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

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1. Introduction

Over the past decade, a broad consensus has developed that good public debt management (PDM) can help countries reduce their borrowing cost, contain financial risk, and develop their domestic debt market. It can also facilitate maintaining financial stability and help develop their domestic financial system. While this holds for all countries, the needs and constraints of countries in designing good PDM systems vary depending, *inter alia*, on each country's degree of development. Thus, while the experience and practices of developed countries is undoubtedly helpful, emerging markets and low income countries need solutions tailored to their needs and constraints: a "cookie cutter" approach will not do. Moreover, debt management strategies need to be fitted in an overall macroeconomic policy framework that preserves stability and is conducive to growth. In particular, the best debt management cannot offset a fiscal policy that results in unsustainable debt or erratic financing needs. Also, a monetary policy that keeps inflation low will facilitate the issuance of debt denominated in domestic currency.

Good public debt management can help reduce borrowing cost in many ways. A well-designed and implemented borrowing program can give confidence to investors and thus reduce the lending spread. A carefully balanced composition of securities can contain risk—which are harder to manage in countries having few alternative sources of finance.

Good public debt management can also help develop the domestic financial market. Domestic financial institutions benefit from having available public debt instruments in which to invest and which can provide benchmarks for the pricing of other instruments. Moreover, firms and individuals also benefit for similar reasons. In turn, a well-developed domestic financial market can facilitate economic development, and make the economy more resilient to external shocks, such as capital outflows.

In light of these benefits, it is important to define more specifically the objectives, components, and the principles that constitute a sound public debt management strategy, and how such a strategy can be designed and implemented. To illustrate this, this paper discusses key issues in debt management, focusing on recent developments in country practices, and experiences of reform in developing countries.

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

The financial crises of the late 1990s encouraged the search for tools that would reduce the likelihood of future crises and reduce the impact of any that happened. International organizations got actively involved in that search. One product of these efforts was the *Guidelines for Public Debt Management* that the International Monetary Fund (IMF) and the World Bank (WB) developed in close collaboration with national debt managers throughout the world. The objectives of the guidelines were “to assist policymakers in considering reforms to strengthen the quality of their public debt management and reduce their country’s vulnerability to international financial shocks”.¹

The Guidelines cover the following areas²:

- 1. Debt management objectives and coordination**
 - a. Objectives
 - b. Scope
 - c. Coordination with monetary and fiscal policies
- 2. Transparency and accountability**
 - a. Clarity of roles, responsibilities and objectives of financial agencies responsible for debt management
 - b. Open process for formulating and reporting of debt management policies
 - c. Public availability of information on debt management policies
 - d. Accountability and assurances of integrity by agencies responsible for debt management
- 3. Institutional framework**
 - a. Governance
 - b. Management of internal operations and legal documentation
- 4. Debt management strategy**
- 5. Risk management framework**
 - a. Scope for active management
 - b. Contingent liabilities
- 6. Development and maintenance of an efficient market for government securities**
 - a. Portfolio diversification and instruments
 - b. Primary market
 - c. Secondary market

The Guidelines also identified six risks for debt managers to monitor and control: market risk, rollover risk, liquidity risk, credit risk, settlement risk, and operational risk. They also noted several pitfalls:

¹ *IMF and World Bank (2003a)*, p. 4.

² *Ibid*,

1. Increasing the vulnerability of the government's financial position by increasing risk, even though it may lead to lower costs and a lower deficit in the short run.
2. Debt management practices that distort private vs. government decisions, as well as understate the true interest cost.
3. Misreporting of contingent or guaranteed debt liabilities.
4. Use of non-market financing channels.
5. Improper oversight and/or recording of debt contracting and payment, and/or of debt holders.

The IMF and the WB followed up on this effort with a pilot program of technical cooperation to help countries implement the Guidelines. Other organizations, like the UN and the OECD have also contributed to the improvement of debt management practices. For instance, UNCTAD has organized annual conferences on debt management and has also developed a technical cooperation program to help computerization of debt management, providing computer programs and training to operate it-- the Debt Management and Financial Analysis System (DMFAS)³. The OECD has acted as a clearinghouse of information among its members—some of the largest and most active government debt issuers—to distill and disseminate sound practices in the area. This has been accompanied by a program of publications and conferences that cover specific topics of debt management, particularly the management of risk. It has also set up a website, jointly with the Italian Treasury, for debt managers to exchange experiences informally. The UN has supported these efforts, as part of its action to strengthen members' governance and ensure financing for development, notably following the Monterrey Consensus. More importantly, many countries have followed up with reform programs, and together with private sector representatives have contributed to move forward the agenda also through participation in conferences and encouraging research on sound practices.

In addition, the World Bank is preparing a methodology to assess performance of government debt management.⁴ This program, the Debt Management Assessment Tool (DeMPA) sets performance indicators on the following fifteen debt management functions:

Governance and Strategy Development

1. Legal Framework
2. Managerial Structure
3. Debt Management Strategy
4. Evaluation of Debt Management Operations
5. Audit
- 6.

³ See UNCTAD (2006)

⁴ World Bank (2008).

Coordination with Macroeconomic Policies

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

Borrowing and Related Financing Activities

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

Cash Flow Forecasting and Cash Balance Management

13. Cash Flow Forecasting and Cash Balance Management
- 14.

Operational Risk Management

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

Debt Records and Reporting

17. Debt Records
18. Debt Recording

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

A debt management strategy is a key element of sound practice. As Wheeler notes, that strategy “enables debt managers to make portfolio decisions within well-defined parameters for cost and risk”.⁵ Thus, it helps balancing the need for the debt manager to have operational freedom in implementing the government’s debt objectives, but makes the manager accountable for attaining those objectives. The strategy should be explicit and made public, to inform the market and facilitate monitoring of the debt manager’s performance. Moreover, the debt manager needs a planning horizon that goes beyond the immediate future. The desired debt composition may need time to be attained, and there are often constraints—such as underdevelopment of the domestic market—that require careful identification and actions that go beyond the short-term. Thus, a medium term strategy (MTDS) can provide a framework that takes into account the government objectives, evaluates risks and costs over time, identifies problems and sets a plan to address them in a systematic and timely manner. Despite its advantages, designing a debt management strategy is not simple. Thus, while it is common practice for OECD countries to have a published debt management strategy, a recent survey of

⁵ Wheeler, Graeme (2006), *and* p. 2.

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

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

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

In an environment of high liquidity and low interest rates, it became easier for emerging market countries to restructure their debt, particularly their external liabilities. Debt buybacks allowed them to obtain financing on better terms, as regards liquidity, maturity and/or currency-denomination. Improvements in debt ratings helped this process. Also, domestic financing substituted for foreign debt. For example, outstanding Brady bonds fell from almost \$150 billion in 1996 to about \$10 billion in 2007.⁸ In addition, several emerging market countries (including some in Latin America) have bought back or exchanged a large share of their foreign bonds. Moreover, countries that owing to past problems had difficulties in placing foreign debt regained market access. Costa Rica (Box 1) was one such case. Emerging markets have also taken advantage of the unprecedented development of derivative instruments to change their debt profiles. Thus, according to the IMF/WB, more than 20 emerging market sovereigns have arranged for swap credit lines with international banks.⁹

As a result the structure of public debt has changed significantly in a number of emerging market economies. Table 1 below shows that several countries have reduced their dependence on foreign currency debt, on short-term debt or done both.

⁶ IMF and World Bank (2007a)

⁷ IMF and World Bank (2007a)

⁸ Ibid.

⁹ Ibid.

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

	<u>Foreign currency debt</u>		<u>Short term debt</u>	
	Total Marketable debt		Total domestic mkt. debt	
	1996	2005	1996	2005
	(in percent)			
Brazil	48	14	57	22
Colombia	30	25	0	6
Czech Republic	13	13	56	16
Hungary	30	26	15	22
India	0	0	19	3
Indonesia	n.a.	6	0	0
Malaysia	5	7	5	2
Mexico	67	29	29	23
Philippines	16	34	55	29
Poland	27	22	42	8
South Africa	3	10	6	6
Thailand	49	7	0	24
Turkey	31	37	60	7

Source: Strengthening Debt Management. IMF/ WB (2007a)

Moreover, indicators of the foreign debt burden for developing countries also show improvement (Table 2), reflecting factors such as the fall in interest rates, more prudent economic management in borrowing countries, higher exports, and also debt forgiveness initiatives. (Further data on the evolution of foreign debt in developing countries is presented in the Annex).

Table 2: Selected foreign debt burden indicators

INDICATOR (in percent)	COUNTRY GROUP	1996	2005
Total debt /Exports of goods and services	Low income	259.42	92.79
Total debt /Exports of goods and services	Lower middle income	144.2	61.14
Total debt /Exports of goods and services	Upper Middle Income	116.43	83.48
Total debt /Gross National Income	Low income	51.02	27.63
Total debt /Gross National Income	Lower middle income	33.2	24.08
Total debt /Gross National Income	Upper Middle Income	38.25	35.65

Source: GDF

The reduction in foreign debt, for a number of countries resulting mainly from debt relief, has created space for new borrowing, and this has created an opportunity to adopt good public debt management practices. Such practices would help to avoid a repetition of the problem of high indebtedness, and also contribute to greater resilience to macro economic shocks, and to more rapid financial market development. In practice, however, achieving such gains from good public debt management has proven to be difficult owing to the shortcomings in the debt management capabilities of many developing countries.. The IMF/WB Background paper refers to 24 HIPC cases and notes that only five have in place adequate transparency practices and only eleven adequate coordination arrangements among the agencies that manage public debt. Lack of staff affects 18 countries and only seven can record and monitor debt effectively. Thus, a recent report of the World Bank's Evaluation Office concludes that debt management has actually worsened in general in that group of countries and calls for additional help to them in order to improve their debt management capabilities.

4. Implementing Public Debt Management Guidelines—recent experiences.

The World Bank and the IMF followed up on the issuance of the Guidelines with a pilot program of diagnosis and technical cooperation that involved 12 countries: Bulgaria, Colombia, Costa Rica, Croatia, Indonesia, Kenya, Lebanon, Nicaragua, Pakistan, Sri Lanka, Tunisia, and Zambia. Based on an assessment of the extent to which these countries had strengthened their public debt management practices, a report was issued in 2007.¹⁰ The report noted that while significant progress has been made in the structure of debt and in the transparency and governance of debt management functions, weaknesses remain in managing risks, and formulating medium term strategies. These findings are further elaborated below. The ongoing reform efforts, with international support, in some of these countries (Costa Rica and Kenya) are further discussed in Boxes 1 and 2 below.

Countries have made significant progress in:

- ✓ **Improving the debt structure**
 - Longer maturity profile (Colombia, Costa Rica, Czech Republic, Peru)
 - Less reliance on foreign currency debt (Brazil, Colombia, Mexico, Peru, Thailand)
 - More fixed-rate issues (Brazil, Indonesia, Peru, Mexico)
 - Use of debt exchanges or swaps to change debt profile (Colombia, Mexico, Tunisia, Uruguay)
- ✓ **Developing and publishing debt management strategy**
 - Middle income countries (Brazil, Bulgaria, Colombia, Costa Rica, Czech Republic, Hungary, Indonesia, Peru, Poland, Mexico, Turkey)
 - Low income countries (Tanzania, Papua New Guinea)
- ✓ **Improving governance framework**

¹⁰ See IMF and World Bank (2007a, 2007b)

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

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

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

5. Key policy, institutional, and operational issues

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

Debt management strategy and operational issues

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

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

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

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

Contingent liabilities that materialize have sometimes led to serious difficulties for governments and therefore need to be considered in the overall debt management strategy. However, identifying and valuing them pose difficult problems. Identification is easier for those that are explicit, like government-guaranteed loans or insurance schemes. However, some important contingent liabilities are implicit or materialize only in special circumstances but they can be sizeable and disruptive to public finances. Examples include bailouts of various entities: enterprises deemed to be of strategic value to a government, banks which collapse could cause a systemic crisis, or subnational governments unable to meet their obligations. The fact that they are contingent, rather than certain obligations like regular government debt, makes their valuation harder. Despite these difficulties, several OECD countries (like Canada, Denmark, New Zealand, and Sweden) have set up effective arrangements to manage this type of liabilities. Doing so is probably even more important for developing countries, which are likely to have more problems in absorbing the effects of an unanticipated materialization of a contingent liability. Colombia has been pioneering in this area, setting up a sophisticated system for managing this type of liabilities after these led to a crisis in the 1990s.¹¹ At that time, the government had to make significant payments to honor guarantees given for infrastructure projects and to bail out municipalities and departmental governments unable to meet their obligations. This led the authorities to set up a comprehensive system to deal with contingent liabilities, for which they received support from the WB and the IADB.

Also, the debt management strategy needs to take into account market preferences. Box 3 illustrates how the growing demand for Islamic finance instruments for government financing can be addressed.

Risk management

A key piece of the debt strategy is the analysis of risk and cost trade-offs. Asset-liability management (ALM) has become increasingly used as a conceptual framework to do that. This framework is essentially a balance sheet of the government, which on the asset side includes the discounted value of future tax receipts and the discounted return on other government assets

¹¹ For a detailed discussion of country experiences and in particular Colombia's, see Currie and Cardona (2006)

(foreign currency in particular), and on the liability side the debt stock and the present value of future expenditures. A key attraction of ALM analysis lies in its comprehensiveness, which facilitates the matching of cash flows from assets and liabilities and comparing risks and costs. For instance, the risk of borrowing in foreign currency may be offset by tax revenues also denominated in foreign currency. However, modeling costs and risks using ALM is complex and only a handful of countries (such as Brazil, Portugal, Sweden and the UK) have so far begun experimenting with this framework to model risk and cost of their debt. However, many of the insights of ALM can still be used—like the importance of considering both foreign exchange debt and reserves when analyzing the sovereign’s level of risk. This was done for instance, in Hungary, as discussed in a paper by András Réz.¹² However, there are difficulties in doing this. As Réz notes, one is that a country’s foreign exchange reserves are the result of a country’s balance of payments, not solely of the official borrowing. Moreover, the objectives of the central bank—which determines monetary policy and thereby affects the level of reserves—are not necessarily those of the debt manager.

There are other situations that may further complicate the relationship between the debt manager and the central bank. To execute monetary policy, central banks usually operate in the debt market. Central banks in many countries have had cash (and often debt) management responsibilities. The trend, though, has lately been for central banks to relinquish those functions. This may be particularly difficult in cases where central banks have to issue their own debt owing to quasi-fiscal deficits. From this discussion, it is clear that exchange of information and some form of coordination between the central bank and the debt manager can help both achieve their objectives.

Often, reforming public debt management requires legal changes. These can be needed for a number of reasons, for example, to give more autonomy to debt management—e.g., by setting up an autonomous or semiautonomous public debt management agency, to consolidate debt management functions in a single entity, or to adjust the restrictions imposed on debt management practices. For instance, in 2005, Thailand passed a Public Debt Management Act that put public debt management under the aegis of the Public Debt Management Office, to promote the management of public debt in an efficient and systematic manner and to help control the level of public debt”. Croatia passed a debt law in 2002 and in the 2003 Budget Act included a chapter on debt management and guarantees. However, getting laws passed is sometimes difficult, and some countries have implemented reforms using lower-level legislation, like presidential decrees. Some reforms, like unification of debt management offices within a ministry can be adopted through a ministerial decision. In cases where two agencies issue public debt, some countries have adopted ad hoc coordination arrangements, e.g., between the central bank and the ministry of finance. This was done, for example, in Costa Rica.

Developing a domestic market for government debt is often an objective of debt management reforms. A well-functioning domestic debt market has important advantages. Domestic investors are generally less likely to flee from government debt than foreigners; thus, a strong domestic investor base helps build a stable investor base. Moreover, it provides the central

¹² Réz, (2007)

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

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

There are difficulties in broadening the investor base and in developing money and secondary markets. As regards the former, developing an institutional investor base (e.g., as part of the development of the pension system) and improving access to retail investors (e.g., by expanding electronic access) appear as possible solutions. As regards, the money and secondary markets, a major step is to ensure that the central bank operates its monetary policy through the use of market instruments, rather than compulsory mechanisms like directed credit or reserve requirements. Also, some reforms—like consolidating debt instruments and introducing benchmark issues, can be helpful.

6. Conclusions

Developing countries have made significant progress in debt management over the last decade. Favorable liquidity conditions and debt relief initiatives have allowed many countries to make their debt burden manageable. At the same time, various initiatives have focused on the reform of debt management practices and the development of domestic debt markets. Recent turmoil in international markets provides a reminder that benign conditions may change rapidly. It is important for countries to continue and deepen reforms that will help them maintain access to markets and avoid a repetition of past crisis situations.

The *Guidelines* provide a good benchmark for countries. Like other standards and guidelines, though, tailoring to specific country circumstances is essential. For instance, legal arrangements need to take into account issues like the number of debt issuers in the country. Also, the ALM framework, helpful as it is conceptually may be too complicated for many countries to adopt. A simpler approach, focused only on certain assets and liabilities may be more attainable. Developing and monitoring a good set of indicators is also important for the debt manager.

Like for other reforms, country ownership is essential, and countries will have to bear the main responsibility for reforming the system. However, support from the international community can help in many ways.

First, by providing technical assistance and training in carrying out the reforms. Technical assistance can help in disseminating sound practices and tailoring them to specific country circumstances. This assistance can include the diagnostic stage as well as the technical implementation. Training, if well targeted can help strengthen critical managerial and operational skills in this key public policy function.

Second, by encouraging countries and supporting their efforts. Guidelines, like those developed by the WB/IMF provide helpful benchmarks. Additional guidance on specific issues addressed by the PDM Guidelines, based on country experiences, may facilitate implementation. Assessments by independent parties can also be useful. However, it is important that these do not lead to a distortion of priorities if countries focused on those aspects that they expect to be assessed, which will not always be those of the highest priority for the country in question. Moreover, given their other needs, it may not always be optimal for developing countries to devote the resources needed to obtain perfect scores in an assessment. Thus, it is crucial for recommendations to be prioritized and in many cases technical and financial assistance will be necessary for reforms to be carried out.

ANNEX

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

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

	Income				
Total debt /Gross National Income	Low income		51.02	42.53	27.63
Total debt /Gross National Income	Lower income	middle	33.2	35.6	24.08
Total debt /Gross National Income	Upper Income	Middle	38.25	42.91	35.65

Box 1 Costa Rica

Progress in Debt Management

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

Costa Rica has made significant progress in debt management. The government and the central bank are the main issuers of debt, and sell it at a joint auction.¹³ Their instruments are close (but not perfect) substitutes of each other. Both have reduced the range of instruments, improved standardization and lengthened the domestic currency yield curve. This has helped reduce refinancing risk for the government. Moreover, fixed-rate debt in domestic currency increased to about 1/3 of the total debt stock. The introduction of a market-maker for government debt in 2005 enhanced market liquidity, sharply bringing down the spread on these bonds. Nonetheless, the fact that demand is concentrated in a handful of government-owned banks raises questions as to how competitive bids are.¹⁴ Direct sales of government debt to some agencies—like the social security agency—also further reduce the scope for competition.

In addition, transparency has improved. The government announces twice a year its debt program for the upcoming six months. However, issuance of central bank debt has been less predictable, owing to the complexity of anticipating how much it will need to sell to meet its objectives—which include both monetary policy needs as the financing of its quasi-fiscal deficit, a heritage from the past.

An important development has been the setup of a consolidated cash and debt management office in the ministry of finance—comprising a front, middle and back office—and the parallel setup of a unit in the central bank in charge of asset/liability management. The pooling of all public funds into one account has helped improve cash and debt management. Nonetheless, coordination between these two issuers of debt remains inadequate. Costa Rica still needs to spell out a well-designed debt management strategy, which would increase investors' confidence by reducing their fear of opportunistic issues. Such a strategy would further enhance Costa Rica's standing vis a vis investors, which has already benefited from the country's improved fiscal performance, reflected in a significant reduction in the debt/GDP ratio.

¹³ The central bank issues debt not only for monetary policy purposes but also to finance accumulated quasi-fiscal losses originated in the past.

¹⁴ Public sector institutions (public banks and the social security system) hold more than half of the stock of domestic public debt.

Box 2 Kenya

Institutional Reform after Setback¹⁵

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

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

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

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

Kenya's experience clearly illustrates the fact that little can be done—and progress can be reversed—in the absence of full ownership and commitment of the national authorities. Only then can international cooperation bear fruit in speeding up progress.

¹⁵ Source: Anderson(2007)

¹⁶ This is a software for recording and managing debt offered by the Commonwealth Secretariat

Box 3--- Islamic Bonds and Public Debt management

The growing demand for Islamic bonds, or Sukuks, and the growth in Islamic finance¹ generally poses challenges for public debt management and monetary operations. In countries with a significant presence of Islamic financial institutions (IFIs), the absence of, or inadequate availability of tradable and Shariah compatible instruments for conducting monetary operations with IFIs weakens the effectiveness of monetary policy. For this reason, and to meet the investment needs of IFIs, many governments started to issue sovereign Islamic securities that could be used for both monetary management and Government finance purposes. For example, governments of Bahrain, Malaysia, and Sudan, and the central banks of these countries have been issuing domestic currency Sukuks that have reached sizeable volumes. Other countries, such as Pakistan, and Bangladesh, and several Middle East countries also have issued Sukuks locally, and some are evaluating steps to bring about a regular issue program in Sukuks. More recently, with the growing appetite for Islamic securities, particularly in the oil rich countries in the Middle East, several governments have begun to issue Sukuks internationally.² However, the volumes issued, whether domestic or international, so far have remained inadequate relative to potential demand and issuance has been irregular in many cases. Moreover, the issues are typically held to maturity, and the liquidity of the instruments is consequently weak. These developments raise a host of legal and institutional issues on how to integrate sovereign issues of Islamic bonds into the overall public debt management framework, and create a liquid market for these instruments.

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

- Adaptations of public debt and other financial sector laws, notably laws relating to trusts, to facilitate the issuance of Sukuks; Shariah interpretations of the acceptable design features of Sukuks also need further development and harmonization.
- Bringing about a systematic linkage between spending decisions of the government with the funding decisions using Sukuks. In the absence of such systematic linkage, regular issue program of Sukuks, which, by design, have to be linked to specific assets and commodities, will not be possible. In contrast, for conventional securities, public debt management decisions can be done separately from day-to-day spending decisions.
- Actively use the Sukuks in day to day monetary operations and create an infrastructure for secondary trading in Sukuks. In particular, create short term Sukuks, and other short term instruments such as repurchase agreements based on long-term Sukuks, to facilitate money market transactions and monetary operations. Currently, such instruments are not yet well developed, in part owing to insufficient supply of Sukuks, and differing Shariah interpretations of permissible design of repurchase transactions.

¹ Islamic financial instruments are financial contracts issued in accordance with the principles of Islamic Commercial Jurisprudence (Shariah principles). Some of the key principles include: prohibition of interest, sharing of risks to justify return, not incurring “avoidable” or “excessive” risks, avoidance of financial support to products and activities prohibited by Islam, transparency of contracts, and other ethical principles of Islam.

² The volume of internationally issued Sukuks have reached about \$25 billion in 2007 (end of period), compared to about \$16 billion in 2006. The rapid growth is continuing, with a sharp increase in global corporate Sukuks issuance. International Sovereign issues are declining in share. Sovereign local currency Sukuks issued in national markets have reached significant proportions in some countries such as Malaysia and Bahrain. In Malaysia, for example, total Sukuks, both Sovereign and private totaled \$44 billion, about 31% of total debt securities outstanding in 2007. In Sudan and Iran, all sovereign issues are Islamic. Issue volumes in other countries are estimated to be small, although information is not readily available.

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