Basel, October 1999.

may adopt imprudent asset and liability management practices that could increase the risk of insolvency and systemic failure in the financial system.

Central banks play a crucial role in promoting the development and maintenance of efficient markets for government securities through the pursuit of sound monetary policies. By conducting monetary policy in a way that is consistent with their stated monetary policy objectives, central banks help to increase the willingness of market participants to engage in transactions across the yield curve. Central banks are increasingly implementing monetary policy using indirect instruments that involve transactions in government securities. Proper design and use of such instruments have typically played an important role in contributing to deep and liquid markets for these securities. For example, day-

to-day open-market operations to implement monetary policy can foster adequate market liquidity, thereby contributing to well-functioning financial markets.

The systems used to settle and clear financial market transactions involving government securities should reflect sound practices.³⁸ Sound and efficient payments, settlement and clearing systems help to minimize transaction costs in government securities markets and contain system risk in the financial system, thereby contributing to lower financing costs for the government. Agencies responsible for the payments, settlement and clearing systems for financial transactions normally work closely with market participants to ensure that these systems are able to function well under a wide range of trading conditions.

³⁸ Relevant work in this area includes: the Group of Thirty (G-30) recommendations on clearance and settlement of securities transactions (1989), which cover nine general principles, including such aspects as central depositories, netting schemes, delivery versus payment systems, settlement conventions and securities lending; the *Disclosure Framework for Securities Settlement Systems*, published by the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO), 1997; the CPSS *Core Principles for Systemically Important Payment Systems*, 2001; and the CPSS-IOSCO Joint Task Force consultative report, *Recommendations for Securities Settlement Systems* (2001).

GUIDANCE FOR PLANNING AND CONDUCTING AN AUDIT OF INTERNAL CONTROLS OF PUBLIC DEBT¹

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I. INTRODUCTION

The Public Debt Committee of INTOSAI is responsible for publishing guidelines and other information for use by Supreme Audit Institutions (SAIs) to encourage the sound management and proper reporting of public debt. This guidance gives auditors a set of economic, budgeting and financial concepts and indicators that are commonly used in reviews of public debt operations.

Public debt auditors face increasing audit challenges. They must be able to attest the results of government default renegotiations, be familiar with complex debt instruments, reconcile different valuation practices for debt instruments and ensure transparency in debt reports. At the same time, they are responsible for implementing new audit standards that put more emphasis on reviews of internal controls, which are defined as procedures that help managers achieve their objectives. Internal controls are currently viewed as a continuous process, produced by an entity's management, and designed to provide reasonable assurance that the objectives of the entity are being achieved in the following categories:

- Operations are effective and efficient.
- Financial, budget and programme assessment reports are relevant and reliable.
- Responsible officials comply with applicable laws and regulations.

Of course, internal controls provide a reasonable, but not absolute, assurance of achieving government goals. Periodic evaluations of internal controls of debt operations serve to increase the chances of achieving a sovereign en-

tity's operational, financial and compliance objectives.

At the beginning of an audit of public debt, SAIs define the entities and debt instruments included in the review. At that time they consider the definition of the term "public debt". In this guidance, we have chosen to define "public debt" to include obligations evidenced by a legal instrument issued by a central or federal government; state, provincial, county, regional, municipal or local enterprises owned or controlled by the government; and other entities considered public or quasi-public. Bank loans to governments and marketable securities issued by governments are examples of public debt.

As noted in an earlier report of the Public Debt Committee, *Guidance on Definition and Disclosure of Public Debt*, the definition of public debt varies, depending on use. Economists will want a broad, all-encompassing definition when looking at the contribution of the public sector to the economy. Alternatively, if auditors were concerned about accountability, the definition would be narrowed to debt issued by a government entity with appropriate authority and responsibility. Each SAI exercises its own judgement on the appropriate entities and commitments to be included.

The audit's breadth and depth depend on the SAI's legal mandate, previous audit work done, and what resources are available for performing the audit. Some SAIs has a restricted legal mandate to audit sovereign debt. Others may have a broad legal mandate, but lack the technical expertise required for reviewing complex public debt transactions that have significant linkages to fiscal and monetary operations. These factors would affect which elements of

¹ This is a shortened version of an official publication of the Public Debt Committee of the International Organization of Supreme Audit Institutions (INTOSAI). The complete guidance in English, French and Spanish is available at the following website: www.intosaipdc.org.mx

² Representing the General Accounting Office of the United States, in its quality of member of INTOSAI Public Debt Committee. The other members of the INTOSAI Public Debt Committee are Argentina (Auditoría General de la Nación), Canada (Office of the Auditor General),

Chile (Contraloría General de la República), Egypt (Central Auditing Organization), Finland (State Audit Office), Gabon (Chambre des Comptes), Jordan (Audit Bureau), Lithuania (State Control), Mexico (Auditoría Superior de la Federación), Portugal (Tribunal de Contas), Republic of Korea (Board of Audit and Inspection), Russian Federation (Accounts Chamber), Sweden (National Audit Office), United Kingdom (National Audit Office), Yemen (Central Auditing Organization for Control and Auditing), and Zambia (Office of the Auditor General).

internal controls would be examined by the SAI. The five elements of internal controls are:

- Control environment;
- Risk assessment;
- Control activities;
- Information; and
- Communication and monitoring.

Each element can be viewed as a door that represents a potential audit area. Each door leads to areas whose audit varies in scope and technical complexity. The first door – the control environment – leads auditors to examine the attitude to, and awareness of sovereign debt management, and actions concerning controls. This door may be opened by SAIs with a clear mandate to audit the effectiveness of debt management. The other four internal control areas are more closely related to traditional audits of internal controls. For example, risk assessment would lead auditors to identify what events and circumstances affect the ability of debt management to record, process and report debt information. The rest of this paper describes each of the five elements, and sets out the specific questions which auditors would ask debt managers in order to determine whether internal controls exist and, if so, whether they are implemented effectively.

II. CONTROL ENVIRONMENT

The control environment is the foundation of internal controls by virtue of its influence on the conduct of public debt personnel. Senior debt management is responsible for establishing and nurturing a control environment with high ethical values, supportive human resource policies, an organizational structure with clear lines of responsibility and communication, and computer-based information systems that incorporate adequate security controls. Senior debt management is also responsible for achieving public debt objectives within the limits of its legal authority, ensuring that its personnel are conscious of the benefits of an adequate control environment, and monitoring external factors that affect the government's ability and willingness to service its debt. The key components of the control environment examined by auditors are listed below.

Integrity and ethical values. The effectiveness of internal controls cannot rise above the integrity and ethical values of the individuals who create, manage and monitor them. Because senior management can override internal controls, high integrity and ethical values of senior public debt officials are essential for maintaining effective internal controls.

Human resource policies. The complex nature of public debt operations – which may involve multiple currencies, variable interest rates, debt restructuring, and swaps of currency and interest payments – requires skilled staff to manage public debt instruments. Senior debt management is responsible for obtaining the competence levels necessary for achieving public debt objectives and assigning employees with the appropriate skills to each task.

Organizational structure. Most public debt organizations have several operational units with different management functions and reporting responsibilities. Public debt managers have two basic functions: a high-level function that involves coordinating debt operations with the government's fiscal and monetary operations, and an operational function that involves managing specific debt transactions.

In some countries attempts to improve and strengthen internal controls have focused on making the finance ministry the key institution responsible for public debt management. The finance ministry is put in charge of debt monitoring in coordination with the central bank, and all contracting of public debt and government guarantees requires its approval. Despite efforts to date, much remains to be done in some countries where the finance ministry is formally responsible for debt management, but the de facto institutional responsibility for public debt monitoring is dispersed among the finance ministry, the planning ministry and the central bank.

Computer-based debt information systems have major implications for audits of sovereign debt operations. Auditors must have sufficient computer expertise to carry out tests on the internal controls built into computer systems, which are commonly classified into general and application controls. General controls are the overall policies and procedures that create the environment in which applications are performed. If general controls are weak or non-existent, the reliability of application controls is

severely reduced. An application control helps ensure that debt information fed into the computer is correct and is correctly processed.

Many application controls are embedded into the specific computer system used by the ministry of finance and/or the central bank to manage sovereign debt. Approximately 50 countries have adopted the Debt Management and Financial Analysis System (DMFAS), a computer system designed by the United Nations Conference on Trade and Development (UNCTAD), and a similar number of countries have adopted the Commonwealth Secretariat Debt Recording and Management System (CS-DRMS). In some countries debt management is a component of an integrated financial management system (IFMS) that links debt operations with budgeting and cash management. The best IFMS would allow auditors to have continuous access to records, thereby helping SAIs to assess internal controls more effectively and produce timely audit results.

Laws, regulations, and practices are a key element of the controls environment that determines how debt managers work with their counterparts in other government units, including the budget office and central bank, and the extent of SAIs' authority over debt matters. SAIs review their countries' legal framework and actual debt procedures to gain an understanding of the environment in which debt managers operate and determine the scope of their audit. Some laws may prohibit the use of public borrowing to finance recurring expenditures or impose an overall public debt ceiling that can only be changed by the legislature. The legal framework can also impose audit limitations. For example, SAIs might not have legal authority to examine debt data of major government-controlled enterprises that issue loans guaranteed by the central government.

As part of a debt audit, some SAIs may be able to examine how public debt estimates are programmed into the budget and into the cash management system. Budget documents help to define net debt issuance over the next budget cycle, providing estimates of funding needed for investment and operating programmes. SAIs could also examine how public borrowing is used to fund temporary cash operating deficits. A key element of a cash management system that directly affects public debt operations is the capacity to develop cash flow projections based

on expected receipts and disbursements. This forecasting capacity depends in part on the government's ability to execute the budget and its ability to promptly collect cash and consolidate cash balances in a unified Treasury account. Failure to estimate the timing of cash inflows and disbursements may lead to unnecessary amounts of public debt and excessive amounts of idle cash.

External factors that affect the government's ability and willingness to service its debt should not be ignored by SAIs, even in audits of limited scope restricted to a debt management unit. Also, external sources of information can help SAIs to verify information provided by debt management staff. The ability to have access to debt information from third parties strengthens SAIs' capacity to evaluate the likelihood of sovereign debt defaults. SAIs can contact international organizations that collect debt data, such as the International Monetary Fund and the World Bank, international organizations such as the United Nations and the Organisation for Economic Co-operation and Development, creditor organizations such as the Paris and London Clubs, and credit rating organizations.

International institutions also provide criteria that can be used in sovereign debt audits. For example, rating agencies have identified economic and political factors that determine a country's ability and willingness to pay its debt. These factors include the stability of a country's form of government, the level and changes in a country's inflation, the exports of goods and services that provide foreign exchange reserves to service external debt, and reserve balances of the central bank.

III. SECOND ELEMENT: RISK ASSESSMENT

Risk assessment is the process of identifying circumstances and events that can prevent senior management from meeting debt objectives, and of measuring the probability of their occurrence. Operational risks arise in the normal course of managing debt transactions. Fraud risks arise from intentional misdeeds committed to gain personal benefit. The responsibility for identifying risks and developing plans to manage them lies with management. A risk plan would describe procedures to minimize damage caused by the risks. In the course of an

audit of internal controls of debt, SAIs would examine the risk plan and compare the actual performance of debt managers with the risk plan.

Operation risks usually arise in the areas that provide support services to the public debt organization. SAIs would recognize the following operation risks when they examine the organizational structure of the public debt management unit:

- (a) *Lack of separation of duties or functions.* Debt management staff should independently process, confirm, value, review and monitor public debt transactions.
- (b) *Inadequate staff expertise.* Supervisors must have the proper expertise to avoid becoming a “rubber stamp” for the debt traders. Support staff are usually the first line of defence for uncovering errors and irregularities that may occur in processing debt transactions.
- (c) *Product risk.* New debt instruments can be too complex or poorly understood. As a result, the support area could be unable to process, value and control new debt instruments.
- (d) *System and technology risks.* These risks exist when staff fail to keep abreast of technological developments associated with new information systems or adopt computerized information systems without “re-engineering” their debt management practices.
- (e) *Procedures risks.* These risks exist when the debt management functions do not have written procedures and the work flow is not structured in a predictable and well-designed manner, with proper audit trails maintained. Written procedures are especially important for handling complex debt instruments.
- (f) *Disaster recovery risks.* These risks exist when the debt organization has not planned for alternative sites, computer resources, communications, resources, trading facilities and other support services in the case of a disaster. Debt market makers must have alternative remote trading and technology sites and be able to recover from point of failure with minimal disruptions.
- (g) *Documentation risks.* These risks exist when debt transactions do not have well-designed agreements that are legally au-

thorized, properly executed and supported by appropriate confirmation in a timely manner. Legal departments and support staff must maintain master agreements and supporting confirmations.

- (h) *Valuation risks.* These risks exist when the support staff cannot perform, at least on a regular basis, an independent valuation by all debt instruments or if their valuation differs from the valuation by the SAI or an independent third party.

Fraud risks in the area of public debt are more likely to arise when the following three conditions are present:

- (a) Individuals who exercise control over debt operations have financial needs or desires caused by unexpected crises, a desire to increase their consumption, or simple greed.
- (b) The perpetrators of fraud have the ability to rationalize their illegal act – “the government owes me”. Fraudulent acts are rationalized in order to reconcile illegal behaviour with commonly accepted notions of decency and trust.
- (c) Individuals have an opportunity to engage in and conceal fraudulent debt transactions.

Of these three conditions, senior government officials have direct control over the third – fraud opportunities. In their assessment of the risk of fraud, auditors look for red flags that have been found in past fraud cases. Common fraud indicators include the following:

- Lack of basic internal controls in public debt operations, such as separation of duties involving debt accounting and execution of debt transactions;
- Government officials who fail to correct past audit findings promptly;
- Public debt transactions that lack a clear business or public policy purpose;
- Managers who are reluctant to produce documentary evidence when asked by auditors.

IV. THIRD ELEMENT: CONTROL ACTIVITIES

Control activities comprise the policies and procedures that help ensure that activities are

undertaken to achieve the government's debt objectives. Establishing an effective link between debt objectives and control activities is a critical component of internal controls.

V. OBJECTIVES

In most countries, the objectives pursued by debt managers address short-term and long-term fundamental issues that have been defined by a higher government authority independent of the debt managers. Sovereign debt objectives include the following:

Achieving liquidity for the Treasury. The primary purpose of a debt manager is to ensure that there is always cash to pay maturing liabilities. This objective is easier to achieve when the maturity dates of the existing stock of debt are spaced reasonably, and there is an adequate stock of cash to pay short-term obligations.

Maintaining a balance between cost and stability. After ensuring liquidity, a major objective is to find a balance between cost and stability, taking into account the risks associated with lowest cost. Because interest rates are generally higher for bonds with longer yields to maturity, lowest cost can generally be obtained by issuing instruments with shorter terms. But these entail increased risk. The shorter the term to maturity of a debt stock, the more susceptible it is to fluctuations in interest rates, inflation and currency movements.

Developing and maintaining an effectively functioning domestic capital market. In countries where the government is a major debt issuer, ensuring that the bond issuance and trading rules are fair and transparent is fundamental to encouraging both issuers and investors to use the domestic bond market.

VI. STRATEGIES

Debt strategies should be linked directly to debt objectives and defined in a way that allows them to be assessed. Debt strategies are commonly defined in terms of desired characteristics of the stock of public debt, such as the following:

- (a) *Ratio of fixed to floating debt.* In general, fixed debt is any marketable debt that is maturing or repriced in more than 12 months. For example, Canada had a policy to raise this ratio from 50 per cent in 1990 to 65 per cent by 1998. A reason for moving to a higher ratio of fixed debt is to stabilize long-term debt servicing costs.
- (b) *Average terms to maturity.* The benefits from increasing the ratio of fixed to floating debt come from the cost stability that long-term debt provides. The longer the term to maturity, the greater the stability of debt service payments. But increased stability may involve increased cost. The debt manager has to have a way of assessing the trade-off between cost and stability, taking into account the increased risk associated with borrowing in the short end of the yield curve.
- (c) *Need for benchmark yields.* Some governments have a policy of maintaining a well-functioning debt-based domestic financial market. If the government is the largest single borrower, it will have to consider whether it has issued sufficient tradable securities in a variety of maturity dates to sustain an efficient debt market.
- (d) *Ratio of domestic to foreign currency debt.* Assuming that there is a domestic currency market for a country's debt, there are two principal reasons for borrowing in foreign currency: to lower costs and to maintain a reserve of foreign currency as part of a country's exchange rate policies. But with borrowing in foreign currencies comes currency risk, which has to be weighed against the benefits of foreign currency debt.
- (e) *Ratio of real to nominal debt.* Governments have also issued debt that varies with inflation. The rate on this debt is a base or real rate plus an adjustment for inflation. With such debt, the government rather than the creditors assumes the risk associated with inflation. If the government believes that its inflation-reducing efforts will be effective, such an investment policy may be less costly to the government. Governments have also issued inflation-indexed debt in order to provide a market-based measure of inflation expectations that is monitored by monetary authorities.

VII. OPERATIONAL PLAN

Debt programme implementation depends on preparing an operational plan that is consistent with objectives and strategies. The operational plan includes procedures for selling debt securities, developing relationships with creditors and underwriters, and establishing control systems to collect, measure and report on debt transactions. Some of the steps involved in a debt programme include the following:

Selection of primary dealers, domestic and/or foreign. Most governments use dealers or underwriters to sell their debt. The choice of dealers (given their location, nationality and other attributes) and the maximum share of each bond issuance would be based on criteria consistent with a debt strategy.

Designing an appropriate debt issuance process. Debt is generally distributed to dealers either by auction or on tap. The process would be designed to ensure market integrity. This means that the markets would be transparent, orderly, liquid and efficient.

Maintaining relations with stakeholders. Maintaining confidence in the issuer, in terms of the economic stability of the country and the transparency of debt operations, can produce long-term savings. Market participants do not like surprises, and they reward governments that behave in an open and consistent nature. Maintaining a debt programme that provides confidence and transparency requires regular consultations with stakeholders on process, disclosure, issuance schedules, and so forth.

Managing operations risks. This is discussed above in the section on risk assessment.

Developing procedures to maintain financial integrity. A basic element of control is to reduce or minimize the risks associated with fraud, financial negligence and violation of financial rules, and loss of assets or public money.

At this point SAIs would develop audit procedures to review the controls embedded in each of the above activities. These procedures would include examining reports that monitor daily debt operations and provide assurance that the activities support debt objectives and strategies.

VIII. FOURTH ELEMENT: INFORMATION AND COMMUNICATION

In order to achieve public debt goals, policy makers need to rely on an information system that captures and disseminates relevant and reliable sovereign debt information. Such information is easier to produce under the following four conditions:

- A uniform system of government accounts is used consistently in budget, cash and public debt operations.
- An integrated database provides consistent cash, budget and public debt data, and facilitates the flow of information between and within operating units.
- An accounting-standards-setting body establishes a uniform accounting framework, and form and content reporting requirements.
- Inter-agency coordinating groups manage the evolution of information systems in an integrated and responsive manner.

For public debt transactions, the accrual basis of accounting is recommended over a cash or hybrid basis. Governments that record transactions on a cash basis could miss obligations to vendors for goods and services received but not yet paid for, which are usually a substantial liability. Similarly, governments that operate credit and loan guarantee programmes on a cash basis may recognize obligations when claims are paid rather than when commitments are made. This accounting method could lead to an understatement of public debt and produce distorted incentives for credit managers.

Timely public debt reports help to prevent irregularities and safeguard assets. Because public debt operations are associated with large sums of cash, timely information on cash proceeds and payments associated with public debt transactions can discourage perpetrators of fraud.

IX. FIFTH ELEMENT: MONITORING

The design and operation of a debt management unit are not immune to the need for change. Thus, appropriate vehicles for monitoring change should be in place that help decision makers detect when the environment has

changed and help debt managers to respond promptly and effectively.

Monitoring internal controls over public debt could involve using communications of outside parties, such as reports of external stakeholders, including institutional creditors, sovereign credit rating agencies and international organizations. Monitoring can be effected through both the normal ongoing public debt operations and separately focused audits. Debt managers normally depend on periodic reports and inquiries from inside and outside stakeholders to detect unexpected trends or changes. Ongoing monitoring should be built in through the use of periodic site visits, checks to determine whether procedures are being followed, and management review of reports. From time to time, senior debt management could also order a separate, thorough evaluation of internal controls.

X. SPECIFIC AUDIT PROCEDURES: CONTROL ENVIRONMENT

This section provides suggested audit objectives and procedures for each of the five internal control elements – the control environment, risk assessment, control activities, information and communication, and monitoring. The following sources of information are commonly used in the audit procedures listed in this section:

- Past audit experience;
- Interviews with public debt officials;
- Biographical details of senior public debt officials;
- Organization charts;
- Procedure manuals;
- Laws and regulations that cover issuance and reporting of public debt;
- Management reports;
- Internal audit reports; and
- Meeting minutes.

As examined above, the elements of the control environment can be categorized as (a) integrity and ethical values, (b) human resource policies, (c) organizational structure and (d) computer-based management systems. The audit objectives and procedures for these elements are listed next.

Integrity and ethical values

Objective 1: Determine whether a code of conduct exists and, if so, how it is implemented.

Procedures: SAIs would obtain oral and documentary evidence to answer the following questions:

- (a) Does management promulgate a written code of conduct, applicable to management and staff, to act as a benchmark for management and staff attitude and behaviour?
- (b) Does the code of conduct cover conflicts of interest or expected standards of behaviour?
- (c) Is the code communicated throughout the debt management unit?
- (d) Do employees periodically acknowledge it?
- (e) Are employees informed of what they should do if they encounter improper behaviour?
- (f) Are written policies in place to regulate management's dealings with employees, customers, creditors and insurers?
- (g) Is there a written policy regarding transactions with related parties?
- (h) Is there a written policy regarding the gifts and hospitality that may be accepted?
- (i) Is there a written policy regarding the declaration pecuniary benefits and outside financial interests (including such things as sponsorships, commission payments and directorships) by key public debt officials?
- (j) Are independent checks performed for the purpose of revealing common ownership, directorships and family relationships before major public debt transactions or orders are placed?

Objective 2: Determine the debt manager's attitude to internal controls.

Procedures: SAIs would examine documentation to answer the following inquiries:

- (a) Does management encourage and act on independent assessments of the control environment and internal controls?
- (b) Are auditors' management letters reviewed and responded to at board level?
- (c) Are internal audit reports on controls encouraged by senior management?

- (d) Is there an audit committee that has oversight arrangements for internal and external audits?
- (e) Does management actively respond to breaches of codes of conduct and law?
- (f) Is disciplinary action that is taken as a result of breaches communicated throughout the organization?
- (g) Does management ever override normal procedures, codes or internal controls? If so, is this documented and investigated?
- (h) Does management provide adequate resources for an appropriate level of internal audit work? Consider whether the internal audit function has an appropriate size, quality and independence.

Human resource policies

Objective 1: Determine the policies and practices for the recruitment, retention and remuneration of the debt manager.

Procedures: SAIs would examine documentation to answer the following inquiries:

- (a) Are vacant senior positions widely advertised within the pool of suitably qualified individuals (internally and/or externally)?
- (b) Are promotion and appointment mechanisms transparent and based on objective and appropriate criteria to prevent undue patronage and nepotism?
- (c) Is there an independent review (that is, by a sponsoring department or remuneration board) of remuneration, including termination payments?
- (d) Are factors other than achievement of short-term performance targets included in performance appraisals?
- (e) Are integrity and ethical criteria included in performance appraisals?
- (f) Is there an independent review (that is, by the internal audit, external audit or supervisory board) of the function and competence of key officers?
- (g) Are there job descriptions? If so, do they contain sufficient reference to control-related responsibilities?
- (h) Are executive functions assigned to appropriate levels of management?
- (i) Do delegated authorities appear to be appropriate?

Objective 2: Determine the policies and practices for the debt manager's recruitment and training.

Procedures: SAIs would obtain evidence by observation and examination of documents to answer the following questions:

- (a) Are recruitment policies in writing? Trained management personnel who are aware of the requirements of vacant positions and have appropriate interviewing skills would carry out application screening and recruitment interviews.
- (b) Are there appropriate procedures to verify candidates' experience, qualifications and references?
- (c) Do hiring policies require that candidates be investigated to ascertain whether they have a criminal record?
- (d) Are new employees made aware of their responsibilities and management's expectations, preferably by a detailed written job description that is kept up to date over the course of their employment?
- (e) Is there a regular review of each employee's job performance by relevant line management, and also by senior management?
- (f) Do performance reviews cover achieving developmental and training needs and the future developmental and training requirements of employees?
- (g) Are there appropriate disciplinary or remedial procedures for ineffective performance?
- (h) Are there appropriate disciplinary procedures for transgressions of the organization's code of conduct or other unacceptable employee behaviour?

Organizational structure

Objective: Determine the organizational structure of debt management.

Procedures: SAIs would obtain evidence by observation and examination of documents to answer the following questions:

- (a) Is there a clearly defined management/organization structure? If so, does it have clear reporting lines encompassing all of the organization's functions and staff?

- (b) Are the responsibilities of public debt officials clearly defined (preferably in writing)?
- (c) Are public debt officials' employment contracts reasonable (in terms of length, remuneration conditions, etc.)?
- (d) Are there appropriate checks and balances within the senior management structure (for example, non-executive directors, audit committees, separation of chairman and chief executive responsibilities, and oversight by the appropriate authority)?
- (e) Does the board (or its equivalent) have an appropriate range of expertise and experience (in areas such as economics, finance, accounting and information systems)?
- (f) Are there up-to-date procedure manuals covering both public debt operational and financial/accounting procedures?

Computer-based debt management systems

Objective 1: Evaluate general controls of computer-based debt information system.

Procedures: SAIs would obtain evidence to answer the following questions:

- (a) Is the computer-based debt information system administered by a high-level person who reports to senior officials in the Ministry of Finance or Central Bank, or both?
- (b) Are the developers of the software prevented from operating the computers and using the software with real debt data?
- (c) Are the debt programme and debt data secured and checked out only to authorized individuals by a custodian?
- (d) Does the custodian of the debt programme and debt data have access to the computer equipment to operate programs or change the debt data?
- (e) Are passwords formally assigned, routinely changed and protected against use by unauthorized people?
- (f) Are there terminal identification codes to prevent access by unauthorized terminals over communication lines?
- (g) Are current lists of authorized personnel and the extent of their authorizations maintained and verified?
- (h) Are sensitive hard-copy printouts routinely destroyed before they are discarded? Are

debt data on diskette and magnetic tapes thoroughly erased when the corresponding file addresses are removed from the file directory?

- (i) Is encryption used to protect confidential transmissions of debt data?
- (j) Is debt-related computer hardware tagged with identification numbers and assigned to specific employees? Is there a reconciliation of financial records and inventory counts?
- (k) Are modifications to software tested to verify that the changes made process debt data correctly?

Objective 2: Evaluate application controls of computer-based debt information system.

Procedures: SAIs would obtain evidence to answer the following questions:

- (a) Does the computer system have embedded rules, such as edit checks, to verify the accuracy of debt information as it is entered into the computer?
- (b) Are debt officials promptly notified of errors in processing debt transactions?
- (c) Are file controls used to check that the correct debt information is being updated and to prevent inadvertent destruction of files?
- (d) Are back-up copies of debt files, programs and documentation maintained?
- (e) Is there adequate documentation of the programs, applications and debt processing procedures?
- (f) Are exception reports provided to debt managers promptly? Are exceptions investigated and resolved?

XI. SPECIFIC AUDIT PROCEDURES: RISK ASSESSMENT

As discussed earlier, risk factors related to operations are greater in a debt management unit that lacks separation of critical duties and trained staff, has systems that do not meet technical standards, has work procedures that are informal, lacks the ability to revalue debt securities on a regular basis, and does not keep complete documentation of debt transactions.

Audit objectives and procedures for **operations risk** and **fraud risk** are as follows.

Objective 1: Determine whether operations risk indicators are present in debt management operations.

Procedures: Obtain sufficient evidence to answer the following questions:

- (a) Are staff responsible for custody of assets (debt securities, cash) separated from accounting?
- (b) Are staff responsible for public debt accounting provided with access to cash, debt instruments or bank accounts?
- (c) Are staff responsible for authorizing public debt transactions separated from the custody of the related assets?
- (d) Is recording of debt transactions separated so that a single staff member is not able to record a public debt transaction from its origin to its ultimate posting in the subsidiary and general ledgers?
- (e) Do the specialists who engage in debt transactions, their supervisors and the processing staff have comparable technical levels of experience and qualification in the field of debt management?
- (f) Are debt management staff properly trained in valuing, trading and processing new, complex debt products before they are introduced?
- (g) Are the systems for capturing, processing and reporting debt transactions reliable? Do they meet the latest technical standards?
- (h) Are the procedures in the debt management unit written, predictable and well-designed, with proper audit trails maintained?
- (i) Has the debt management unit planned for alternative site, computer resources, communication resources, trading facilities and other support services in the event of disaster?
- (j) Are debt transactions properly covered by well-designed master agreements that are properly executed and supported by appropriate documentation in a timely manner? Are debt transactions executed according to laws and restrictive covenants, including pledging of government assets, use of cash proceeds and debt restructuring agreements?

- (k) Are debt management staff able to perform an independent market valuation for all debt securities?

Objective 2: Determine whether fraud or high-risk indicators are present in debt management operations.

Procedures: Obtain sufficient evidence to answer the following questions:

- (a) Are public debt officials reluctant to provide information to auditors?
- (b) Are past audit findings of weak internal controls ignored?
- (c) Is there a significant risk of management overriding prescribed policies and procedures for illegitimate purposes namely, for the purpose of personal gain or enhanced presentation of sovereign debt's condition or compliance status?
- (d) Are serial-numbered documents always used in public debt transactions?
- (e) Are there photocopied or missing debt documents?
- (f) Are there unexplained public debt transactions that lack a clear purpose?
- (g) Are there public debt transactions that have not been approved by senior officials?
- (h) Have public debt securities been exchanged at other than fair market value with private investors?
- (i) Are government officials using foreign bank accounts held in a company name?
- (j) Are there unreconciled discrepancies between bank deposits and payments and public debt accounting records?
- (k) Are there unexplained public debt transactions involving dormant banking accounts?
- (l) Are there unexpected overdrafts or declines in account balances used in public debt transactions?
- (m) Have there been significant recent changes in debt regulations or accounting pronouncements that have not been implemented?
- (n) Have new personnel been assigned to perform control activities without adequate training?
- (o) Have new computer-based debt information systems been installed without adequate testing?

- (p) Have new debt transactions or securities been introduced without an understanding of their full impact on the government's financial condition and budget?

XII. SPECIFIC AUDIT PROCEDURES: CONTROL ACTIVITIES

As discussed earlier, control activities help ensure that the debt management staff are acting to achieve the government's debt objectives. In order to have effective control activities, senior debt officials should define in writing the debt objectives in each specific area, such as debt liquidity, cost and stability of the debt service.

Control activities that seek to achieve specific debt objectives would be added to the common control activities that ensure that there is proper authorization to engage in debt transactions, a complete enumeration and accounting of debt transactions is carried out, and assets are adequately safeguarded.

Objective 1: To determine whether the government has clearly defined debt objectives, policies, and procedures.

Procedures: Obtain sufficient evidence to answer the following questions:

- (a) Does the government have a debt management strategic plan and procedures manual?
- (b) Are public debt transactions authorized and executed in accordance with senior management directives so as to achieve specific objectives, such as guaranteeing sufficient liquidity to pay current obligations, a target average maturity of debt, a desired mix of foreign-currency debt, and an active domestic capital market?

Objective 2: To determine whether transactions were executed in accordance with general control policies related to effective and efficient recording of debt transactions, safeguarding of assets, reconciliation of debt records and transparency of debt reporting.

Procedures: Obtain sufficient evidence to answer the following questions:

- (a) Are public debt forms properly designed and adequately used to provide a complete

recording of the public debt terms, including the date on which the public debt transaction is made, original amount, collateral, period of repayment, interest rate, creditor's identity, currency, amortization of principal schedule, and guarantor?

- (b) Is a single entry of debt data used to avoid duplication errors and inconsistency in reports and to minimize costs?
- (c) Is the numbering system for debt transactions and instruments consistent with the reports to external stakeholders such as the World Bank?
- (d) Do debt reports meet the disclosure and transparency standards set by the international community?
- (e) Is access to debt documents and cash proceeds from debt issuance restricted?
- (f) Are trade confirmations of debt dealers reconciled with the government's public debt accounting records?
- (g) If the central bank acts as the fiscal agent of the government in debt transactions, does an independent auditor examine its internal controls?

XIII. SPECIFIC AUDIT PROCEDURES: INFORMATION AND COMMUNICATION

Internal controls in information and communication have the objective of providing senior government officials with the reliable debt reports they need to make timely borrowing, budget and cash decisions.

Objective: Determine whether government officials receive the debt information they need to carry out their ministerial responsibilities.

Procedures: Obtain sufficient information to answer the following questions:

- (a) Do senior government officials obtain timely debt information to produce a budget that incorporates a reliable debt service?
- (b) Do debt management officials obtain timely information on the government's daily cash position in order to issue enough debt to guarantee the government's liquidity at reasonable cost?
- (c) Do senior government officials in highly indebted countries (HIPCs) have relevant

and reliable debt information to obtain all the benefits of debt reduction under the HIPC Initiative?

- (d) Do public debt reports incorporate the most current information on new issues, debt restructuring and debt of government-sponsored enterprises guaranteed by the central government?
- (e) Are debt reports presented in accordance with the generally accepted accounting standards of the country and the disclosure standards adopted by the international community?

XIV. SPECIFIC AUDIT PROCEDURES: MONITORING

Monitoring of internal controls would be done by in-house audit staff; outside consultants can be called to perform major reviews of internal controls.

Objective: To evaluate the effectiveness of ongoing monitoring activities.

Procedures: Obtain sufficient information to answer the following questions:

- (a) Are there previous internal audit records of public debt transactions? If so, review internal audits' recommendations and ascertain whether corrective action has been taken.
- (b) Are internal audit reports submitted to senior debt policy makers?
- (c) Have staff obtained internal audit records and management reports that compare budget with actual performance in terms of public debt borrowings, repayments and interest expenses?
- (d) Are significant variations between budgeted and actual borrowing, repayments, interest expenses and debt balances reviewed and explained by debt managers?
- (e) If the number of public debt transactions has been small and the amounts involved have been high, have audit procedures been expanded to trace the movement of cash proceeds of funds from new borrowings into the cash account and cash receipts?
- (f) Are communications from creditors, regulators and other outside parties monitored for items of significance in debt management?
- (g) Is the appropriateness of current control activities evaluated when new accounting and information systems are developed and implemented?
- (h) Are accounting and information systems upgraded when the volume and complexity of debt transactions and debt stock information increase significantly?
- (i) Are employees required to sign off to evidence the performance of critical internal control activities?
- (j) Are investors' complaints promptly investigated for their underlying causes?

GUIDELINES FOR THE COMPILATION OF EXTERNAL DEBT STATISTICS

Robert Heath

I. INTRODUCTION

The need for comprehensive, comparable and reliable information on external debt to inform policy makers, financial markets and other users has long been recognized. It was reinforced once again by the international financial crises in the 1990s. Because they carry obligations to make future payments, external debt liabilities have the potential to create circumstances that render an economy vulnerable to solvency and liquidity problems. Moreover, as experience has shown, external vulnerability can have widespread economic costs, and not just for the initially affected economy.

To a considerable extent, the traditional focus of external debt statistics has been on borrowing from banks and government sources, often by the public sector. For the purposes of public debt management, good measurement of external debt allows a debt manager to determine how much is owed, to make budgetary projections, and to inform policy makers of the borrowing position in relation to any authorized limits. Depending on the stage of economic development, borrowing by the public sector from banks and government sources may still remain the focus of external debt analysis for a number of countries. But for many countries, the growth during the 1990s of cross-border private sector capital flows, the exposure of the private sector to foreign borrowing, the widespread issuance of debt securities, and the use of financial derivatives and similar instruments, have necessitated a wider scope for external debt analysis. In other words, in addition to the traditional focus, there has been an increasing need to monitor the cross-border financial borrowing activities of the non-bank private sector, including external borrowing by all sectors of the economy in the form of debt securities.

The new *External Debt Statistics: Guide for Compilers and Users (the Guide)*¹ responds to the concerns of markets and policy makers with regard to the provision of better external debt statistics to help assess external vulnerabili-

ties at a time when increasing international capital flows are resulting in greater interdependence of markets. Its purpose is to provide comprehensive guidance for the measurement and presentation of external debt statistics. It also provides advice on the compilation of these data and on their analytical use. The intention is to contribute to both an improvement in, and a greater understanding of, external debt statistics. The previous guidance on the measurement of gross external debt was provided in *External Debt: Definition, Statistical Coverage and Methodology, 1988*,² and included an agreed definition of what constituted external debt, with the intention of encouraging a greater consistency of approach in its measurement.

The production of the *Guide* has been jointly undertaken by the Bank for International Settlements (BIS), the Commonwealth Secretariat, the European Central Bank, Eurostat, the International Monetary Fund (IMF), the Paris Club Secretariat, the Organisation for Economic Co-operation and Development (OECD), the United Nations Conference on Trade and Development (UNCTAD) and the World Bank under the auspices of the Inter-Agency Task Force on Finance Statistics (TFFS). The TFFS is one of the inter-agency task forces formed under the aegis of the United Nations Statistical Commission and the Administrative Committee on Coordination – Sub-Committee on Statistical Activities, and was set up in 1992. It was reconvened in 1998 to coordinate work among the participating agencies to improve the methodological soundness, transparency, timeliness and availability of data on external debt and international reserve assets. The Task Force is chaired by the IMF. The production of the *Guide* also involved consultation with compilers and users in IMF member countries through a series of regional seminars conducted in 2000 and 2001, as well as through written comments on a draft that was posted on the Fund's website in March 2001.

¹ Available at <http://www.imf.org/external/np/sta/ed/ed.htm>

² Often referred to as *The Grey Book*.

II. WHAT IS EXTERNAL DEBT?

The *Guide* defines gross external debt as, at any given time, the outstanding amount of those actual current, and not contingent, liabilities that require payment(s) of principal and/or interest by the debtor at some point(s) in the future and that are owed to non-residents by residents of an economy.

For a liability to be included in external debt it must exist and be outstanding. Commitments to provide economic value in the future cannot establish debt liabilities until items change ownership, services are rendered or income accrues; for instance, amounts yet to be disbursed under a loan or export credit commitment are not to be included in the gross external debt position. The definition of external debt does not distinguish between whether the payments that are required are principal or interest, or both. For instance, interest-free loans are debt instruments although no interest is paid, while perpetual bonds are debt instruments although no principal is to be repaid. In addition, while it may normally be expected that payments will be made in the form of financial assets, such as currency and deposits, the definition does not specify the form in which payments need to be made. For instance, they could be made in the form of goods and services. Also, the definition does not specify that the timing of the future payments of principal and/or interest need be known for a liability to be classified as debt.

From the viewpoint of the national accounts, the definition of external debt is such that it includes all financial liabilities recognized by the *System of National Accounts 1993* as financial instruments that are owed to non-residents, except for shares and other equity, and financial derivatives.

III. CORE ACCOUNTING PRINCIPLES

For it to qualify as external debt, a resident must owe the debt liability to a nonresident. Residence is determined by where the debtor and creditor have their centres of economic interest, typically where they are ordinarily located, and not by their nationality. The guiding principle regarding whether claims and liabilities exist and are outstanding is determined at any moment in time by the principle of ownership.

The creditor owns a claim on the debtor, and the debtor has an obligation to the creditor.³

External debt data are to be compiled on the accrual basis; that is, transactions are recognized when economic value is created, transformed, exchanged, transferred or extinguished. The *Guide* recommends that interest costs accrue continuously on debt instruments, thus matching the cost of capital with the provision of capital. Traditionally, external debt recording systems have not recorded as external debt interest costs that have accrued and are not yet payable.

The compilation of the gross external debt position statement is complicated by the fact that the liabilities may be expressed initially in a variety of currencies or in other standards of value, such as special drawing rights (SDRs). The conversion of these liabilities into a reference unit of account is a requirement for the construction of consistent and analytically meaningful gross external debt statistics. From the perspective of the national compiler, the domestic currency unit is the obvious choice for measuring the gross external debt position. Such a position so denominated is compatible with the national accounts and most of the economy's other economic and monetary statistics expressed in that unit. The most appropriate exchange rate to be used for conversion of external debt (and assets) denominated in foreign currencies into the unit of account is the market (spot) rate prevailing on the reference date to which the position relates.

The *Guide* recommends that debt instruments be valued on the reference date at nominal value, and, for traded debt instruments, at market value as well. The nominal value of a debt instrument is a measure of value from the viewpoint of the debtor because at any moment in time it is the amount that the debtor owes to the creditor. This value is typically established by reference to the terms of a contract between the debtor and creditor, and is frequently used to construct debt ratios. The market value of a traded debt instrument is determined by its prevailing market price, which, as the best indication of the value that economic agents currently attribute to specific financial claims, provides a measure of the opportunity cost to both the debtor and the creditor.

³ Thus the *Guide* does not recognize any unilateral repudiation of debt by the debtor.

IV. PRESENTATION OF EXTERNAL DEBT STATISTICS

In the *Guide*, institutional units, and the instruments in which they transact, are grouped into categories so as to enhance the analytical usefulness of the data. Institutional units are grouped into institutional sectors, and financial instruments are classified by their nature into instrument categories. The institutional sector breakdown groups institutional units with common economic objectives and functions: general government, monetary authorities, banks and "other sectors". The "other sectors" cover non-bank financial corporations, non-financial corporations, households and non-profit institutions serving households.

For countries in which there is a particular interest in public sector debt, consistent with the framework of the World Bank's Debtor Reporting System, the *Guide* additionally provides a presentation of external debt on the public and publicly guaranteed external debt basis (public-sector-based approach). Such a presentation also includes non-guaranteed private sector external debt. As the concepts for its measurement remain consistent throughout the *Guide*, the gross external debt position for the whole economy – depending on whether traded debt instruments are valued at nominal or market value – should be the same regardless of whether data are presented by the institutional sector or on a public and publicly guaranteed basis.

Inter-company lending between entities in a direct investment relationship is separately presented because the nature of the relationship between debtor and creditor is different from that for other debt, and this affects economic behaviour. Whereas a creditor principally assesses claims on an unrelated entity in terms of the latter's ability to repay, claims on a related entity may be additionally assessed in terms of the overall profitability and economic objectives of the multinational operation.

As regards maturity, the traditional distinction between long- and short-term maturity, based on the formal criterion of original maturity, is employed. Long-term is defined as debt with an original maturity of more than one year or with no stated maturity. Short-term, which includes currency, is debt repayable on demand or with an original maturity of one year or less. If an instrument has an original maturity of one

year or less it should be classified as short-term, even if the instrument is issued under an arrangement that is long-term in nature.

The *Guide* defines as instruments debt securities, loans, currency and deposits, trade credit and other debt liabilities. Arrears are separately identified because such information is of particular analytical interest to those involved in external debt analysis, as the existence of arrears indicates the extent to which an economy has been unable to meet its external obligations.

To enhance analytical usefulness, various memoranda data series might be presented, together with a presentation of the gross external debt position, including on financial derivatives, equity securities, and debt securities issued by residents that are involved in reverse security transactions between residents and non-residents – all instruments and transactions which could render an economy vulnerable to solvency and, particularly, liquidity risks.

V. EXTERNAL DEBT AND DATA DISSEMINATION STANDARDS

With respect to the external debt data category, the Special Data Dissemination Standard (SDDS)⁴ prescribes the dissemination of quarterly data with a one-quarter lag, covering four sectors (general government, the monetary authorities, the banking sector, and other). Furthermore, the data are to be disaggregated by maturity (short- and long-term) and provided on an original maturity basis and by instrument, as set out in the fifth edition of the International Monetary Fund's *Balance of Payments Manual*. The transition period for countries to meet this prescription finishes at the end of March 2003. The SDDS encourages countries to disseminate supplementary information on future debt service payments, in which the principal and interest components are identified separately, twice yearly for the first four quarters and the following two semesters, with a lag of one quarter. The data should also be broken down into sectors – general government, monetary authorities,

⁴ The purpose of the SDDS is to guide Fund member countries in the provision to the public of comprehensive, timely, accessible and reliable economic and financial statistics in a world of increasing economic and financial integration. The SDDS is geared to those countries that have, or might seek, access to international capital markets. Subscription to the SDDS is voluntary.

the banking sector and other sectors. The dissemination of a domestic/foreign currency breakdown of external debt with quarterly periodicity and timeliness is also encouraged. A disaggregation by type of currency is not required.

With regard to the General Data Dissemination System (GDDS),⁵ the core data category for external debt includes public and publicly guaranteed debt, and the associated debt service schedule. Recommended good practice would be that the stock data, broken down by maturity, be disseminated with quarterly periodicity and timeliness – one or two quarters after the reference date. In addition, the associated debt service schedules should be disseminated twice yearly, within three to six months after the reference period, and with data for four quarters and two semesters ahead. Data on non-guaranteed private debt and debt-servicing schedules, with annual periodicity, are encouraged data categories to be disseminated within six to nine months after the reference period.

VI. OTHER MEASURES OF EXTERNAL DEBT

Data compiled and presented using the concepts described above provide comprehensive coverage and an informed picture of the gross external debt position for the whole economy and/or the public sector. However, such data do not provide a complete picture of emerging vulnerabilities to solvency and liquidity risk; for instance, the currency and interest rate composition of external debt liabilities, and the pattern of future payments, might all be potential sources of vulnerability. To assist in compiling additional data series of analytical use in understanding the gross external debt position, the *Guide* provides further guidance.

The important need for data on debt maturity profiles and currency breakdowns has been highlighted in international forums and, improving coverage of private sector debt liabilities, helped motivate preparation of the *Guide*. Thus,

the *Guide* provides conceptual guidance, and presentation tables, for data series such as the debt service schedule (especially relevant for liquidity analysis), the currency composition of debt, and other series proven to be of analytical use, such as on remaining maturity. The *Guide* also explains the concept of net external debt – that is, a comparison of the stock of external debt with holdings of external financial assets of similar instrument type – and incorporates financial derivative positions into external debt analysis. Presentational tables are provided that are flexible frameworks to be used by countries in the long-term development of their external debt statistics.

Debt reorganization

Debt reorganization transactions are a feature of external debt activity, and are described in the *Guide*. Economies sometimes face difficulties in meeting their external debt obligations or debtors may want to change the repayment profile of their external obligations for different reasons, including reducing the risk of future payment difficulties or reducing the cost of borrowing. In this context, they may undertake debt restructuring and debt conversions. Debt reorganization is defined in the *Guide* as bilateral arrangements involving both the creditor and the debtor that alter the terms established for the servicing of a debt. Types of debt reorganization include:

- (i) *Debt rescheduling*: a change in the terms and conditions of the amount owed, which may result, or not, in a reduction in burden in present value terms. These transactions are usually described as rescheduling. They are also sometimes referred to as refinancing or as debt exchanges. Included are transactions that change the type of debt instrument owed, for example loan for bond swaps, but not debt forgiveness transactions, as described in (ii) below
- (ii) *Debt forgiveness*: a reduction in the amount of or the extinguishing of a debt obligation by the creditor via a contractual arrangement with the debtor.
- (iii) *Debt conversion, and prepayments*: the creditor exchanges the debt claim for something of economic value other than another debt claim on the same debtor. This includes debt conversion, such as debt-for-equity swaps, debt-for-real-estate swaps,

⁵ The GDDS is a structured process focused on data quality that assists countries in adapting their statistical systems to meet the evolving requirements of the user community in the areas of economic management and development. Participating countries voluntarily commit themselves to adhering to sound statistical practices in developing their statistical systems.

and debt-for-nature swaps,⁶ and debt prepayment or buy-backs for cash.

Debt reorganization packages may involve more than one type – for example, most debt reorganization packages involving debt forgiveness also result in a rescheduling of the part of the debt that is not forgiven or cancelled. The *Guide* provides advice on measuring debt reduction arising from debt reorganization, and a table that presents such information according to the sector of the debtor (public-sector-based approach) and by type of creditor. Additionally, the table captures information on debt reduction arising from debt reorganization of bonds and notes.

VII. CONTINGENT LIABILITIES

The financial crises of the 1990s highlighted the shortcomings of conventional accounting systems in capturing the full extent of financial exposures arising from traditional “off-balance” sheet obligations, such as contingent liabilities, and from financial derivative contracts. The discovery of the magnitude and role of these obligations in those crises reinforced the need to monitor them.

Contingent liabilities are complex arrangements, and no single measurement approach can fit all situations; rather, comprehensive standards for measuring these liabilities are still evolving. Indeed, experience has shown that contingent liabilities are not always fully covered in accounting systems. Nonetheless, to encourage the monitoring and measurement of contingent liabilities, with a view to enhancing transparency, after defining contingent liabilities the *Guide* provides some measurement approaches, and then some reasons for their measurement. The focus is on explicit liabilities. More specifically, the *Guide* also provides a table for the dissemination of external debt data on an “ultimate risk” basis; that is adjusting residence-based external debt data for certain cross-border risk transfers through the provision of guarantees.

⁶ Some agreements described as debt swaps are equivalent to debt forgiveness from the creditor together with a commitment from the debtor country to undertake a number of development, environment, etc., expenses. These transactions should be considered under the second type of debt reorganization, as counterpart funds are not provided to the creditor.

VIII. OTHER MATERIAL IN THE GUIDE

An overview is provided of methods of compiling external debt, along with specific advice in this regard on compiling government and public-sector external debt data, banks’ and “other sectors” external debt data, and data on traded securities. Case studies of country experience in respect of the compilation of external debt statistics are also included.

The analytical use of external debt data is explained, helping compilers to place their work in context and users to interpret the range of information that can be available.

International agencies undertake considerable work in this field. The external debt data available from the BIS, IMF, OECD and the World Bank are described, and compared, and the debt monitoring systems of the Commonwealth Secretariat and UNCTAD are explained. Technical assistance activities in external debt statistics, and related macroeconomic statistics, of the international agencies involved in the production of the *Guide* are set out.

There are five appendices. The first provides detailed definitions and classifications of debt instruments and specific transactions. The second discusses reverse security transactions and how they should be recorded in the gross external debt position. The third provides a glossary of external debt terms, while the fourth describes the relationship between the national accounts and the International Investment Position (IIP). The last appendix explains the Heavily Indebted Poor Countries (HIPC) Initiative.

IX. CONCLUSION

The *Guide* is intended to be of value to compilers and users of external debt statistics by providing clear and consistent guidance on the measurement and presentation, as well as use, of external debt statistics. The International Monetary Fund will continue to undertake seminars and other activities to support external debt statistics compilation work.

PRIVATE SECTOR EXTERNAL DEBT

Balliram Baball

Private sector external debt (PSED) has grown in importance in the macroeconomic landscapes of many developing countries over the last decade. A convergence of factors has contributed to this, including the privatization of parastatals, the promotion of the private sector as the main engine of economic growth and the increasing role of that sector relative to the government, the increase in private capital flows to developing countries, both in absolute and proportional terms and the increase in private sector external debt relative to total external debt.

The South-East Asian financial crisis threw into stark reality the strong linkages of private sector external borrowings to the macroeconomy and the vulnerability of the economy to severe movements in these flows. This occurred in an environment of impressive macroeconomic performance and conventional debt indicators which were within safe prudential limits.

Developing countries are therefore taking more interest in this economic variable and are monitoring or considering monitoring these flows on a detailed loan-by-loan basis using computerized debt management systems such as UNCTAD's Debt Management and Financial Analysis System (DMFAS). Before this is done, however, several factors should be considered, especially with respect to availability of information.

The first relates to the type of exchange regime. Three regimes can be distinguished:

- Fully controlled, where all borrowings have to be approved by the authorities;
- Fully liberalized, where no approvals are required for borrowing and for repatriation of funds; and
- Semi-controlled, where loans satisfying certain criteria (e.g. servicing from external accounts or going to specific economic sectors, or under certain amounts, say US\$ 5 million) are exempt from the approval process.

Loan-by-loan information should be available from the administrative records in the fully controlled regime and a significant amount of

data should also be available for the loans requiring approval in partially liberalized economies. However, in fully liberalized economies, the authority to collect the information for loan-by-loan monitoring may have been lost with the abolition of exchange controls. Even in this type of regime, sufficient information on government-guaranteed private sector external borrowings should be available from the institution responsible for monitoring the contingent obligations of the government arising from these liabilities. Also, details of commercial banks' and other financial sector external borrowings could be made available through the authority of the various acts governing their operations. The challenge is really to collect information on private sector non-government-guaranteed external debt in fully liberalized regimes.

A country considering developing/strengthening systems for private sector external debt monitoring, especially one with a fully liberalized regime, has to first consider the necessity of undertaking this exercise relative to competing priorities in developing other statistical databases and the resources required. In the first case, this relates to the importance of PSED in the economy and the potential vulnerability of the economy to movements in this category of debt. Different indicators, such as PSED to exports of goods and services, PSED debt external service to total external debt service, PSED to reserves, and short-term PSED to total PSED, could be used to assess the relative importance of PSED in the economy.

Having opted to monitor this category of debt, the country then has to decide on aggregated or loan-by-loan monitoring, as this has significant implications for resources, methodology, etc. If the choice is for aggregated monitoring, the information can be collected through a survey of private capital flows or balance of payments. If the country chooses to adopt loan-by-loan monitoring, it has to decide whether it will target all private sector external loans or focus on a particular subset, as this can also affect the quantum of resources devoted to this exercise. Some countries have requested that only loans over a certain amount be reported individually, with aggregate information being

provided for all other loans. It can be adapted to different situations by altering the report limits, as necessary. This approach has been adopted by countries with semi-controlled regimes and fully liberalised regimes. Although there are no firm figures on the amount of resources “saved” by adopting this approach, it can be considerable. Some countries have estimated that this approach can yield resource savings of up to 50 per cent, while maintaining data collection of approximately 80 per cent of the value (not volume of loans and transactions) of the debt. This approach can also yield better response rates (a frequent problem) than if a larger subset is chosen, as the resources are concentrated in a smaller target group.

Developing/strengthening a system for collecting and monitoring private sector external

debt is not an insignificant task. It can be even more difficult than setting up a comprehensive system for public external debt. In the latter case, it has sometimes taken two years or more to build a comprehensive debt database. Taking into account the option chosen and the size and complexity of the private sector external debt, countries embarking on this exercise should prepare carefully, secure adequate resources and be prepared to undertake a medium-term exercise.

This session looks at how three countries with different types of regimes – fully liberalized (Indonesia), fully controlled (Malawi) and semi-controlled (Philippines) – are dealing with issues relating to the monitoring of private sector external debt.

MONITORING OF PRIVATE SECTOR NON-GUARANTEED DEBT: THE EXAMPLE OF A FULLY LIBERALIZED REGIME – INDONESIA

Veronica W. Sulisty

I. INTRODUCTION

The Asian crisis provided strong and fresh evidence of how harmful the volatility of international capital outflows could be for emerging economies. Sudden shifts in market expectations and confidence triggered a reversal of capital flows and therefore the initial financial turmoil in Indonesia, the Republic of Korea, Thailand, Malaysia and the Philippines. The crisis worsened and the recovery process was long and painful since those countries' economies were heavily burdened with foreign debt incurred by the corporate and banking sectors.

The five countries had attracted massive private capital inflows during the 1990s. Net private capital inflows into these countries reached \$93 billion in 1996 (see table 1). The bulk of these flows (80 per cent) were in the

form of private debts. In the case of Indonesia, the huge amount of private sector external debt, prior to the crisis (1997), was never properly recorded or monitored due to the liberalized capital inflows regime.

In the second half of 1997, these flows suddenly reversed themselves in outflows of \$12 billion. There was thus a turnaround of capital flows of \$105 billion in just 12 months. The most dramatic swing originated from commercial bank lending (which fell by \$77 billion), whilst foreign direct investment remained constant.

This paper will discuss a number of elements, such as the capital account regime in Indonesia and the country's private external debt monitoring development.

Table 1. Five Asian economies' external financing (billion \$)

| | 1996 | 1997 | Change between 1996 and 1997 |
|-------------------------|-------|--------|---------------------------------|
| External financing, net | 92.8 | 15.2 | - 77.6 |
| Private flows, net | 93.0 | - 12.1 | - 105.1 |
| Equity investment | 19.1 | - 4.5 | - 23.6 |
| Direct equity | 7.0 | 7.2 | 0.2 |
| Portfolio equity | 12.1 | - 11.2 | - 23.7 |
| PriMe creditors | 74.0 | - 7.6 | -81.6 |
| Commercial banks | 55.5 | - 21.3 | - 76.8 |
| Non-bank creditors | 18.4 | 13.7 | - 4.7 |
| Official flows, net | - 0.2 | 27.2 | 27.4 |

Source: Institute of International Finance (1998). *Capital Flows to Emerging Economies*. Washington D.C.

II. CAPITAL ACCOUNT LIBERALIZATION

Since the early 1980s Indonesia had pursued economic policy reforms, and opted primarily to reduce the economy's reliance on the oil sector by expanding the role of the private sector, and encouraging the creation of competitive non-oil sectors and an export-oriented industrial base. The key elements of the reform

included the gradual liberalization of direct investment and financial sector reform through the liberalization of external inflows.

In 1985, Indonesia maintained a liberal regime for the capital outflows of resident individuals and corporations. Lending abroad by banks and financial institutions to non-residents was, however, prohibited. Limitations on out-

flows through banks and financial institutions remained in effect throughout the period.

In 1989, the authorities liberalized portfolio capital inflows by eliminating quantitative limits on banks' foreign borrowing. However, their net foreign exchange open positions could not exceed 25 per cent of their equity. Foreign investors were permitted to invest in the stock market, and to acquire up to 49 per cent of the ownership of listed stocks. However, they were not allowed to purchase stocks issued by private banks.

In 1990–1991, the Indonesian economy started to overheat. The current account deficit widened, inflation accelerated and interest rates rose substantially.

However, in the context of maintaining a stable real exchange rate, the increase in interest rates was accompanied by a substantial inflow of foreign capital. These capital inflows were mainly in the form of commercial bank borrowings.

Concerned that the inflows through the banking sector were excessive and complicating macroeconomic management, the authorities reimposed quantitative controls on foreign borrowings by banks and state enterprises. They also introduced stricter limits on banks' open foreign positions and reduced banks' foreign exchange swap positions as a percentage of their capital base. The limitations on public sector borrowing from abroad remained in place from 1992 to 1996.

Despite imposing limitations on banks' foreign borrowing, the authorities continued to broaden foreign borrowing arrangements for trade and finance by private entities as part of their more general economic and financial sector development. This included the sales of securities to non-residents and the liberalization of foreign direct investment and portfolio investment. In 1992, for instance, foreign investors were allowed to purchase equity in commercial banks on condition that they did not hold the majority stock.

As a result of a large interest rate differential, a stable exchange rate and a rapid growth of its domestic stock market, Indonesia continued to attract net capital inflows from 1992 to the first half of 1997. These inflows took the form

of both net direct and portfolio investment. They came to an abrupt end, however, at the beginning of the Asian crisis.

In order to counteract the pressure of capital outflows, the authorities took a number of administrative measures. Non-residents' transactions in the forward market were restricted to \$5 million per customer, and each bank's net open position in the forward market was limited to \$5 million. In September 1997 the authorities removed the 49 per cent limit on the banking sector and allowed a foreign stake of up to 99 per cent of the total.

In sum, Indonesia maintained a liberal regime of capital outflows from 1985 to 1997. The only restrictions were on banks' and other financial institutions' foreign lending. Indonesia further liberalized its regime for capital inflows. There was basically no limitation on foreign investors' purchase of equity. The number of sectors closed to foreign direct investment had decreased and the domestic ownership requirement had become minimal. There were no restrictions on foreign borrowing by the corporate sector, while the foreign borrowing by banks and the public sector was subject to quantitative limitations. However, no minimal-rating requirements were imposed on foreign borrowing by banks, the public sector and corporate sector, unlike in the case of Chile.

III. THE PRIVATE EXTERNAL DEBT MONITORING SYSTEM BEFORE THE CRISIS

Since its first long-term economic development plan (1969), economic growth had remained constant at around 5 to 6 per cent. Thus, Indonesia's income per capita had also substantially improved – from \$80 in the late 1960s to around \$900 in the mid 1990s. During the latter decade a target of \$1,000 by the year 2000 was optimistically set.

Indonesia's success in the area of development has further reinforced its need for financing, but has also limited its receipt of official development assistance and concessional loans. The private sector is therefore at the forefront of the economy.

Unlike in the case of government external debt, which is well managed and monitored

through prudential guidelines and a recording system called the Debt Analysis Management System (DAMS)¹, there are no guidelines or recording system for private sector external debt, especially for the non-bank sector. Only the State-Owned Enterprise (SOE) and Bank Indonesia have a guideline for incurring external debt. This guideline was set out in Presidential Decree No. 39 of 1991. In order to make it applicable, the Commercial Offshore Loan Team (COLT) was established. Its task is to set the commercial external debt ceiling for the private sector, especially the SOE and the banking sector.

The COLT team will carefully select the SOE's project financed by external debt. Meanwhile, the setting of a ceiling and monitoring for the banking sector is a task for Bank Indonesia as a member of COLT. There are no regulations for the non-banking sector except reporting (see table 3).

Owing to the ineffective private non-bank external debt reporting system, which is not subject to legal enforcement, the amount of private debt at the end of 1997 could not be estimated. This caused speculation about its actual size and triggered further pressure on the rupiah.

IV. THE PRIVATE EXTERNAL DEBT MONITORING SYSTEM AFTER THE CRISIS

Since the previous regulation on private external debt monitoring failed to properly cover private external debt data, the government issued Presidential Decree No. 56 of 1998 Concerning the Obligation to Report on Foreign Commercial Borrowings Obtained by Private Companies. Bank Indonesia enacted this decree by issuing the Decree of the Board of Managing Directors of Bank Indonesia (No. 31/5/KEP/DIR, dated 8 April 1998) Concerning the Obligation to Report on Foreign Commercial Borrowings Obtained by Private Companies.

¹ DAMS is an application system for external debt data management, especially government external debt. Each loan is individually entered and administered in the system. Therefore, many kinds of information regarding the loan can be obtained from the database, and every month Bank Indonesia produces a Government External Debt Report. The report is used by departments and institutions, such as the Ministry of Finance, National Development Planning Agency, WI3 and the International Monetary Fund.

This Bank Indonesia decree provided for an administrative penalty in the form of a fine, in order to enhance coverage of entities reporting and also external debt data. The number of those reporting increased significantly from \pm 700 reporters before April 1998 to \pm 2,600. With the increase in coverage of private external debt data, data were provided on the monthly outstanding repayment schedule, and also terms and conditions.

This was not followed by the establishment of an effective recording system. DAMS was used as a temporary recording system to record private sector external debt, however, DAMS, was designed and developed to record government external debt, whose characteristics are different from private external debt. Consequently, important information regarding private external debt, such as those of company group ownership, foreign ownership, disbursement and arrears, could not be collected. A new recording system for private external debt was therefore developed by using the DAMS application as a base, and was separated from the DAMS server.

Under the new recording system, the inputting process was transferred from Bank Indonesia to the reporting entities in order to decrease the human error in inputting and processing time lag, and the reporting medium was changed from paper to floppy disk.

In accordance with Act No. 23 of 1999 Concerning Bank Indonesia, and Act No. 24 of 1999 Concerning Foreign Exchange Flows and the Exchange Rate System, the Decree of the Board of Managing Directors of Bank Indonesia No. 31/5/KEP/DIR (8 April 1998) was improved in order to accommodate these new acts and to improve the recording system, through the issuance of Regulation of Bank Indonesia No. 2/22/PBI/2000 (dated 2 October 2000) Concerning the External Debt Reporting Obligation.

This new regulation states that the monitoring of external debts is part of the measures initiated by Bank Indonesia in a bid to enhance the effectiveness of monetary policies through effective monitoring of foreign exchange flows. This monitoring will support the application of free foreign exchange flows in order to avoid any adverse impacts on the nation's economy.

Monitoring of foreign exchange flows comprises monitoring of all transactions that

contribute to transfers of assets and financial liabilities between residents and non-residents, including external debts. The monitoring obligates banks, non-bank institutions and individuals to report their external debts to Bank Indonesia.

The external debt reported is the debt of residents to non-residents, in foreign currency and/or Rupiah, based on a loan agreement, securities or other agreements such as trade payables except banks' liabilities in the form of demand deposit, saving deposit and time deposit.

The aim of the new regulation is to gather external debt statistics of external debt for the purpose of balance of payments and foreign exchange reserves management and monetary policy formulation.

Unlike external debt monitoring, which provides in-depth information about external debt (liabilities) incurred by residents, foreign exchange flows monitoring provides information about the flow of foreign exchange, both inflows and outflows (assets and liabilities). To implement foreign exchange flows monitoring, Bank

Indonesia issued Decree No. 1/9/PBI/1 999 Concerning Monitoring of Foreign Exchange Flow Activities of Banks and Non-Bank Financial Institutions.

This decree requires banks to report all transactions relating to their holdings of foreign financial assets and liabilities on a transaction report form. Meanwhile, the current position of their foreign financial assets and liabilities should be reported on a position report form. These reports should be submitted to Bank Indonesia online. Special emphasis is placed on payments via current accounts (nostro accounts of the reporting bank held with non-resident banks, vostro accounts of non-resident banks held with the reporting banks, current accounts of non-resident nonbanks held with the reporting banks).

V. EXTERNAL DEBT STATISTICS

Profiles of private external data are provided below.

Chart 1.

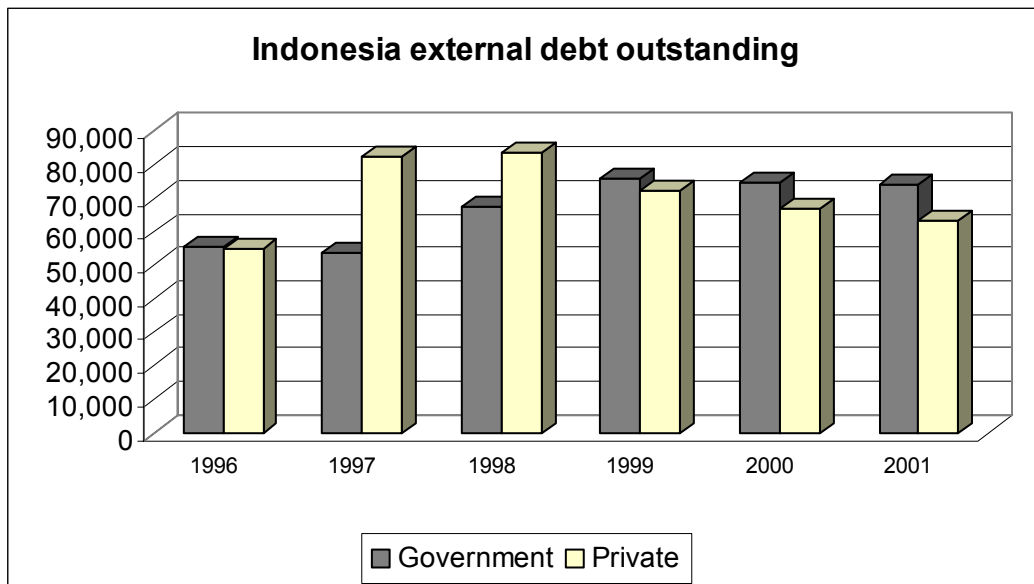


Table 2. Indonesia's external debt outstanding

| | (Million \$) | | | | | |
|-------------------|--------------|---------|---------|---------|---------|----------------|
| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 August |
| Government | 55 303 | 53 865 | 67 315 | 75 862 | 74 916 | 74 164 |
| | 50.2% | 39.6% | 44.6% | 51.2% | 52.9% | 53.9% |
| Private | 54 868 | 82 223 | 83 572 | 72 235 | 66 769 | 63 438 |
| | 49.8% | 60.4% | 55.4% | 48.8% | 47.1% | 46.1% |
| Bank | 9 049 | 14 364 | 10 769 | 10 836 | 7 719 | 6 952 |
| Non-Bank | 45 819 | 57 588 | 67 515 | 58 243 | 56 879 | 54 429 |
| Securities | - | 10 271 | 5 288 | 3 156 | 2 171 | 2 056 |
| Total | 110 171 | 136 088 | 150 887 | 148 097 | 141 685 | 137 602 |

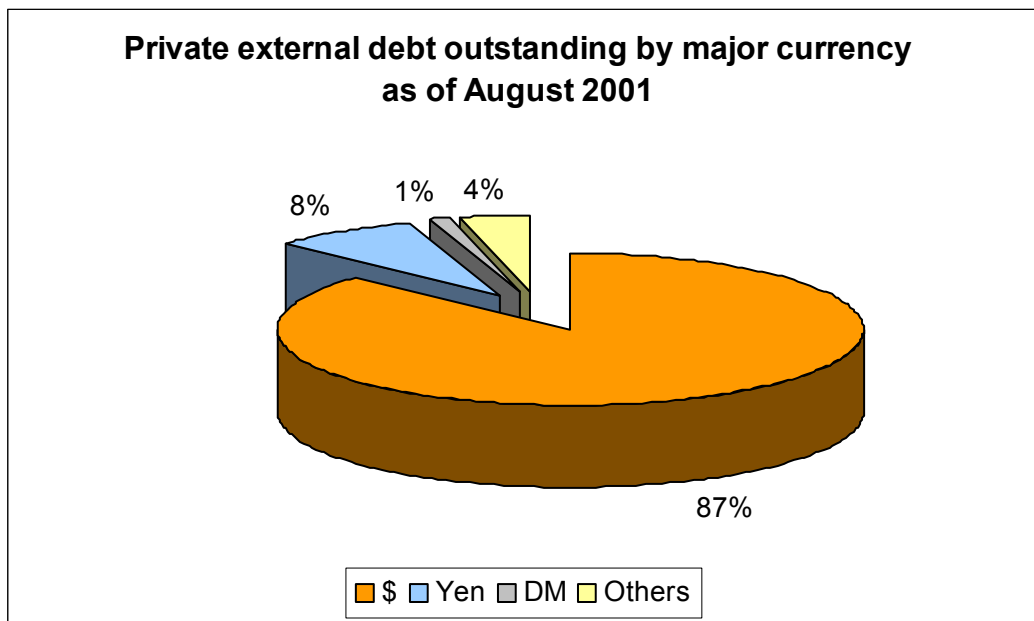
Chart 2.

Chart 3.

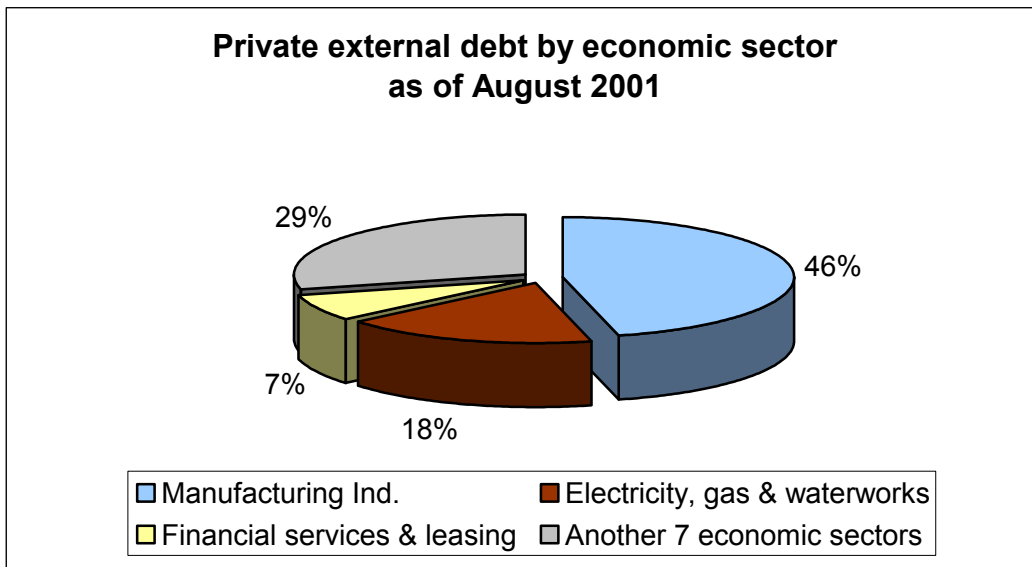
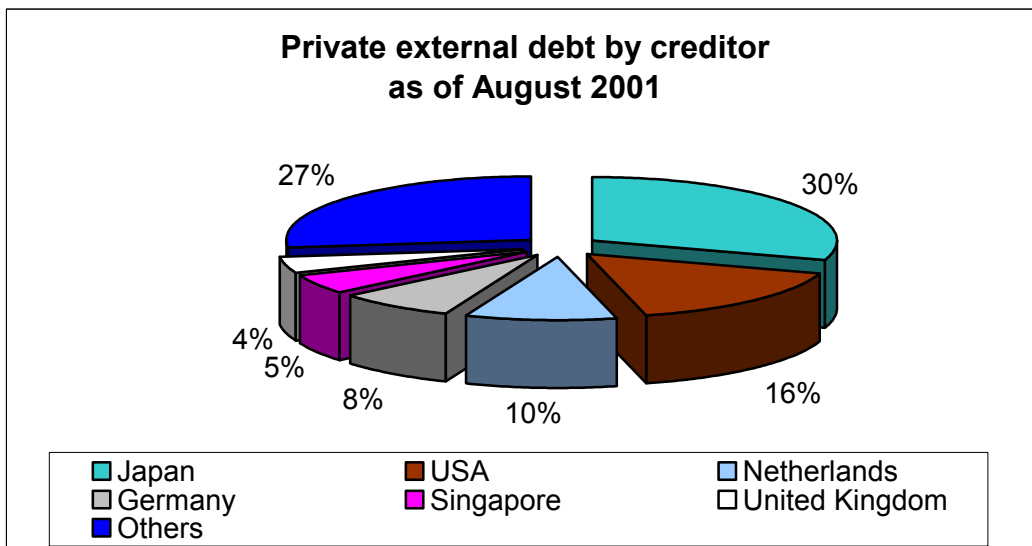


Chart 4.



VI. CONCLUSION

A good monitoring and recording system for private external debt is the most important part of external debt management. Lack of external debt statistics derived from such a system makes it difficult to ascertain the magnitude of the debt and debt service schedule. This was what happened in Indonesia at the end of 1997.

Thanks to the issuance of a new regulation on the external debt reporting obligation and

improvement of the recording system, information on amortization schedules and other information regarding external debt can be produced. This can help in managing external debt, and especially in ascertaining the sustainability of the debt position from a liquidity perspective in future periods.

There should be a continuous improvement in monitoring private external debt (including its recording/statistics), either in the application system or hardware.

Table 3. Guidelines in incurring external debt

| | SOE | Banking sector | Non-banking sector |
|-----------------------|--|--|---|
| | Yes | Yes | No |
| Ceiling | Set by Coordinating Minister for Economic, Finance and Development Supervision for each project financed by external debt | Set by Coordinating Minister for Economic, Finance and Development Supervision for each project financed by external debt. | |
| Loan executing | Should have consent from COLT | Should have a consent from Bank Indonesia | No |
| Monitoring | Done by COLT & BI Decree of the Board of Managing Directors of Bank Indonesia No. 291193/KEP/IDIR dated 26 March 1997 regarding reporting of external commercial debts by non-bank institutions. | Done by COLT & BI Decree of the Board of Managing Directors of Bank Indonesia No. 291192/KEP/DIR dated 26 March 1997 regarding guidelines for the receipt of external commercial debts by banks. | Done by COLT & BI Decree of the Board of Managing Directors of Bank Indonesia No. 291193/KEP/DIR dated 26 March 1997 regarding reporting of external commercial debts by non-bank institutions. |

**REGULATION OF BANK INDONESIA NUMBER 2/22/PBI/2000
DATED 2 OCTOBER 2000
CONCERNING: EXTERNAL DEBT REPORTING OBLIGATION
AND
CIRCULAR TO BANKS, NON-BANK INSTITUTIONS, AND INDIVIDUALS IN
INDONESIA NUMBER 2/20/DLN
DATED 9 OCTOBER 2000
SUBJECT: EXTERNAL DEBT REPORTING OBLIGATION**

The scope, types of reporting, and reporting deadline of the regulation are as follows:

The scope of regulation:

- A. The external debt reported is debt of residents to non-residents, in foreign currency and/or Rupiah, based on a loan agreement, securities, or other agreements such as trade payables except banks' liabilities in the form of demand deposit, saving deposit, and time deposit.
- B. The securities to be reported include the securities issued on overseas money markets or capital markets, in Rupiah or in foreign currency, including bonds, CP, PN, MTN, and FRN.

The loans in terms of trade payables to be reported refer to external debts arising from international trade with or without settlement through L/Cs with tenor of over 6 months. For banks, the loans to be reported are liabilities with L/Cs or without L/Cs that have become the bank's obligation such as drafts already endorsed by banks. For non-bank private corporations, the trade payables to be reported refer to non-L/Cs liabilities outside obligations already assumed by banks.

The bank's offshore loans to be reported are the external debts received by:

- Head office as well as branch offices of a commercial bank of Indonesian legal entities.
- Overseas branch offices of a bank with head office domiciled in Indonesia, irrespective of whether or not the loans are transferred to Indonesia.
- Foreign bank's branch office domiciled in Indonesia.

Reporting agents are: all the head offices of commercial banks of Indonesian legal entities, and foreign banks' branch offices domiciled in Indonesia, head offices of SOE, Regional State Enterprises (RSE), Private Corporations, and individuals, that have external debts.

The amount of external debts to be reported:

- External debt that is based on loan agreement amount to a minimum of USD 500,000 or equivalent to another currency based on the exchange rate prevailing when the loan agreement is signed.
- External debts in form of securities and based on other agreements such as trade payables should all be reported without any limit of a minimum amount.

The types of reporting

External debt reports consist of basic data of external debt and its outstanding:

1. Basic data of external debt comprises:

- Data of debtors, covering information of name, address, status, group of companies, group's name, and foreign ownership.

- Data of external debts, covering information of nominal, currency, date of signing, terms & conditions, disbursement and repayment schedule, economic sector, and creditor's name.

Data of external debt outstanding consist of data of external debt outstanding based on loan agreements, securities, and in the form of loans or trade payables, covering information of amount of disbursement, or amount of securities' issuing in nominal, amount of repayment, arrears and outstanding in the reporting month.

Reporting deadline:

- A. Basic data of external debt based on the loan agreement should be submitted to Bank Indonesia every time an external debt agreement is executed and/or amended.
- B. Basic data of external debt based on securities should be submitted to Bank Indonesia every time securities are issued.
- C. External debt outstanding based both on loan agreement and securities should be submitted to Bank Indonesia every month.
- D. Basic data and outstanding of external debt based on trade payable should be submitted to Bank Indonesia every month.

MONITORING OF PRIVATE SECTOR NON-GUARANTEED DEBT: THE EXAMPLE OF A FULLY LIBERALIZED REGIME – MALAWI

Jos Milner

I. INTRODUCTION

Malawi's adjustment efforts in the external sector have focused on a number of areas: (i) trade policy, foreign exchange market reforms and overall liberalization of the current account; (ii) export diversification efforts; and (iii) debt management strategies. Overall, these reforms have aimed at increasing the efficiency of foreign exchange allocation and encouraging export diversification and foreign capital inflows through the maintenance of an open, flexible and competitive exchange and payments system.

This paper will concentrate on issues related to private sector external debt, particularly in the areas of the mandate of the Reserve Bank of Malawi, reporting requirements, and analysis and monitoring techniques. It begins by presenting the background to Malawi's exchange control and its economy. This is followed by a discussion of institutional arrangements, which presents the mandate of the Reserve Bank of Malawi with respect to exchange control. In the next section, we attempt to justify the control over foreign borrowing before looking at the loan application and approval process in section V. Section VI outlines the recording of private sector external debt. The paper ends with some concluding remarks in section VII.

II. BACKGROUND TO MALAWI'S EXCHANGE CONTROL AND ITS ECONOMY

General

Malawi, located in southern Africa, is a landlocked country whose economy is predominantly based on agriculture, which accounts for about 40 per cent of gross domestic product (GDP) and for more than 90 per cent of the country's export earnings. About 80 per cent of total agricultural production is by way of small-holder production, while the rest is produced commercially on estates. Against this background, Malawi is a net exporter of primary products, which account for a substantial portion

of the country's foreign exchange reserves. Malawi is also dependent on donor assistance.

Malawi's exchange control system has evolved in phases. The initial phase, which came into effect in 1964, was characterized by a liberal trade and payments system. The second phase, in the early 1980s, emerged as a response to a series of external shocks. The third phase, which began in 1988, was part of a broad economic reform programme.

Evolution of Malawi's exchange controls

(i) *Post-independence phase*

The first phase, following the attainment of independence in 1964, was relatively liberal. For a number of items, import licences were required regardless of the country of origin. All other goods, originating from the Commonwealth or from non-Commonwealth but GATT member countries, were imported under an open general licence. Authorized dealers, without seeking approval from the Reserve Bank, automatically granted foreign exchange for the imports. In the case of capital, inward transfers were not restricted. Thus, residents were free to contract foreign loans, provided that repayment terms were acceptable. Outward transfers were nonetheless restricted, but non-residents were allowed to repatriate investment capital to their country of origin abroad, provided that the original investment funds came from abroad.

(ii) *External shocks phase*

The second phase, in the early 1980s, came in response to a series of external shocks, including oil price shocks, a decline in the prices of Malawi's major export crops, disruption of Malawi's shortest trading route to the seaport of Nacala in Mozambique due to Mozambique's civil war, and a worsening external debt service position due to increased uptake of short-term loans from international commercial banks. These developments influenced the implementation of expansionary fiscal and monetary policy.

The shocks resulted in declining growth rates as well as a deteriorating foreign exchange

reserves position and escalating inflation rates, and prompted the authorities to adopt a policy of restricting the allocation of foreign exchange for priority imports on the basis of an annual budget. This state of affairs did not provide an inducement to relax the restrictive policies on the capital account. This policy prevailed during most of 1986–1987.

(iii) Trade liberalization phase

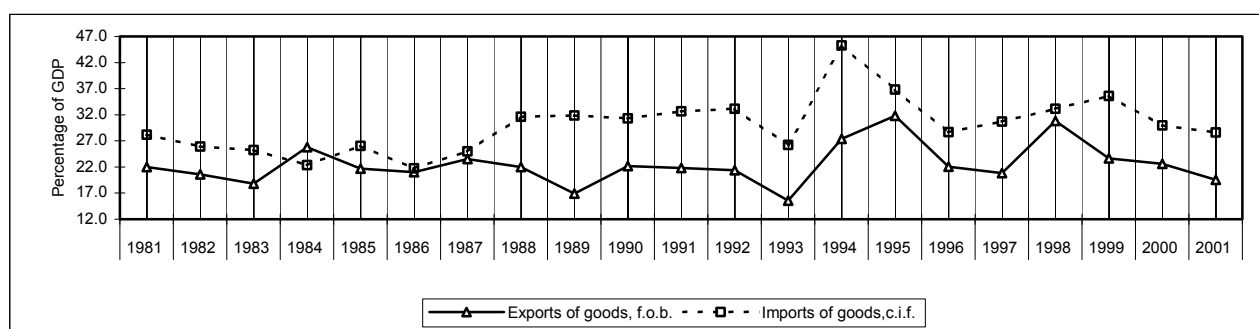
In 1988, Malawi embarked on an import liberalization scheme within a broader and comprehensive economic recovery programme designed towards the end of 1987. The economic recovery programme aimed at reducing the rate of inflation and moving the country towards a sustainable balance-of-payments position consistent with the growth objective and with price stability. The implementation of the import liberalization scheme formed the lynchpin of the third phase in the evolution of Malawi's exchange control system. In order to augment liberalization efforts and achieve a more efficient allocation of resources as well as a competitive

production structure, a market-based exchange rate determination system was instituted in February 1994. On 7 December 1995 Malawi accepted Article VIII obligations under the International Monetary Fund's Articles of Agreement.

Developments in the current and capital accounts

Over the years, developments in the balance of payments have been a reflection of how macroeconomic fundamentals have managed to either promote or hamper trade development. Chart 1 shows the movement of exports and imports expressed as a percentage of GDP. Generally, the ratio of exports to GDP has been higher than that of imports to GDP, notwithstanding a significant increase in the import bill in 1993 and in 1994. This increase was due to both the steep depreciation of the Malawi kwacha exchange rate and the relaxation in import procedures resulting from complete liberalization of the current account.

Chart 1. Imports and exports as percentage of GDP¹ (1981–2001)



The period between 1981 and 1987 in chart 1 depicts movement of the ratio of exports and imports to GDP under Phase II in the evolution of Malawi's exchange control system, during which phase the authorities adopted a policy of restricting the allocation of foreign exchange for imports. Thus, the ratio of imports to GDP declined from about 20 per cent in 1981 to a low of 13.4% in 1984, then rebounded in 1985 and fell again in 1986. In addition to the restrictions, the authorities devalued the kwacha several times during that period², making it more expensive to import. Thus, both quantitative restrictions and prices were used to restrict imports. In contrast, exports appear to have moved mainly in tandem with the devaluation attempts. The increase in the ratio of exports to GDP in 1984 was entirely in response to the September 1983 devaluation and also the pegging of the currency in 1984 to a basket of seven currencies.

During the third phase (from 1988 onwards), the ratio of imports to GDP hovered around 20% until 1993, when it shrank to 16.1% largely owing to severe foreign exchange shortages. Following the flota-

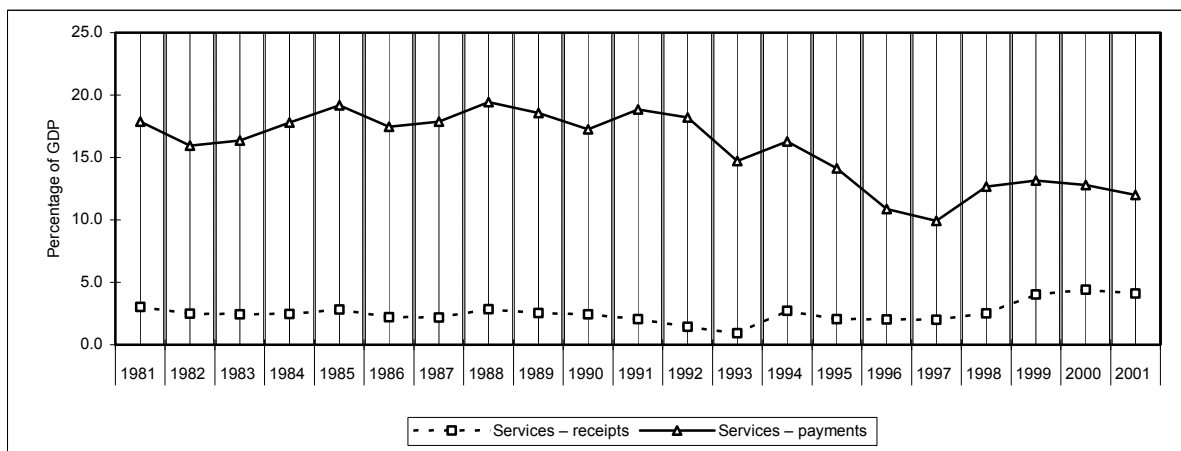
¹ The charts in this paper do not show the developments during the post-independence phase in the evolution of the exchange control system.

² The kwacha was devalued by 15% against the SDR on 24 April 1982 and by 12% on 17 September 1983. Following its pegging to a basket of seven currencies on 17 January 1984, the kwacha was devalued by 15% on 2 April 1985, 10% on 16 August 1986, 20% on 7 February 1987, 15 per cent on 16 January 1988, 7 per cent on 24 March 1990, 15 per cent on 28 March 1992 and 22 per cent on 11 July 1992.

tion and subsequent depreciation of the kwacha, the ratio rose substantially to 27.2% and bounced back to the 20% levels in subsequent years. During this phase, Malawi's creditworthiness was greatly undermined by foreign exchange shortages. The ratio of exports to GDP behaved in a similar fashion. It should be noted that the steep rise in 1994 is greatly exaggerated by the elimination of the large initial overvaluation of the currency over the entire period.

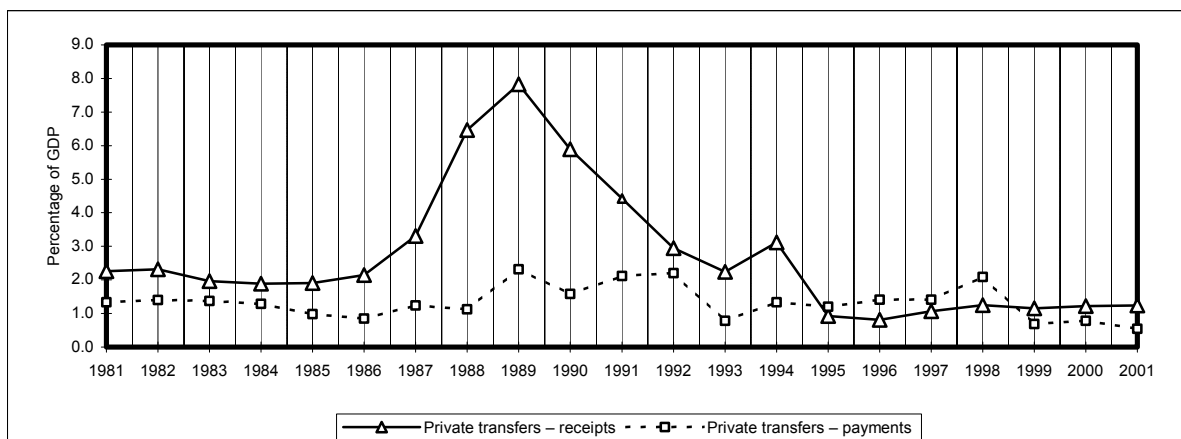
Receipts (in respect of services) as a percentage of GDP averaged 2.3% during the period 1981–2001 (chart 2). The major foreign exchange earner in that regard is tourism and to a lesser extent interest, accruing to the Reserve Bank of Malawi. Thus, during the entire period under review, these receipts remained almost constant. The ratio of payments for services to GDP, on the other hand, averaged 18.7%. The major component in this category is shipment. During the external shocks phase, the war in neighbouring Mozambique moved Malawi's c.i.f. margin to 45%. Again the steep rise in 1994 was a manifestation of the elimination of the initial overvaluation of the currency. From 1997, receipts began to increase while payments started on a declining trend.

Chart 2. Services as percentage of GDP (1981–2001)



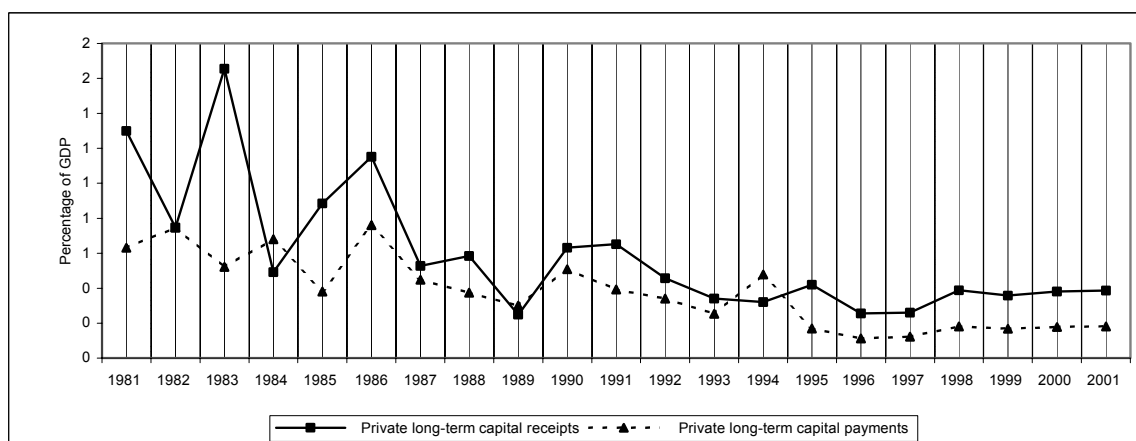
During the second phase of the evolution of Malawi's exchange control system, private transfer receipts and payments averaged 2.3% and 1.2% of GDP respectively (chart 3). Migrant remittances and religious missions accounted for the bulk of receipts under this category. On the payments side, remittances in respect of balance of earnings and other private transfers dominated the category. In the third phase, private transfer receipts averaged 3.4% of GDP. Whereas migrant remittances diminished in importance during that phase, religious missions ameliorated their position. Payments, on the other hand, averaged 1.6% of GDP. Other transfers³ are a major component in this regard.

Chart 3. Private transfers as percentage of GDP (1981–2001)



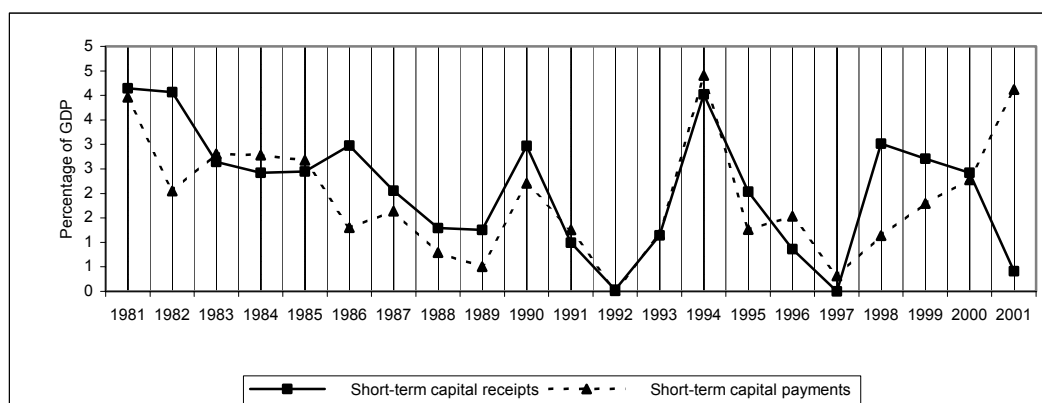
During the three phases of the evolution of exchange control in Malawi, the policy stance with respect to private sector capital flows was that of restricting outflows while remaining relatively open for inflows. Chart 4 reflects that policy stance to some extent, as payments are lower than receipts between 1981 and 2001. In percentage terms, these flows are too low, perhaps an indication of Malawi entrepreneur risk-aversion. Additionally, trade policy at that time, together with the overall environment, was more restrictive. The other movements are a reflection of the devaluations in those years. Since the Malawi kwacha was floated in 1994, both receipts and payments of long-term capital appear to have stabilized somewhat.

Chart 4. Private long-term capital as percentage of GDP (1981–2001)



The bulk of private short-term capital flows are accounted for by trade credit. Thus, chart 5 shows large swings in the evolution of short-term flows because of the uncertainty behind these flows. For example, following the foreign exchange shortages before 1994, trade credit was inevitable. The build-up also shows the relationship between these flows and the movement in the Malawi kwacha exchange rate whereby a significant depreciation following the flotation in 1994 led to a proportionate increase in short-term capital flows. In addition, at that time, domestic interest rates, especially on treasury bills, were very high and attracted some foreign investors to go into the 90-day treasury bills. The Reserve Bank of Malawi, however, took a guarded position by closely monitoring and sterilizing such inflows to avoid the likely impact on macro aggregates. Sterilization took the form of provisioning for the outflows within the foreign exchange budget to ensure minimal effect on the exchange rate in case of repatriation.

Chart 5. Private short-term capital as percentage of GDP (1981–2001)



³ Other transfers include non-resident accounts, pensions and provident funds, gifts and maintenance, deceased estate, contributions to international agencies, religious grants and miscellaneous income transfers.

III. INSTITUTIONAL ARRANGEMENTS FOR EXCHANGE CONTROL

The administration of exchange control is a function of the Treasury, which is under the Ministry of Finance. However, considering the strategic position of the Central Bank, the Minister of Finance has delegated, subject to the provisions of Regulation 32, all the powers conferred upon him by Regulation 33 issued under Section 3 of the Exchange Control Act, 1989 to:

- The Governor of the Reserve Bank of Malawi;
- The Commissioner of the Malawi Police Force;
- The police officer in charge of the Criminal Investigation Division of the Malawi Police Force; and
- The police officer in charge of the Fiscal Section of the Criminal Investigation Division.

In order to operationalize the Exchange Control Act and Regulations, the Reserve Bank has issued an Exchange Control Manual, which is supplemented by various instructions, circulars, directives and press releases. The supplementary information is issued in accordance with current policy guidelines, which are formulated by the Reserve Bank of Malawi in consultation with the Minister of Finance from time to time.

Consistent with the liberalized environment, the Reserve Bank of Malawi has given authority to some players in the market to be authorized dealers in foreign exchange to assist the Central Bank in administering exchange control. All applications of an exchange control nature are made to these authorized dealers. Authorized dealers fall into the categories of authorized dealer banks, foreign exchange bureaux and tourist operators. Whereas authorized dealers may process current account applications, all capital account applications are submitted to the Central Bank through authorized dealer banks. When forwarding capital account applications to the Reserve Bank of Malawi, authorized dealer banks verify that all applications are supported by relevant documentation. Authorized dealers are required, however, to submit monthly reports to the Central Bank on current account transactions for statistical purposes.

Functionally, the Exchange Control Division in the Reserve Bank of Malawi comes under the International Operations Department and has the following sections: Statistics and Analysis; Monitoring and Inspection; and Capital Account.

IV. CONTROL OVER FOREIGN BORROWING

Control over borrowing by residents from non-residents is not for the purpose of restricting external borrowing per se but to facilitate the management of balance-of-payments flows. In the past, exchange controls were used to channel resources towards specific and priority sectors such as manufacturing, tourism and agriculture. Control is also necessary in order to minimize capital flight.

Perhaps most importantly, when residents contract foreign loans, they place the country in a position whereby the lender has a call on the country's foreign exchange reserves. Control over borrowing therefore gives the country a chance to plan its foreign exchange resources properly. Thus, it is necessary for prior approval to be granted to ensure that repayment and servicing of loans do not place unnecessary pressure on foreign reserves and the country's exchange rate. By granting prior approval, the Central Bank is able to manage short-term capital flows, which are sometimes disruptive in nature. Furthermore, before granting approval, the Exchange Control Division determines whether applicable interest rates are in line with prevailing international rates.

In the case of government-guaranteed foreign loans, no prior approval is required because the Reserve Bank of Malawi is normally involved in the negotiations for such loans. At the same time, the data on the Government's external borrowing are continuously updated and can be accessed without difficulty.

V. LOAN APPLICATION AND APPROVAL PROCESS

The bulk of foreign loans available to Malawian residents are either loans from non-resident shareholders or loans from other non-residents. In the case of loans from non-resident shareholders, applications have to be supported

by a board resolution authorizing the loan, in addition to other supporting documents.

(i) *Application process*

As pointed out earlier, applications to acquire foreign loans may be submitted to the Exchange Control Division only through an authorized dealer bank, which verifies that all applications are supported by the following:

- A duly completed Exchange Control application form;
- A draft loan agreement;
- Cash flow projections;
- Audited accounts; and
- A board resolution in the case of shareholders' loans.

The Exchange Control Division insists on a draft loan contract because sometimes it will recommend and request the borrower to make certain changes to the contract. It is always difficult to amend contracts that have already been signed. The cash-flow projections and audited accounts are used to determine applicants' ability to repay the loan through an analysis of financial ratios of the borrowers. These requirements are applicable to both corporate and individual applicants, as well as to loans that will be serviced through foreign-currency-denominated accounts. In order to ensure consistency, applications submitted directly to the Exchange Control Division are returned to applicants, who are advised to submit them through authorized dealer banks.

Applications submitted by authorized dealer banks are made on an Exchange Control application form containing an exchange control (EC) number. The EC number identifies the foreign loan and serves as a reference number for disbursement and debt servicing. Thus, all further foreign-loan-related correspondence, including that related to amendments or cancellations, between authorized dealer banks and the Reserve Bank of Malawi quote the initial EC number.

When assessing applications for foreign loans, the Exchange Control Division considers the amount of the loan, the period involved (whether short-, medium- or long-term), the purpose of the loan (e.g. export-oriented, job creation), the terms of the loan (including inter-

est, fees, grace period, guarantee and currency composition), and the ability of the borrower to repay the loan. Under normal circumstances, the Division responds to these applications within three days of receipt of applications.

(ii) *Approval of loan application*

After assessing an application and being satisfied with the application as well as supporting documentation, the Exchange Control Division grants approval-in-principle for the borrower to receive the loan proceeds through an authorized dealer bank. Although the borrower has the option to receive the loan through other authorized dealers, such as forex bureaux, borrowers are encouraged to channel the proceeds of loans only through authorized dealer banks for monitoring purposes. During this time applicants also make amendments, if any, to loan contracts in readiness for submission of signed copies to the Central Bank.

Formal approval of the foreign loan is granted upon receipt of evidence of receipt of loan proceeds in Malawi together with a signed copy of the loan contract. Evidence of receipt of funds is in the form of copies of bank advices (such as copies of credit slip and/or bank statement). Where the loan is disbursed by way of drawdowns, the borrower is required to submit copies of bank advices in respect of each drawdown, as and when it occurs. This information is submitted through authorized dealer banks that prepare EC applications, which refer to initial EC numbers for the loans. The Reserve Bank of Malawi registers each drawdown in its own right and grants formal approval as well as rights to externalize interest and principal on the registered amount when they fall due.

(iii) *Repayment of foreign loans*

Once formal approval of the loan is granted, borrowers may remit, through authorized dealer banks, foreign exchange in respect of principal and interest payable on foreign loans as and when they fall due. In other words, payments of principal and interest do not require the approval of the Exchange Control Division because, in the case of interest, it is a current account item and, in the case of principal, approval is granted when loan proceeds are received in Malawi. Applications to service foreign debt are supported by advice from the borrower and Exchange Control Forms E (General), which contain a full description of the transaction, includ-

ing the reference number of the loan in the form of the EC number.

If the borrower is unable to service a loan, the borrower is required to so inform Exchange Control through an authorized dealer bank, giving reasons for not servicing the loan. This means that the authorities do not entertain arrears as such there must be good reasons for a build up of arrears.

VI. RECORDING PRIVATE SECTOR EXTERNAL DEBT

The Exchange Control Division records details of foreign loans on a spreadsheet during the initial application of the loan. At this time, it records the following information: EC number, name of borrower, name of lender, amount borrowed, date loan contracted, interest rate and maturity. It uses this information when assessing new loan applications and when conducting portfolio reviews. Although loan details as recorded by the Division suffice in terms of exchange control requirements, these details are not adequate for the requirements of balance-of-payments compilation as well as for formulation of debt strategy and policy.

Authorized dealer banks submit all discharged documents (regardless of whether in respect of current or capital account transactions) to the Reserve Bank of Malawi for statistical purposes on a monthly basis. The documents reach the Central Bank within two weeks of dispatch. The Exchange Control Division scrutinizes them to ensure that the transactions comply with exchange control requirements. Where it is established that they do not comply with exchange control requirements, the Division makes appropriate inquiries with the authorized dealer banks concerned. The documents are then forwarded to the Research and Statistics Department, where the Coded Data Section uses them for data capture. In terms of recording debt service data, therefore, the Research and Statistics Department is the responsible department.

According to the database, the number of registered loans is slightly in excess of 110 and represents foreign loans amounting to over \$200 million. However, there are fewer active loans because some of the registered loans have since been fully repaid. In terms of currency mix, 95 per cent of the loans are contracted in United States dollars, while the balance is in Deutsche marks, euro, pounds sterling and South African rand. Almost 40 per cent of the total is concentrated in the tobacco industry in the form of pre-export finance. Other sectors that have also obtained foreign loans include tourism, agriculture and manufacturing.

VII. CONCLUDING REMARKS

Since Malawi accepted Article VIII obligations under the International Monetary Fund's Articles of Agreement on 7 December 1995, it no longer maintains restrictions on current account transactions. Developments in the balance of payments, within each of the phases highlighted above, therefore depicted how macro-economic fundamentals during those phases either promoted or hampered trade development.

The current exchange control regime is a move towards an enhanced role of market forces, and increased private sector participation, in resource allocation and use. Notwithstanding the benefits of capital convertibility, however, the financial sector in Malawi has not fully developed to cope with the associated risks and it is very unlikely that Malawi will completely remove exchange controls in the medium term.

In the interim, Malawi is making preparations for capital account convertibility, particularly by developing information systems and statistical databases, since their role in a liberal system cannot be overemphasized.

Annex 1. Malawi, selected economic and financial indicators, 1998–2000

| | 1998 | 1999 | 2000 Prel. | 2001 Proj. |
|---|-------|-------|---------------|---------------|
| (Percentage change, unless otherwise indicated) | | | | |
| GDP and prices | | | | |
| GDP at constant market prices | 2.0 | 4.0 | 1.7 | 2.7 |
| Consumer prices (end of period) | 53.0 | 28.2 | 35.4 | 24.7 |
| GDP deflator | 26.2 | 41.1 | 25.2 | 26.3 |
| Money and credit¹ | | | | |
| Money and quasi-money | 55.6 | 33.6 | 42.4 | 14.0 |
| Net foreign assets | 11.0 | 11.5 | 46.8 | 1.5 |
| Net domestic assets | -54.5 | 22.1 | -4.4 | 12.5 |
| Credit to the Government | -29.9 | -2.9 | 6.9 | 11.2 |
| Credit to the rest of the economy | 18.5 | 20.6 | 12.4 | -4.0 |
| (In percentage of GDP, unless otherwise indicated) | | | | |
| Central Government² | | | | |
| Revenue (excluding grants) | 17.7 | 17.3 | 17.9 | 17.7 |
| Expenditure | 29.8 | 29.9 | 32.4 | 27.9 |
| Domestic balance (cash modified basis) ³ | -4.0 | -2.8 | -4.5 | -3.3 |
| Overall balance (cash modified basis, excluding grants) | -11.9 | -12.3 | -14.5 | -10.2 |
| Overall balance (cash modified basis, including grants) | -5.5 | -5.0 | -5.3 | -0.6 |
| A. Savings and investment | | | | |
| Domestic savings | 5.8 | 0.3 | 1.7 | 1.2 |
| Net factor income and private transfers | -4.1 | -1.6 | -1.6 | -1.4 |
| Foreign savings ⁴ | 11.6 | 17.1 | 12.9 | 12.4 |
| Gross investment | 13.3 | 15.8 | 13.0 | 12.3 |
| B. External sector | | | | |
| Exports, f.o.b. | 31.0 | 24.7 | 24.3 | 21.6 |
| Imports, c.i.f. ⁵ | 33.4 | 37.3 | 33.7 | 30.6 |
| External current account (including official transfers) | -2.5 | -8.3 | -4.0 | -5.9 |
| External debt | 142.7 | 143.3 | 156.4 | 141.6 |
| Debt service ratio ⁶ | 18.2 | 17.7 | 21.8 | 21.5 |
| Terms of trade (1990 = 100) | 71.9 | 62.3 | 67.8 | 68.3 |
| Kwacha per United States dollar exchange rate (period average) ⁷ | 31.1 | 44.2 | 60.8 | ... |
| Gross official reserves | | | | |
| End-period stock (millions of United States dollars) | 257.8 | 244.2 | 242.5 | 255.5 |
| In months of imports of goods and non-factor services | 4.0 | 4.2 | 4.5 | 4.3 |
| External debt (disbursed and outstanding, end of period; millions of United States dollars) | 2 479 | 2 589 | 2 612 | 2 642 |

Sources: Malawian authorities; and IMF staff estimates and projections.

¹ End of period expressed as a change in percentage of money and quasi-money at the beginning of the period.

² The domestic balance is defined as revenue less total expenditure, foreign interest and foreign-financed development expenditure.

³ External current account, excluding official transfers.

⁴ External current account, excluding official transfers.

⁵ Including drought-related maize operations in 1998.

⁶ In percentage of exports of goods and non-factor services in the following period, before any assistance under the HIPC Initiative.

⁷ For 2000, January through November.

MONITORING OF PRIVATE SECTOR NON-GUARANTEED DEBT: THE EXAMPLE OF A FULLY LIBERALIZED REGIME – THE PHILIPPINES

Patria B. Angeles

I. INTRODUCTION

As a developing economy, the Philippines taps external financing extensively in order to help support its various financing requirements. Cognizant of the need for a systematic approach to managing external borrowings, the Government enacted in the early 1960s a law on foreign borrowings to institute broad policies and safeguards on foreign borrowings. Administrative mechanisms were also established to implement the legal provisions and rationalize the debt management process.

A debt management system was put in place encompassing the entire debt cycle, from project selection up to servicing of the credits, which funded the project. The system covers foreign borrowings of both the public and private sectors as the Government has always recognized the important role that the private sector plays in spurring economic growth and development.¹

With exchange controls then in place, it was not difficult to implement the system and ensure compliance therewith. Over the years, the system has evolved to address new developments, including the progressive dismantling of barriers to capital movements.

II. INSTITUTIONAL ARRANGEMENTS FOR DEBT MANAGEMENT IN THE PHILIPPINES

In the Philippines, external debt management involves the concerted efforts of various government agencies, particularly the following:

The *National Economic and Development Authority (NEDA)*, the central economic plan-

ning body of the country, which draws up the national economic programme in consultation with other key government agencies.

The *Investments Coordination Committee (ICC)*, a top level inter-agency body chaired by the head of the economic planning body and having as its members heads of key government agencies (such as Finance, Budget and the Bangko Sentral). The ICC reviews major project proposals in the context of consistency with overall development thrusts, as well as economic, social and financial implications.

The *Board of Investments (BOI)*, which prepares the annual Investment Priorities Plan to identify areas of economic activities where the country's needs are greatest for entitlement to investment incentives.

The *Department of Finance (DOF)*, which handles the programming and execution of foreign borrowing activities of the Government and which, more recently, has issued a directive requiring DOF clearance for all proposed foreign borrowings of public enterprises.

The *Bangko Sentral ng Pilipinas (Bangko Sentral)*, the central monetary authority of the country, which is at the forefront of debt management activities.

The Bangko Sentral is vested with the authority to oversee compliance with the law on foreign borrowings from a foreign exchange standpoint. It derives its mandate from the highest law of the land, the Philippine Constitution, as well as other legislation, including the Foreign Borrowings Law and the New Central Bank Law. As such, it is concerned with the following:

- Keeping track of the debt stock;
- Maintaining outstanding foreign liabilities at manageable levels; and
- Securing borrowings on the best terms available.

¹ This was particularly evident in the 1990s when private enterprises incurred substantial amounts of foreign debt for various projects. From 1993 to 1997, private borrowings averaged about 53 per cent of total credits approved by the Bangko Sentral ng Pilipinas. As a result of the Asian crisis, however, a deceleration in borrowings was noted, with approvals for the private sector representing about 36 per cent, on average, of total approvals from 1998 to 2001.

In this regard, it is authorized under its charter to obtain information on transactions/operations in foreign exchange and gold.

The Bank currently performs these activities through the Monetary Board (its highest policy-making body) and the International Operations Department² (which is primarily responsible for formulating and implementing policies, rules and regulations on foreign borrowings and related accounts, and handling the day-to-day activities of debt management).

Debt management tools

The Bangko Sentral employs various debt management tools that were initiated and fine-tuned during the last three decades. These include:

- Bangko Sentral policy issuances, which outline the rules, regulations and procedures for foreign borrowing activities. New issuances are promptly disseminated to the public by publication in newspapers, posting on the Bank's website, press releases and structured briefing sessions, as may be appropriate; and
- Administrative mechanisms, which include an approval and registration process, and a debt monitoring system.

Loan approval and registration (covering both real and contingent liabilities)

Bangko Sentral approval for a loan proposal of a private sector borrower must be applied for and obtained before the covering documents can be executed and the funds disbursed. The Bangko Sentral's evaluation process involves a thorough review of the proposal in order to determine, among other things consistency of purpose with the country's overall development thrust, the benefits expected from the project, the reasonability of financial terms and conditions, and the loan's impact on the country's total debt service burden vis-à-vis the economy's capacity to meet maturing obligations.

² Formerly the Management of External Debt Department (MEDD), which was originally organized in 1970 as the External Debt Monitoring Office. MEDD was renamed International Operations Department in October 1999 with the broadening of its responsibilities to include trade and investments.

In order to ensure compliance with the terms and conditions of Bangko Sentral approval, including proper utilization of loan proceeds, the private sector borrower is required to register foreign loans following receipt and use of borrowed funds. Applications for registration must be supported with a copy of the signed loan documents as well as proof of disbursement and utilization of loan proceeds. After the documents have been found to be satisfactory, a Bangko Sentral Registration Document (BSRD) is issued which authorizes the borrower to buy foreign exchange from local banks for debt servicing on scheduled due dates. However, purchases of foreign exchange from banks to cover any payments not consistent with the loan terms reflected in the BSRD require prior Bangko Sentral approval.

When the country was under full exchange controls, it was required that foreign exchange receipts of residents be surrendered for pesos to banks. All foreign borrowing proposals had to be approved by and registered with the central bank and each purchase of foreign exchange from the banking system for debt servicing was subject to prior central bank approval, even for registered accounts. But in the early 1990s certain controls on foreign exchange transactions were progressively dismantled. This started with the phased lifting of the mandatory surrender requirement for foreign exchange receipts of residents. In line with this, regulations on private sector foreign borrowings³ were also modified, giving these enterprises the option not to undergo the approval and registration process provided that they do not purchase foreign exchange for debt servicing from the banking system. At present, there are three types of private sector borrowings:

- (i) Those which continue to be subject to prior approval and registration (accounts involving real or contingent liability or exposure on the part of any state-owned entity or banking institution);
- (ii) Those which only need to be registered (such as acquisitions of freely importable commodities like capital equipment on deferred payment arrangements, and inter-company accounts for eligible projects); and

³ There was no change in policy on public sector borrowings as the policy emanates from provisions of the Philippine Constitution and other legislation.

- (iii) Those for which approval and registration are optional (those cases not falling under items (i) and (ii). Accounts which did not go through the approval/registration process cannot be serviced with foreign exchange purchased from the banking system. Nonetheless, despite the relaxation of foreign exchange regulations, most borrowers (particularly those with substantial funding requirements) choose to obtain approval from the Bangko Sentral for their foreign borrowings to ensure access to banking system resources, whenever necessary, to meet maturing debt payments. A large number of international creditors also require Philippine enterprises to have their borrowings approved by and registered with the Bangko Sentral to preclude any possible difficulty in servicing the account.

III. EXTERNAL DEBT MONITORING SYSTEM

A. Coverage

The concept of external liabilities follows the core definition formulated by a group of international experts and used internationally.⁴ The system encompasses all forms of obligations (loans, debt securities, deposits, etc.) under all maturity categories (short-, medium- and long-term) of the different sectors of the economy (the monetary authority, central government, bank and non-bank enterprises, both state and privately owned) owed to all creditor types (multilateral, bilateral, banks and other financial institutions; bond/note holders; suppliers/exporters; others).

B. Reporting system

A reporting mechanism is in place to facilitate comprehensive data capture. Report forms are designed considering the type of data required (which are used both for regulatory and statistical purposes) and the source of information. There are three major data sources that provide information to the Bangko Sentral on a regular basis, which are described below.

Borrowers

Borrowers (bank and non-bank) submit monthly reports to the Bangko Sentral. They are important data sources as they have first-hand knowledge of transactions and balances pertaining to their foreign loans. Familiarity with the reporting system, which was instituted during the era of exchange controls, facilitates compliance by borrowers as the required internal systems and procedures have long been established. As the Bangko Sentral treats data submitted to it with the utmost confidentiality, it has earned the trust of the private sector, further encouraging reporting of accounts.

The liberalization of foreign exchange rules, however, poses the challenge of maintaining an effective monitoring mechanism for private sector debt. While the approval and registration process has now become optional for certain types of accounts, the reporting requirement has not been lifted. For borrowers who choose not to make themselves subject to the approval and registration requirement, there is not much incentive to continue complying with the reporting requirement as they can freely service their debt using their own foreign exchange.

Thus, the Bangko Sentral has become more aggressive in propagating information on, and compliance with, its reporting requirements. It takes a proactive approach in this regard by directly communicating with borrowers (particularly new ones with substantial funding requirements); providing advice on the Bank's reporting requirements; explaining the need for, and uses of, data requested; and exerting moral persuasion to obtain the borrower's cooperation.

The Bank also continues to explore other data sources for private sector debt. For instance, international publications provide information on flotation of debt instruments offshore. This serves as a basis for the Bangko Sentral to approach borrowers and advise or remind them about reporting requirements. Linkages with other government agencies, which can serve as supplemental data sources, are also being studied.

Major foreign creditors and offshore banking units operating in the country

Creditors submit monthly reports, which allow validation of data provided by borrowers

⁴ This is based on the definition in the Grey Book, pending availability of the New Debt Guide which will replace the Grey Book.

and supplement information obtained from other sources.

Local banks (including branches/subsidiaries of foreign banks operating in the Philippines)

Bank reports are submitted weekly and provide data on purchases and sales of foreign exchange, including those that are external-debt-related. Monetary penalties and other sanctions help ensure compliance with reporting requirements.

Reports are in absolute amounts and original currencies, although the United States dollar equivalent is required for bank reports to facilitate comparison/cross-checking with figures that are submitted in aggregate pesos and United States dollars equivalent to other Bangko Sentral departments/units.

C. The external debt database

The database was designed to allow monitoring of individual loan accounts through the entire loan cycle from approval through disbursement, registration and repayment. It contains detailed information on each debt account, such as credit terms, transactions and loan balances. Records are maintained in original currencies but can be easily converted into United States dollars or other currencies.

D. Output reports

The system can produce consolidated or detailed reports such as different profiles of debt stock (e.g. by maturity – original or residual basis; borrower's sector; currency; creditor's country, based on residency or head office/citizenship); transaction summaries; and projected debt service burden.

E. Review of debt statistics

Statistics on the debt stock produced from the system are compared with those contained in other publications such as OECD/BIS *Statistics on External Indebtedness*, BIS *International Banking and Financial Market Developments*, and the World Bank's *Global Development Finance*.

IV. PROSPECTS AND CHALLENGES

The country's external debt monitoring system remains robust, enabling the Bangko Sentral to meet vital data user requirements. However, potential reporting gaps could emerge in the liberalized foreign exchange regulatory environment. Furthermore, new challenges continue to emerge. These include globalization (which increases vulnerability to external shocks for economies that are more open) and the growing sophistication of financial instruments (which complicates the classification and treatment of accounts both for regulatory and for statistical purposes). Concerning the latter, the absence of clear standards and guidelines also leads to the issue of data comparability (national vis-à-vis international statistics, and data across countries).

To address these issues, existing policies, systems and procedures are continuously reviewed and refined. Other sources of information and mechanisms for data capture are being explored. The reporting system and report forms are likewise scheduled for review for further streamlining and simplification, where possible or as may be appropriate, to bring about greater compliance with reporting requirements. The objective is to further strengthen the Bangko Sentral's capability to produce comprehensive, reliable and timely debt statistics necessary for the exercise of its regulatory mandate, for policy formulation and for meeting the requirements of other data users.

PART 4

SYMPOSIUM ON COMPUTERIZED DEBT AND INTEGRATED FINANCIAL MANGAMENT SYSTEMS

INTEGRATED FINANCIAL MANAGEMENT SYSTEMS: AN INTRODUCTION

Enrique Cosio-Pascal

I. WHAT IS AN INTEGRATED FINANCIAL MANAGEMENT SYSTEM?

An integrated financial management system (IFMS) is an interrelated set of subsystems that plans, process and reports upon resources, quantifying them in financial terms. The aim of an IFMS is to integrate and consolidate the information on public revenue and on public expenditures, facilitating its control and making public finances more transparent and accountable. An IFMS integrates public liabilities and assets management.

The IFMS subsystems are able to exchange information with ease and to share commonly used data, avoiding duplication of databases. Incompatible or duplicative systems would be wasteful, inefficient and would not provide the information that governments need for effective management.

An IFMS is a decision-making support tool for controlling the aggregate spending and the budget deficit; it will also allow strategic prioritization of expenditures across policies, programmes and projects for efficiency and equity. It aims at a better use of budgeted resources to achieve outcomes and produce outputs at the lowest possible costs.

Traditionally, control has been the dominant if not the single reason for developing an IFMS. This control will always be central. Nevertheless, unique definitions of standards and decentralization between levels of government also underscore the importance of an adequate IFMS. Central control and decentralization of operations will allow non-duplication of data entry and report consistency.

II. THE OBJECTIVES OF AN IFMS AND THE MEANS TO ACHIEVE THEM

The main objective is transparency in managing the public resources and to produce timely and reliable information for decision-making. This will allow effective public administration

with embodied and external well-established control systems.

The means to achieve the objectives are a unique definition of standards, the decentralization of operations and non-duplication of data entry, the setting of procedures that define functions and assign levels of responsibility among the different public sector entities, and, last but not least, communication through electronic means, thus avoiding hard copies proliferation.

Regarding the last above point, it should be noted that computerization is a key issue. Since major investment is required to set up a modern computer-based information system, integration is a requirement, not an option.

III. IMPLEMENTATION OF AN IFMS

Implementation should be seen in the context of a broad institution-building and policy reform. This will need a conceptual framework that provides an overview of the system network to support financial management.

Computerization is indeed a key issue because IFMS implementation means the implementation of an integrated network of information systems. Technical staff and skills requirements to set up such a network are considerable. This is one of the reasons why integration should be carried out over time and in stages.

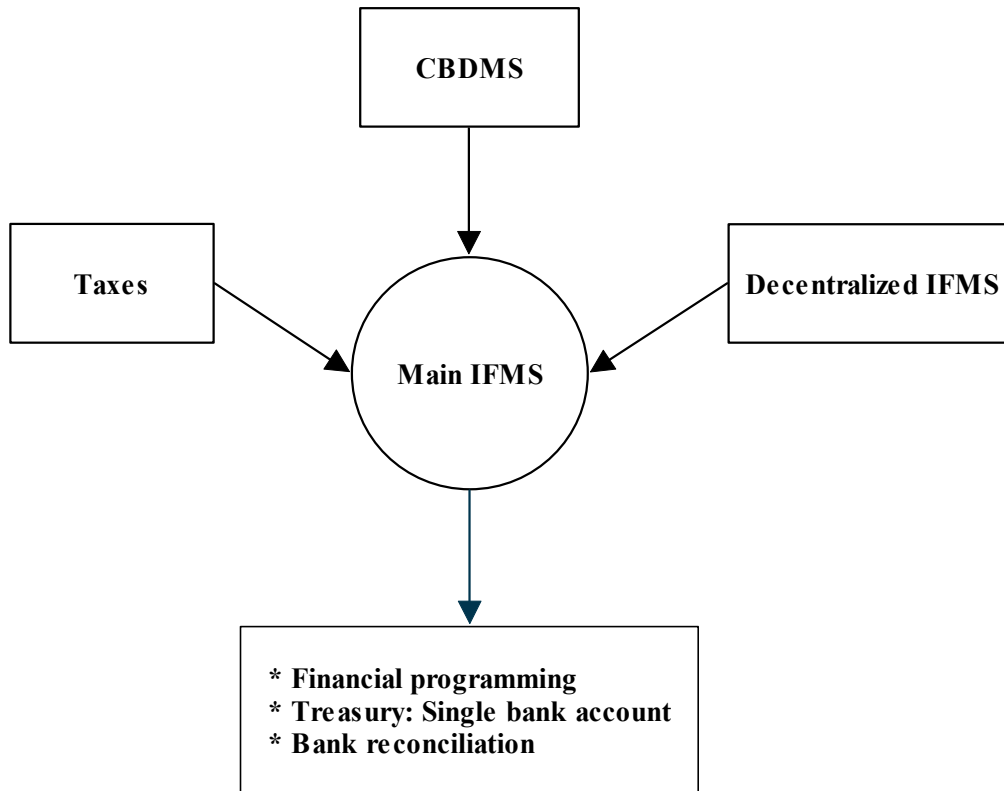
The implementation of an IFMS covers many aspects: budget, treasury, public accounting and cash flow. It also deals with the public payroll and the government's purchases and contracts. It addresses the public liabilities and assets management.

This paper looks at only some features of implementation that will show the power of the IFMS as a decision-making tool. It discusses some aspects of cash flow management involving financial programming, the treasury single bank account and bank reconciliation.

Figure 1 shows the structure and the requirements of an IFMS in order to have the necessary information to proceed to financial pro-

gramming and utilization of the single bank account, and then to achieve bank reconciliation.

Figure 1. Main IFMS



In figure 1, the main IFMS collects information from the taxes paid and forecast to be paid, the public debt service and disbursements through the computerized base debt management System (CBDMS), as well as from the decentralized IFMS (public enterprises, municipalities, etc.). This information meets the main IFMS needs for undertaking the financial programming. With the help of the single bank ac-

count the public resources will be managed more efficiently. The individual ledger of each bank in the banking system in the main IFMS will make it possible to perform the bank reconciliation easily. This process is explained as follows: figure 2 sets out the mechanism of the financial programming, figure 3 shows how the single bank account works and figure 4 deals with bank reconciliation.

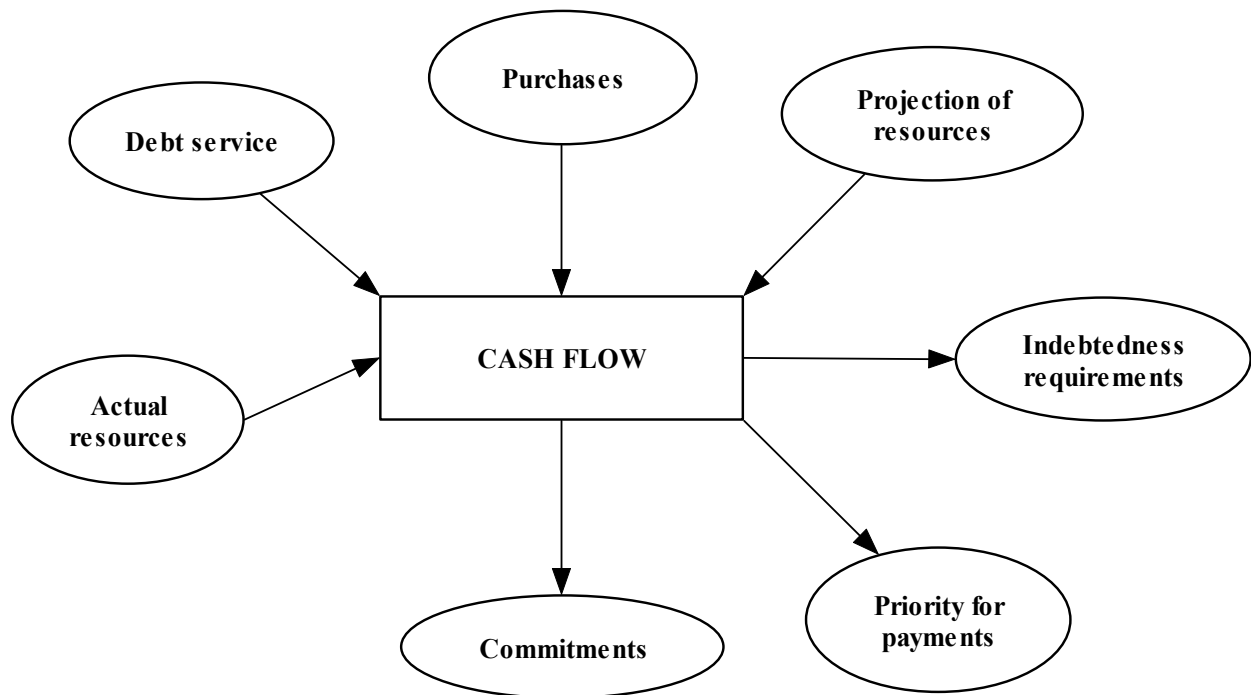
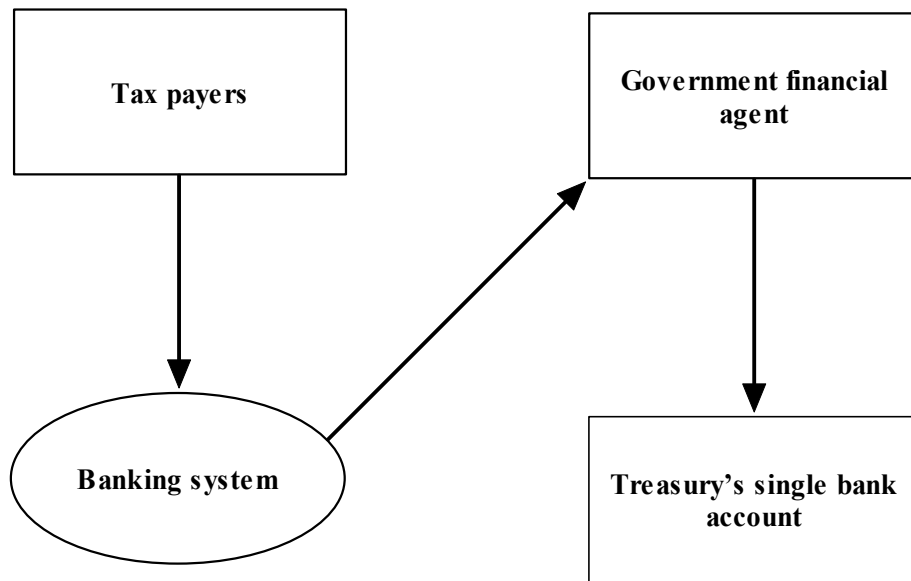
Figure 2. Financial Programming

Figure 2 shows the relationship among the different variables affecting the cash flow. The actual resources put in front of the debt service, the programmed purchases and the projections of resources will make it possible to determine the commitments to be made in function of the priority for payments and, eventually, the indebtedness requirements.

Figure 2 shows the importance of a good cash-flow forecast for efficient financial programming. The IFMS will provide the budget authorities the necessary indebtedness informa-

tion within a time-span that will also permit the debt office to issue the necessary Treasury Bonds (or another instrument as required) in order to cover the budget spending needs.

Figure 3 shows the principle of the Treasury's single bank account. The single bank account is one of the cornerstones of modern financial public management: putting all the public resources in the same account makes their utilization more efficient, transparent and accountable.

Figure 3. How the Treasury single bank account works

In an efficient financial environment, the banking system (most often private banks) collects the tax payments from their customers and forwards them to the government financial agent. The government financial agent manages a single account for the central government resources: the Treasury's single bank account.

Having the single bank account prevents an eventual lack of resources in a specific account if some kind of government revenue has been earmarked for specific expenditure – for instance, if petrol consumption taxes are allocated to building and repairing roads. In such a case, the authorities could be tempted to open a bank account only for this purpose, where the resources from petrol taxes would be deposited and to which all expenditures for building and

repairing roads would be charged. The obvious danger with this practice is that the account could have either a deficit or idle resources. This can happen when there are resources in other accounts, or when other accounts require resources.

The Treasury's single bank account thus avoids earmarking of resources: once a currency unit is deposited there, from wherever it comes, it is "mixed" with the other monies and there is no way of knowing where it is spent. In this modern budget theory and practice there is no "earmarking of resources". Once a currency unit enters the single bank account it cannot be distinguished from another currency unit coming from another source.

Figure 4. Bank reconciliation

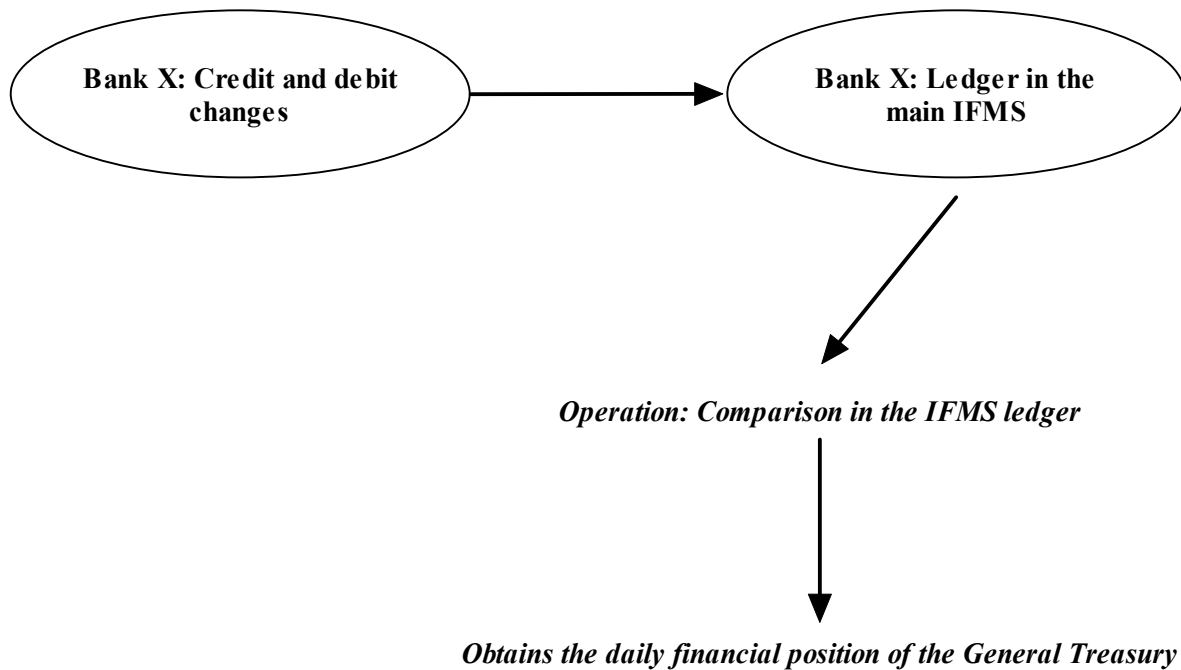


Figure 4 shows how bank reconciliation is done. All the banks in the banking system have a ledger in the IFMS. The IFMS compares the banks' credits and debits reporting so that the Treasury can compare and clear this information in the corresponding ledgers. The result is that the Treasury knows its daily financial position at the end of each day.

This is extremely useful information for the budget manager as well as for the National Treasurer and shows the importance of having an efficient IFMS as well as its power as a management tool.

Figure 5. IFMS as a managerial decision-making tool

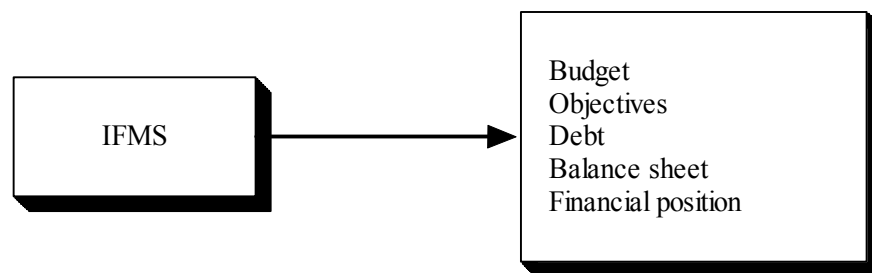


Figure 5 shows the IFMS outputs as a management tool. This makes it possible to have control and to efficiently monitor budget execution, budgetary objectives, and public debt, both service and disbursements, and, last but not

least, to have an updated balance sheet as well as the financial position.

Without any doubt, modern public management cannot do without the power of IFMS as a monitoring and management tool.

**BOLIVIA: INTEGRATED MANAGEMENT AND ADMINISTRATIVE
MODERNIZATION SYSTEM (SIGMA)
ADMINISTRATIVE DECENTRALIZATION AND RESPONSIBILITY
PROJECT – ILACO II**

*Carmen Zuleta
Jacqueline Gómez¹*

I. FRAME OF REFERENCE

The decade of the 90s and the reform of public administration in Bolivia

The enactment of Law 1178 of 20 July 1990 on Governmental Administration and Control was the start of the process of reform of the public administration with the objectives of:

- Restoring to the civil service its natural role of serving society;
- Remodelling the concept of responsibility on the part of the civil service;
- Emphasizing effective and efficient public management, going beyond the formal aspects and concentrating on the end result of management and the imperative need for fundamental baseline information in order to reach decisions.

This was the background to the setting up of the State Comptroller General's Office within the Ministry of Finance and the decision to put into operation the Integrated Financial Information System (SIIF), made up of the Treasury and Accounting modules. Subsequently, the SIIF was modernized to form another data processing platform including the modules of: budget management, funds in trust, grass roots participation, public credit, cash flow, budgetary performance of decentralized agencies, bank reconciliation, electronic transfers and debit notes.

The end of 1997 saw the completion of the framing, approval and putting into effect of the basic rules for the systems regulated by Law 1178.

1999: The technical decision behind the change

In relation to the technological changes of

the 90s, the crucial objective of generating timely and reliable financial information for the use of the Ministry of Finance and the agencies of the public sector still remained pending. Experience had shown that it is indispensable to bring reform processes to completion if they are not to undergo reversal or erosion.

With the technical and financial support of the World Bank, the Ministry of Finance resolved to complete the reform on the basis of the conceptual changes in the governing bodies of the systems regulated by Law 1178 on "Governmental Administration and Control", Law 1654 on "Administrative Decentralization", and Law 1551 on "Grass Roots Participation", assigning to the Administrative Decentralization and Responsibility Project (ILACO II) the task of developing and installing a single system which would interact with and receive information directly from the Ministries, prefectures and municipalities for the management of its own operations, with necessary procedural reforms in the areas of budget, administration of goods and services, personnel management, treasury, public credit, accounting and its relations with the public investment system.

This assignment has meant reshaping the information system (SIIF), developed and deployed in an initial phase to form the Integrated Management and Administrative Modernization System – SIGMA, which comprises:

- A change in management through retooling of procedures, on the basis of a new definition of the roles and responsibilities of each of the bodies that make up the public sector and of the officials who work in them, so that managerial productivity can be measured in terms of attainment of goals and objectives and not only by monitoring its conformity with the law;
- A new conception of financial administration that relates management with registration so that it can be performed simultane-

¹ Paper prepared by Carmen Zuleta and presented by Jacqueline Gómez

ously, replacing the perusal of documents, files or records in offices and performing it by data processing with computers connected to the system through a fibre optic network in the city of La Paz and teleprocessing in the interior of the country, with security standards and access controls;

- The production of financial and non-financial information in a useful and beneficial manner, i.e. by complying with standards of soundness, clarity, relevance, concreteness, reliability, trustworthy presentation, comparability and timeliness;
- Rationalization of the handling of fiscal resources by modernizing the treasury and public credit systems through the operation of the single treasury account, so as to optimize the management of resources; thus suppliers or beneficiaries in contractual relations with the State will receive payment directly into their accounts at any commercial bank;
- A strategy for the system based on recognition of the desirability of equipping the agencies with a modern and efficient data processing infrastructure that will ensure the development of SIGMA.

The new SIGMA conception not only requires sophisticated rules, methodologies and data processing developments; it implies a cultural change in the daily activities of public servants and a process of continuous training. That training must not, however, concentrate exclusively on the transmission of knowledge concerning methodology or procedures, but also on the inculcation of behavioural standards and of the awareness the public servant must have of being at the service of society in administering resources that have been entrusted to him or her.

2000: The political decision for transparency

The putting into operation of SIGMA is backed by the firm, explicit and irreversible political decision taken at the highest level, and by making possible the publication of the government's proceedings ensures transparency. Thus the citizenry can exercise control over the resources they contribute, which moreover constitutes a challenge to pockets of feudal power in the public bureaucracy.

In August 2000 provision was made by Supreme Decree for the gradual installation of

SIGMA throughout the public sector, as an instrument of the public administration made up of an array of policies, principles, rules, procedures, computer tools, other media and/or resources and agencies that play a part in the planning, management and control of public funds.

2001: Putting into operation of an integrated public management system

Beginning on 2 January 2001, SIGMA was put into operation in 25 of the most important agencies in the public sector, namely the Vice-Presidency of the Republic, the legislature, all Ministries (16), the National Treasury (TGN), the Comptroller-General's Office, the National Electoral Court, the Supreme National Defence Council, and the National Staff Administration and State Property Services.

II. CONCEPTUAL AND OPERATIONAL FRAMEWORK

The application of systems theory is the methodological basis for the conceptual and operational features of the Integrated Management and Administrative Modernization System (SIGMA) and each of the systems comprising it.

In addition to the traditional concepts of input or entry, product or output, process and feedback, systems theory introduces two basic new ones: the interrelation between systems and the principle of regulatory centralization and operational decentralization.

The concepts of centralization and decentralization are not contradictory but complementary, since in a properly organized system a balance must be achieved between the functions that must be centralized and those which must be decentralized.

Regulatory centralization implies the determination of general policies, framing and application of general, common rules, methodologies and procedures to govern the operation of each system, without prejudice to any adaptations required in consideration of the characteristics, peculiarities and specificities of the various public bodies.

Operational decentralization implies that each system can be administered by the public institutions themselves. The decentralization of

administrative systems can take various forms and operate at different levels. Their greater or lesser degree of decentralization will depend as much on the political and legal framework and the greater or lesser managerial capabilities of the various public bodies as on the specific characteristics of each of the systems. Thus the degree of decentralization in a ministry is not the same as in a decentralized agency, a university, a public enterprise or a municipality; in that last case, the level of decentralization is higher because we are dealing with entities that have greater governmental autonomy.

Operational decentralization must meet two basic requirements:

- (i) The decentralization decided for one system must be related with that established for the others;
- (ii) It must be duly regulated so that the respective powers, rules and procedures of the central agencies and the various peripheral agencies are unequivocally determined.

If the concepts of regulatory centralization and operational decentralization are to be effectively applied, each system must be organized so as to comprise a central level and various local levels. There must accordingly exist central agencies and peripheral agencies functionally related with the former.

Law 1178 stipulates that the Ministry of Finance is the directing authority of the systems designated programming of operations, administrative organization, budget, personnel administration, administration of goods and services,

treasury and public credit and accounts; it is accordingly responsible for the formulation of policies and evaluation of their implementation, for establishment of rules, methodologies and general procedures to be applied in public sector agencies and, also, for centralizing information produced by those agencies.

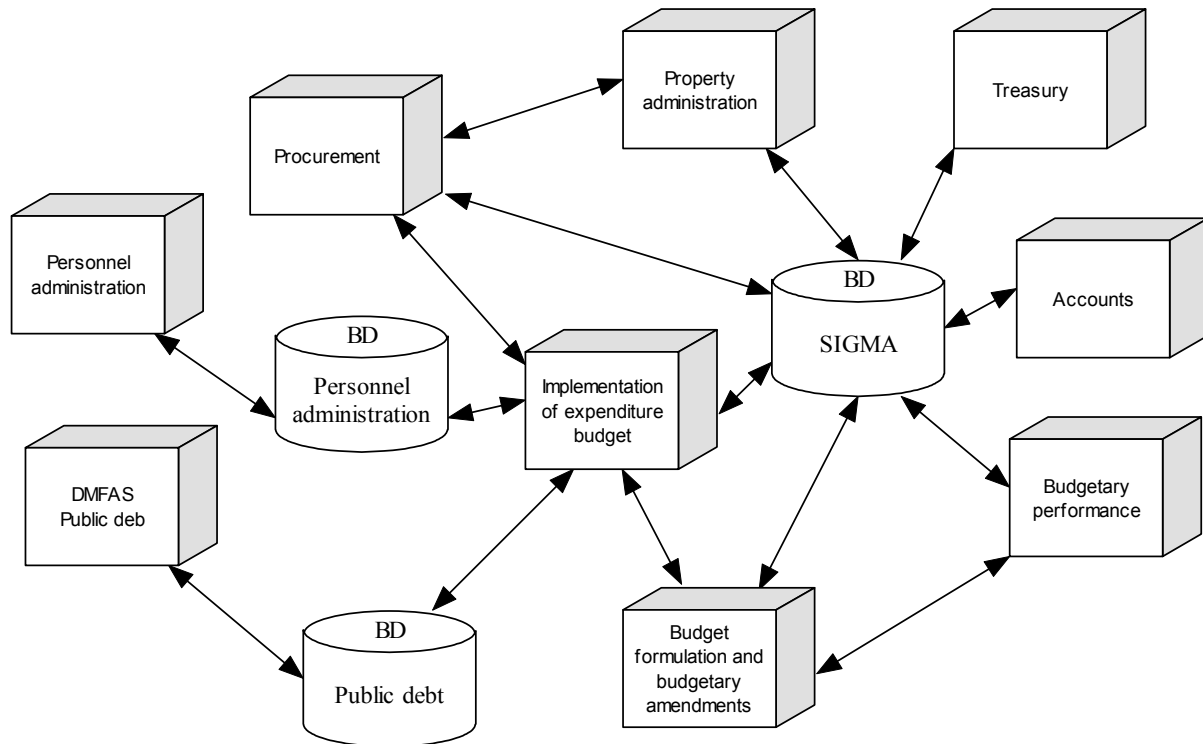
The agencies are responsible for operating these systems in terms of application of centrally defined policies, rules, methodologies and procedures, duly adapted to the specific characteristics of each of them, which currently comprise the ministries, decentralized agencies, public undertakings, universities and municipalities.

According to this scheme, each authorized user or public servant in the unit where he or she serves has an access key corresponding to a level of responsibility which alone allows him or her to perform in the areas relating to: procurement, human resources, property administration, and budgetary, economic, financial and accounting transactions, recording the information once only.

The processing of data on the part of the users is done by means of microcomputers that operate as terminals connected by a fiberoptic network to a single computing centre located in the premises of the Comptroller-General's Office. The data processed by the users of the various systems keep up to date a single database where the information is interrelated by transactional rules which ensure that the integration of the system is total, producing simultaneous results for all the financial variables, in real time.

The foregoing description is summarized in the following chart:

Chart 1. Components of SIGMA



III. PURPOSE, CHARACTERISTICS, COMPONENTS AND INTERRELATIONS

The Integrated Management and Administrative Modernization System (SIGMA), as an instrument of public administration, is an array of policies, principles, rules, technical procedures, computer tools, other means and/or resources and agencies, which play a part in planning, management and control of public funds.

Purpose

- The management of resources in conditions of absolute transparency;
- The generation of useful, timely and reliable information;
- Economy, efficiency and effectiveness in public management;
- Interrelation between financial administration systems and internal and external control systems.

Characteristics

- Regulatory centralization and operational decentralization;
- Single register of transactions;
- Procedures that demarcate functions and assign levels of responsibility;
- Simultaneous production of budgetary, economic, financial, accounting and management information;
- Indissoluble unity of design.

Components

- Central SIGMA: Ministry of Finance and the other agencies of the Central Administration;
- Municipal SIGMA;
- Decentralized SIGMA;
- SIGMA – UEPEX (External Loan Management Units).

Interrelations

- The Planning and Public Investment Systems;
- The Revenue Collection Systems;
- The Outcome-monitoring System;
- The electronic signature;
- Digital file.

Each system has its own dynamics and its own operative process and is equipped with its own internal controls, and all of them, at their differing times, are responsible for providing information concerning public financial resources. Their information flows converge at the managerial levels to assist the decision-making process.

The SIGMA system as a whole coordinates its functioning with the Planning and Public Investment Systems through operations programming and the Information on National Investments System (SISIN), uses the electronic signature for the authorization of transactions and identification of the public servants responsible for each step within the transactional processes, sends information on results of operations to the Outcome-monitoring System (SISER), and must have at its disposal the digital file and the indispensable facilities provided by the computerization of the systems.

The components of SIGMA cannot be considered in isolation: they are linked together in an indissoluble unity of design by virtue of the single purpose to which they are all directed. Deviations occurring in any of the systems affect the entire process of financial administration and, at the same time, a change in government policies acts upon the parts or elements of the administration.

IV. OPERATIVE PUBLIC DEBT MANAGEMENT

The volume and complexity of public credit operations as a source of financing necessitates the organization of a single, reliable register of public debt. To that end, the Debt Management and Financial Analysis System (DMFAS), developed by UNCTAD, takes its place as an interactive component of SIGMA, facilitating:

- The recording of the history of each loan from the signature of the relevant agreement, the disbursements made, and the corresponding debt servicing; the issue, placing and redemption of bonds; the granting, monitoring and recovery of guarantees.
- The generation of projections of due dates for disbursements or placing and servicing or redemption, together with calculation of amortization, interest and commissions, periodically or at a given date, in the original currency or converted into local currency.

DMFAS is considered as the main ledger of the "public debt" account of liabilities in the general accounting system. It is analogous to the card index or "cardex" of creditors, arranged by DMFAS single code, type of debt, creditor, interest rate, short or long term, internal or external, etc.

The register of public loan operations is connected directly with SIGMA at three stages:

- (i) When a loan is subscribed or bonds are issued;
- (ii) When disbursement of the loans subscribed or placing of bonds occurs;
- (iii) When debt servicing or redemption of bonds takes place.

Each of these stages constitutes execution of the budget for resources or expenditures, as the case may be, and generates double entries in the general accounting system.

When the information needed for the record originates in DMFAS, it is registered automatically and simultaneously in DMFAS and SIGMA: in DMFAS according to the specific and individual characteristics of each type of debt, and in SIGMA in the budgetary and accounts registries in accordance with the instruction manuals on recording of expenditure and resources.

When the information originates in SIGMA, it also automatically generates the corresponding registration in DMFAS.

Actual experience with integration shows us that there is no need for reconciliation of data between the systems, because it is impossible for discrepancies to occur as in the past: for example, in the placing of bonds, the TGN registers

according to the cash value and public credit according to the nominal value. The system will register the nominal value, the cash value, the market value or exchange differences and the bankers' or brokers' commissions produced by this type of operation.

DMFAS displays the information itemized for each single code and SIGMA in aggregated form by book-keeping account or subaccount or budgetary resource or expenditure, the final summations will always be equal.

This system is not only designed for recording on an accounting basis the liabilities of the State, but in essence constitutes a powerful tool for public debt management because it is used for:

- Budget formulation through determination of the debt maturity projections and the financial requirements of the debt service during the budgetary period;
- Working out of projections of various macroeconomic scenarios, according to requirements and the type of analysis to be performed.

Against this background, DMFAS, in pursuance of Agreement No. 119-2000 BOL/0T0AK signed with UNCTAD and with World Bank financing, is to be installed in the

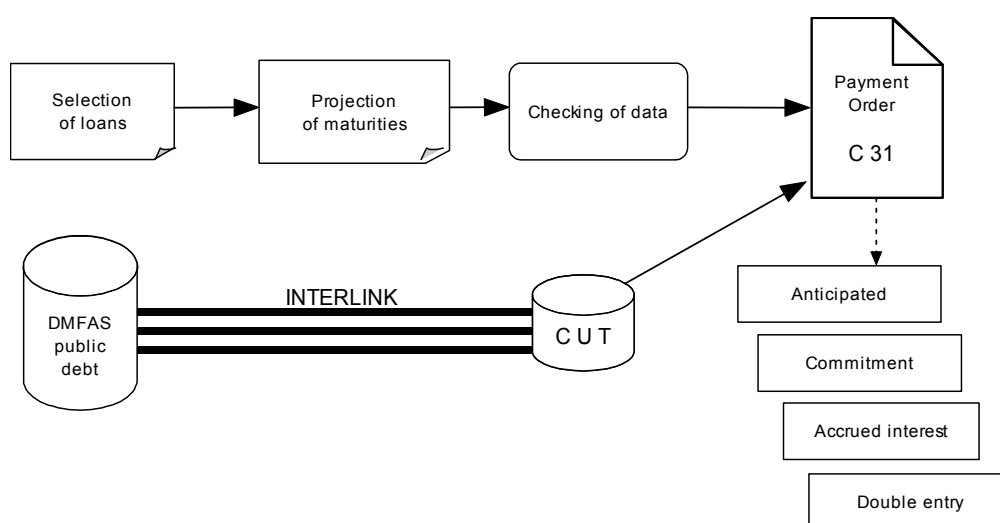
Directorate-General of Public Credit, Vice-Ministry of the Treasury and Public Credit, for the administration of the public debt, and will be connected with the DMFAS installed in the International Affairs Management Office of the Central Bank through an online connection which will establish the mechanisms for continuous updating of the database of information concerning the external debt and will be integrated with SIGMA for the execution and budgetary and accounting registration of internal and external public debt operations.

V. INTEGRATED MANAGEMENT AND RECORDING: THE PUBLIC DEBT SERVICE

Based on the characteristics of SIGMA and with emphasis on the indissoluble unity of design of SIGMA-DMFAS (SIGMALINK), the operating procedure of the public debt service consists of the following identifiable processes:

- Projection of maturities;
- Generation of means of payment;
- Priority ranking of payments;
- Payment to beneficiaries (financing agencies).

**Chart 2. Projection of maturities Recording Centre: Directorate-General of Public Credit
Public debt service and execution of expenditure**



Quarterly or monthly: the operator authorized through DMFAS proceeds to generate the debt service projection, sending information concerning the maturities, interest and commissions to SIGMA.

Up to 8 days before the maturity date: on the basis of the projection of maturities in the

DMFAS-SIGMA link-up the system issues Form C31, "Record of execution of expenditure – anticipated – commitment and interest accrued". Registration may be budgetary or extrabudgetary. SIGMA records the interest earned in the budgetary execution and generates the respective double entries.

Generation of means of payment Recording Centre: Directorate-General of Public Credit

Figure 1.

Nota

Nro. Nota: 00167 Lugar Emisión: LA PAZ Fec. Emisión: 23/05/2001 SIGADE: 66000 Fec. Venc.: 30/05/2001

Benef.: BANCO CENTRAL DE BOLIVIA Doc.: R 2104601 LPZ

Banco Débito: 1004 Cuenta: 3987069001 CUENTA UNICA DEL TESORO Libreta: 009901010C

C-31

| Sec.Nro. C-31 | Tipo C-31 | Ent. | D.A. | U.E. | Total.C |
|--------------------|----------------|----------------------------------|------|------|---------|
| 1 2264 - 1 - 1 - 0 | Presupuestario | 0099 Tesoro General de la Nación | 03 | 03 | 6 |

Beneficiarios

| GrupoBen | Cta. | Sigla | Cuenta | Capital | Interes | Comision | Descripción | |
|----------|------|-------|--------|------------|-----------|----------|-------------|-------------------|
| 004 | 002 | 002 | EID | 4116034001 | 99,388.38 | 0.00 | 0.00 | BANCO INTERAMERIC |

Importes C-31

| Cap. | Int. | Com. | Total C-31 |
|-----------|------|------|------------|
| 99,388.38 | 0.00 | 0.00 | 99,388.38 |

Total Beneficiario

| Cap. | Int. | Com. | Suma Total Beneficiario |
|-----------|------|------|-------------------------|
| 99,388.38 | 0.00 | 0.00 | 99,388.38 |

Totales Nota

Tot Nota: Dólares Americanos Tip. Cambio: 6.54

Buttons: Elegir C31, Verificar, Aceptar

Status bar: I/1 List of Valu... <OSC> <DBG>

The Head of Unit, through SIGMALINK, proceeds to generate the means of payment (note), selecting Form C31, "Record of execution of expenditures" corresponding to that payment and fills in the data concerning the beneficiary (financing agency). The note may be printed (paper) or electronic (file) and its addressee is the Central Bank of Bolivia.

Priority ranking of payments recording centre: Directorate-general of financial programming

The responsible user proceeds to rank by priority in SIGMA the payments that are to be debited in the account selected (CUT or Cta. TGN for foreign currency) and marks as first priority the respective note. SIGMA records the budgetary execution at the stage of the payment, the debit in the Cash or Bank ledger and in the CUT notebook if appropriate; and automatically generates the double entry for the allotment indicated.

Figure 2.

Priorización

Nro. 01420 Fecha 26/11/2001 Estado Generado b) Total Priorizado 1,289,744.17 a - c) Saldo Libreta -25,434,658.39

Cuenta Libreta 0099-002-010-01 a) Saldo -24,144,914.22 c) Débitos 1,289,744.17 d) Títulos Valores .00

Criterios de Priorización

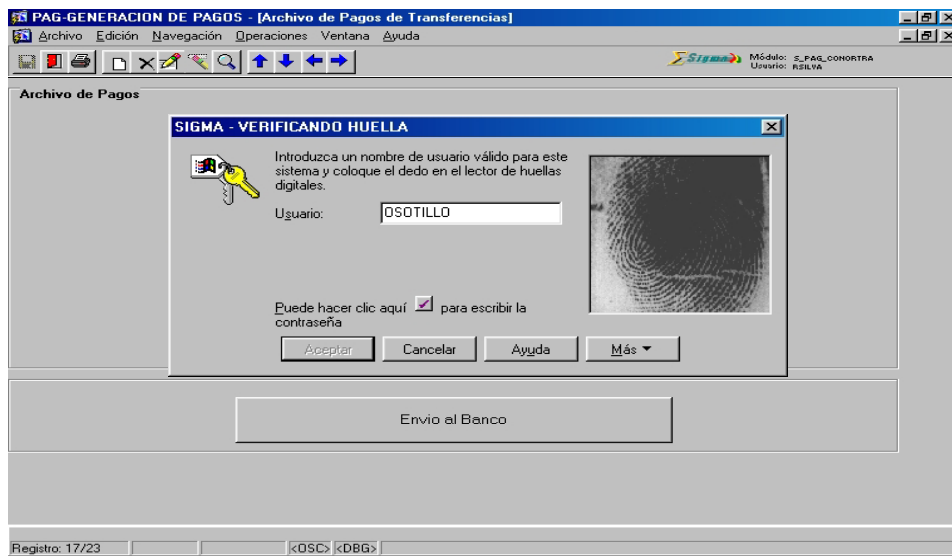
| Criterio | Tipo Documento | Fte. | Org. | Gasto | Corte | Ent. | Dir. | Admin. | Nro. Doc. | Prev. | Nro. Comp. | Nro. Dev. | Monto | Criterio | Cantidad Documentos |
|----------|----------------|------|------|-------|-------|------|------|--------|-----------|-------|------------|-----------|----------------|--------------|---------------------|
| 00000001 | Presupuestario | 41 | 111 | 01 | | | | | | | | | 93,734.53 | | 9 |
| 00000002 | Presupuestario | 41 | 111 | 02 | | | | | | | | | 5,432.00 | | 1 |
| 00000003 | Presupuestario | 41 | 111 | 04 | | | | | | | | | 1,169,189.64 | | 69 |
| 00000004 | Presupuestario | 10 | 111 | 04 | | | | | | | | | 7,761.00 | | 2 |
| 00000005 | Presupuestario | 41 | 111 | 04 | | 65 | | | | | | | 13,627.00 | | 1 |
| | | | | | | | | | | | | | Totales | 1,289,744.17 | 82 |

Rango: Fecha Min. [] Fecha Max. [] Importe Mínimo [] Importe Máximo [] Beneficiario: Tipo Id. [] Documento []

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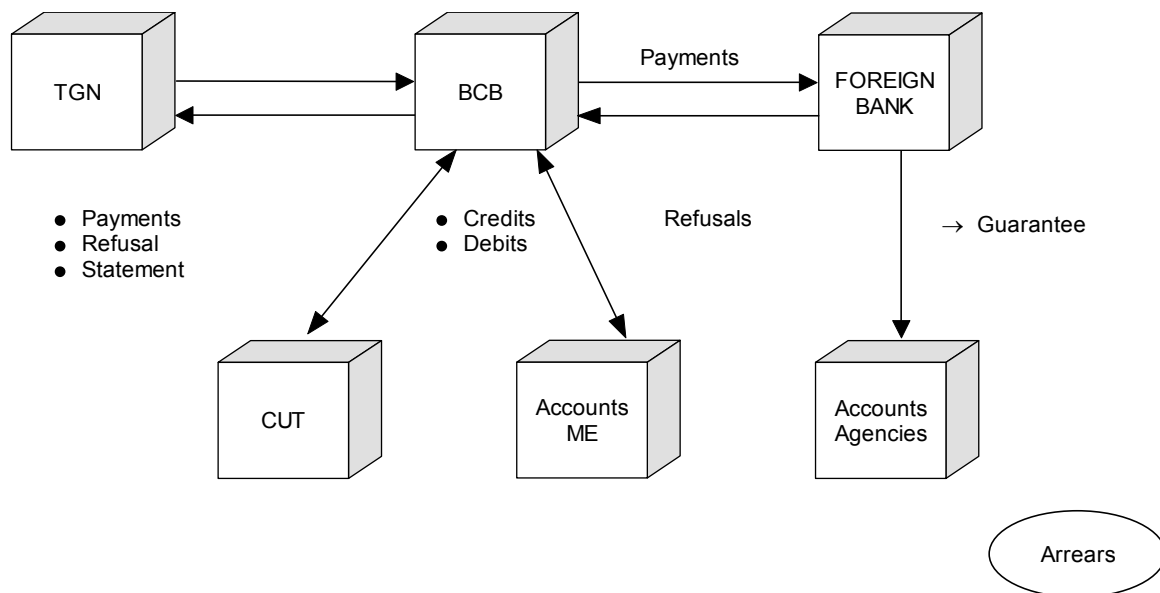
SIGMA automatically generates the file of allotments which are forwarded electronically to the BCB, entering the fingerprint of the authorized official.

Figure 3.



Payments to beneficiaries (financing agencies) Recording Centre: Central Bank of Bolivia (BCB)

Chart 3. Flow of payments to suppliers



On the basis of the information contained in the note generated, whether printed or electronic, the BCB debits the source account specified (CUT or TGN foreign currency account) and credits the accounts of the paying banks. The paying banks will receive particulars of the transfers made to their accounts by the BCB for crediting to the current accounts of the suppliers or the beneficiaries of the payments. On the

same day the BCB transmits to SIGMA the confirmation or refusal of the payment.

At the end of the day the BCB issues the relevant bank statement, which will be available in SIGMA for use in the process of bank reconciliation. This process will enable the credit and debit movements in the single account of the treasury and other current banking accounts to be compared with the resources, payments and

transfers recorded in the bank book and, if appropriate, will generate the application of the register of resources and expenditures to obtain on a daily basis the available balance of the treasury on current account and, finally, the global financial situation.

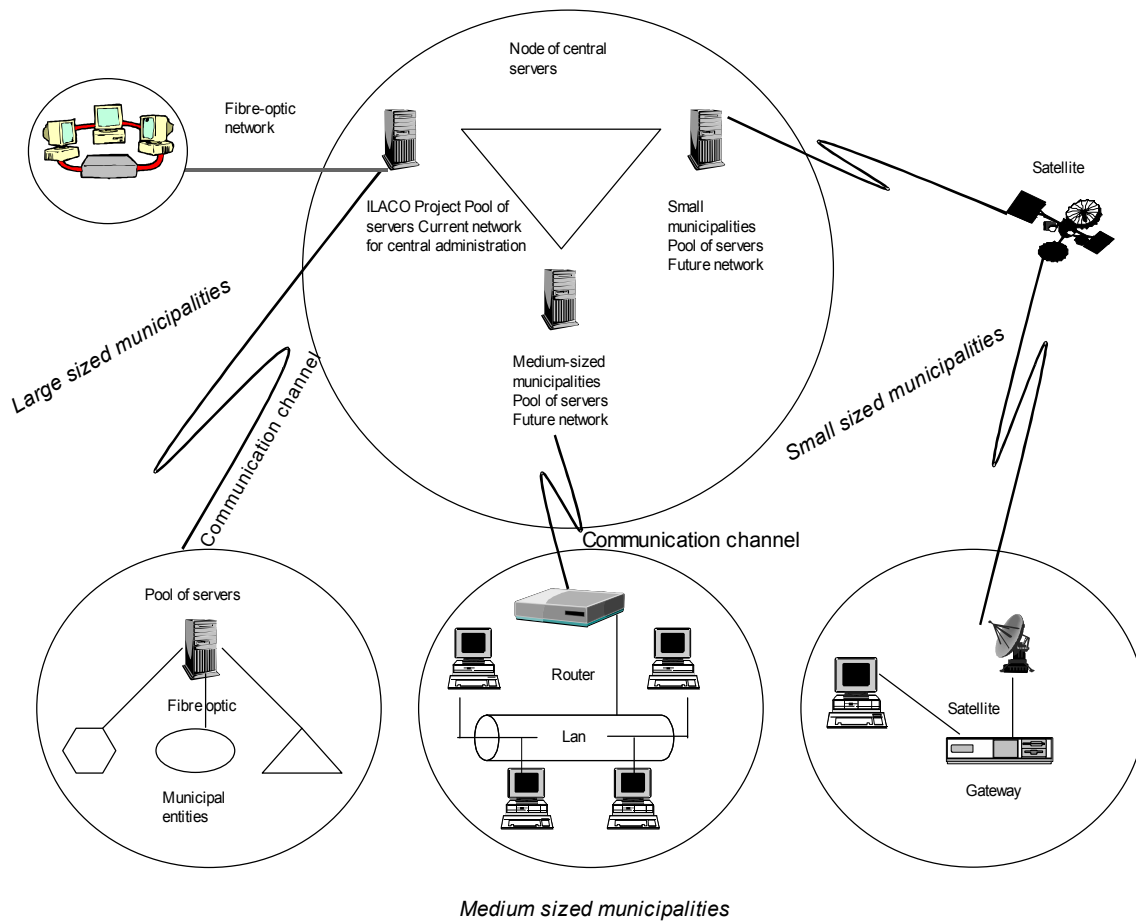
VI. ADMINISTRATIVE AND FINANCIAL DECENTRALIZATION

In the setting of the Enhanced Heavily Indebted Poor Countries Initiative (HIPC II), the guidelines drawn up under the Bolivian Poverty

Reduction Strategy, and the National Dialogue Law, the Municipal Governments constitute the main beneficiaries and administrators of the resources made available.

In this context, the years 2002 and 2003 will see the installation in 91 municipalities of municipal SIGMA, facilitating integration, communication and coordination between the various municipal administrations and the central administration, advancing the country’s fiscal decentralization and the institutional strengthening of the municipalities.

Figure 4. Structure of sigma computing centers



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EFFECTIVE DEBT MANAGEMENT IN FEDERAL COUNTRIES – THE CASE OF ARGENTINA

Emilio Nastri
Marcelo Tricárico

I. DEBT MANAGEMENT IN THE CON- TEXT OF SUB-NATIONAL GOV- ERNMENTS

Introduction

As a general rule, in a federal government system, the national administration has no influence over the public accounts of a sub-national government. Consequently, it is not always clear if the national administration is in a position to regulate the indebtedness capacity of the local administrations.

It is important to note, however, that public accounting carried out at the local government level can have repercussions at the national government level. Turbulence generated by financial difficulties of a local administration will negatively influence federal public credit. Likewise, no sub-national government can obtain reasonable financing if financial difficulties exist at the national government level.

Therefore, international practice is inclined to support central government intervention in the local debt market because of the high cost risk factor of non-interventionist policy. In addition, experience has shown that financial market behaviour is inadequate in avoiding high indebtedness incurred by the local government.

This lesson was learnt by Brazil during its financial crisis in 1999. In this case, the National Treasury needed to assume the indebtedness incurred by the local governments, to the amount of almost \$ 180 billion. The debt was consequently reorganized and an agreement was signed by each local Governor for the reimbursement of the entire amount to the National Government, to be made in instalments over a period of 30 years. Where an instalment is not paid, the local government would forfeit any corresponding tax co-participation. To concretise this point, a new law on fiscal responsibility and strict guidelines was put into force in Brazil in 2002.

Fiscal policy guidelines for federal countries with developing economies and economies in transition

A prerequisite for good public accounting is transparency and fiscal responsibility. In the case of a federal country, this means that strict measures must be taken to ensure that guidelines in this area are respected by the sub-national governments. This demands effective leadership by the central government – in a world that is increasingly decentralized.

In this sense, total transparency, homogeneity and reliability of local government public information is essential in ensuring that the country uses only one information and fiscal language.

Coordination of debt management policies at the national and sub-national level in federal countries

Due to the inter-dependence of indebtedness policies with other macroeconomic policies and the national exchange rate, the only way for federal countries with developing economies to avoid economic instability and recurrent financial crises, is for the different government levels within these countries to share common and coordinated debt management policies with those at the national level. For this, coordination at all government levels is necessary to effectively establish and control debt limits.

Where the national and sub-national governments join forces for obtaining loans or issuing bonds, conditions are better than where negotiated separately. In this same way, the deterioration in the credit rate of a sub-national government can affect the other.

Although effective debt management cannot alone resolve inadequate measures in other areas such as fiscal, monetary or exchange policy, it can, however, reduce financial risk, particularly if incentives exist for the development of the domestic capital market.

An ideal situation for economic growth and fiscal order is where all current expenditure is financed by current income and where debt management is effective. This situation allows for the meeting of payment obligations, for the lowering of financial costs and for the improvement of the payments profile.

II. DMFAS¹ IMPLEMENTATION IN THE SUB-NATIONAL GOVERNMENTS OF THE REPUBLIC OF ARGENTINA

Lessons learnt from DMFAS implementation at the national level

National government strategy regarding public debt administration is part of the framework of reforms that started at the end of 1992 in the Republic of Argentina, in accordance with Finance Administration Law No. 24.156, and carried out at the national administrative level.

As part of the reforms, UNCTAD²'s debt management and financial analysis system (DMFAS), was installed in the national government. From which, the following points can be signalled:

- The implementation of DMFAS is not limited to its installation (i.e. diskette), but implies a reform of the organizational structures in place for effective debt management;
- The installation of DMFAS cannot be successful if it is not carried out within the context of an appropriate legal and institutional framework; and
- Implementation of DMFAS cannot be successful if there is a high staff turnover.

DMFAS implementation in the sub-national governments

Based on the experience of DMFAS at the national level, some of the local governments have signed a project for implementing DMFAS in their administrations, in order to meet their own public debt information requirements, and to help strengthen their capacity in public debt management, recording and administration.

The project aims to establish a framework for the automatic production of consolidated, homogenous and reliable public debt information. As this information comes from different sources, it has been necessary to set up a group of administrative procedures so as to produce this information in an automatic way. These are for:

- A uniform loan codification;
- Determination of a unique cut-off date;
- A uniform classification of debt operations;
- The centralization of participants' information;
- The centralization of interest rates and exchange rate codes; and
- An operative mechanism for data replication.

The project includes the installation, training and use of DMFAS, as well as the creation of a localized team whose organizational structure replicates that of the central DMFAS team at the UNCTAD headquarters. This team has created a complement to the DMFAS User Guide in order to take into account the particular characteristics of the local government public debt of the Republic of Argentina.

It is important to note that DMFAS implementation at the sub-national level allows for the consolidation of policies related to fiscal discipline with those at the national level, and allows for transparency in the use of public resources.

¹ Debt Management and Financial Analysis System

² United Nations Conference on Trade and Development

ORACLE

Charles Leone

How can Oracle complement DMFAS in managing the external debt of public authorities? Why is the combination, DMFAS-Oracle, of such interest? Which Governments are already using Oracle to manage their finances? These are legitimate questions to which we shall try to reply briefly below.

Oracle is the world leader in databases. These databases enable the storage and retrieval of information needed for Governments and companies to operate smoothly. In particular, they are appreciated for their sturdiness and the level of protection that they offer. Oracle is also the second largest supplier of integrated management software packages in the world. These packages use information technologies to provide clients with all the functions needed for their daily operations, while at the same time remain easy to use. Oracle has 41 000 employees world-wide and an annual turnover of more than US\$ 11 billion, and many public authorities and governmental organizations are among its clients.

They include, for example, The Bureau of Treasury in the Philippines, the Hungarian Government Debt Management Agency, the Bank of Venezuela, the Central Bank of West African States (BCEAO) and the Bank of France. Among United Nations agencies, clients include the Food and Agriculture Organization, the World Trade Organisation and the World Meteorology Institute.

The package that fits best with DMFAS is Oracle Financials. This is a set of modules which are part of Oracle's eBusiness Suite. There are many advantages to acquiring a component that is part of a suite: independent research has shown that for each dollar of software package purchased, 3-4 dollars of consulting are needed to enable it to communicate with other packages already installed. When the package is part of a suite, however, there is virtually no cost for integration with other modules.

Oracle Financials makes it possible to monitor all the processes leading up to accounting operations. It compels all users to respect time limits set at the discretion of Governments

or the State agency concerned through Oracle Workflow, a workflow management system that is part of the Oracle eBusiness Suite. Because all information is listed centrally in Oracle Financials, those responsible for monitoring transactions are able to take actual decisions in real time.

For instance, "dashboard" can be set up to list data of interest to the user, enabling him to detect any anomaly as soon as it occurs. The essential information appears on the screen with a few clicks of the mouse.

A feature of Oracle Financials is that it is available in 29 languages and all currencies, using most known characters and ideograms, and is adapted to the specific requirements of a large number of countries around the world. Because of its flexibility, the software can be adapted to the needs of the administration concerned without modification. This versatility guarantees a product capable of being adapted to the many changes that occur in administrations.

Of the many forms of computerized architecture that States may consider to meet their needs, some have undeniable advantages. Some points to remember when planning are set out briefly below:

- Centralize data in a minimum number of databases (if possible only one) so as to avoid diffusion and concentrate complex material in a single place;
- Use web technology (based on the TCP/IP standard) to enable decentralized users (autonomous debt offices, for example) to access the information held on a single database. This data exchange must be possible using a single browser (for example Microsoft Explorer or Netscape Navigator). Because users employ only one browser to access data, no special computer installation is necessary, so maintenance is reduced as much as possible. In addition, this means that no confidential data are delocalized;
- Oracle Financials is based on the same technology as DMFAS and is consequently

similar to DMFAS both in appearance and in use;

- User training is therefore dramatically reduced. Moreover, users accept the product more quickly, as they are working in a familiar environment; and
- Engineers can use the expertise they have acquired with DMFAS in maintaining Oracle Financials.

It is important to stress that Oracle Financials also works without DMFAS if necessary.

The following points enable the chances of an information technology project succeeding within an administration to be maximized:

- Apply a step-by-step approach to avoid confusion;
- Choose a modular product which enables the user to proceed by stages and to achieve the first successful results rapidly, so as to convince all users and policy makers of the project's viability. The rest of the modules can then be applied later;
- Ensure the cooperation of experienced persons (partners) on site to implement the solution that has been chosen;
- Seek sponsors at the very highest political level from the outset of the project. As in any project which brings about change in an organization, it must have leaders who set an example;
- Choose a partner who will be there in a few years' time. After all, nothing can be achieved with a solution that works perfectly but which is no longer supported; and
- As quickly as possible, build a team of super-users who believe in the solution and share their enthusiasm with the rest of the community of users.

To resume:

- Choose a long-term partner. Oracle, a strong candidate because of its leadership in databases and its continuing investment in R&D (more than US\$ 1bn per annum) is a credible partner;
- The Oracle Financials module is installed and working perfectly in many administrations throughout the world;
- In any project, there should be a modular approach enabling investment to be spread over a longer period and the confidence of users and politicians to be won; and
- Bear in mind the ease of integrating Oracle Financials with DMFAS.

More information can be obtained from the Oracle website, www.oracle.com, or by contacting the author.

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