MANAGING A DIVERSE DEBT PORTFOLIO IN A VOLATILE GLOBAL ENVIRONMENT

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Acknowledgements: This note was compiled by Gregory Smith, Mark Thomas, Abha Prasad, Lilia Razlog, Lars Jessen, Gregory Horman, Ablo Ali and Smriti Seth. All from the Macroeconomics and Fiscal Management Global Practice, World Bank Group.
Executive Summary

1. The Seventh Debt Management Facility (DMF) Stakeholders’ Forum: “Managing a Diverse Debt Portfolio in a Volatile Global Environment” took place on May 30-31, 2016, in Lusaka, Zambia. The Forum targeted policy-makers and debt managers from developing countries, international and regional technical assistance providers, representatives of civil society organizations, as well as donors and multilateral development banks.

2. This note summarizes the findings of the Forum. The following key messages emerged:

i. The environment for debt management has been challenged by: (i) growth in industrialized countries remains anemic; (ii) commodity prices have dropped sharply and remain volatile; (iii) many currencies have depreciated sharply; and (iv) interest rates – in many cases both domestic and external – have increased sharply.

ii. Commodity prices are likely to remain soft and financial flows to economies are likely to remain volatile. For many countries this has increased the cost of borrowing considerably and for others it might even result in periods without market access. Debt relief had put high ratios behind many countries, but in some the speed of their return requires urgent attention and understanding. The task of ensuring debt sustainability has become more challenging.

iii. There remains a need to improve the reliability of data, the credibility of policies and communicate better to markets. The increase in market based borrowing requires better communication. Quick decisions are made by investors and a lack of information or reliable data can increase the costs of borrowing. These are reforms that debt managers can champion.

iv. Sound fiscal policies are required to ensure portfolios remain on a sustainable footing, and debt management strategies play an important role in this. Market and economic developments are difficult to predict in the current environment, suggesting caution is required in the implementation of debt management strategies. Furthermore, strategies should when possible be extended to cover explicit contingent liabilities.

v. Debt management is an evolving practice and it requires continuous learning, evolving skills, and institutions that are ready to adapt and react to new debt instruments and market conditions. There is pressing need for continued innovation, new support products, and ongoing analysis. Just because support is provided doesn’t mean reforms are automatic. Eight years of DMF support has produced good results in many countries, but in others reforms have not taken root and challenges remain. The forum provided vital feedback that can be used to improve the quality of support and ensure lessons from the successful reformers are shared among all.
A. Introduction

3. Debt managers have over the past 12 months been confronted with a volatile global economic environment, bringing with it the following challenges for effective debt management:
   - Growth in industrialized countries remain anemic.
   - Commodity prices have dropped sharply and remain volatile.
   - Many currencies have depreciated sharply.
   - Interest rates – in many cases both domestic and external – have increased sharply.

4. This has led to pressure on fiscal and monetary policies – and has demonstrated the important links between macroeconomic policies and public debt management. The first-round effects come in the form of higher costs of borrowing, leading to budget pressures, domestic market tensions, and higher debt levels. Second-round effects can include the materialization of explicit and implicit contingent liabilities, and increased refinancing risk.

5. These events have placed unprecedented focus on debt and debt management as core issues for economic development. Advanced economies have become increasingly indebted, while developing and emerging economies face increased dependence on domestic and international commercial debt, as the trend of graduation from access to traditional multilateral concessional financing continues. Recent shocks and volatility have highlighted the need for strong debt management practices, including management of contingent liabilities and management of subnational debt while – in many countries – institutions and capacity for effective debt management continue suffer from weaknesses. Governments also face new challenges of coordination across macroeconomic policy levers in a volatile macroeconomic environment while also facing increased levels of scrutiny from domestic and global investors, and while ensuring debt levels remain sustainable.

B. What are the Challenges for Debt Managers?

6. Emerging economies have witnessed renewed volatilities because of lower commodity prices resulting in higher fiscal deficits and financing needs. Further, market issuances by emerging economies especially in Africa has increased significantly in recent years, widening yield spreads for emerging economies despite low underlying global rates. Domestic financing costs have also risen due to high inflation and monetary policy tightening in these countries.

7. Imminent risks for debt management in emerging economies, include: increased credit scrutiny, receding risk appetite; continued need for concessional borrowing given high domestic and international funding costs; for many countries debt maturity profiles that include substantial amounts maturing from 2022 onward related to international bond issues c; and interest costs that may rise further with US fed rate hikes.

8. Recent World Bank analysis, presented at the forum, highlights changes in the Low Income and Lower Middle-Income countries issuing in international debt markets. The level of issuance from such countries has not increased, relative to 2000s, but now it is dominated by Sub-Saharan Africa (figure 1) and the average and Minimum GDP Per Capita (US$ 2005) of issuing countries has fallen (figure 2).
9. Measures that emerging economies could take to address to tackle these challenges and manages the risks better include: diversify the domestic economy and export base (value addition in commodities required); increase transparency and communication with market participants/investors, and provide reliable data; improve credit worthiness; and disciplined and credible public policies to continue attracting capital flows.

C. New Financing Sources in Developing Countries

10. ODA has been growing in size, but its relative importance for developing countries is falling, and the future is likely to bring new and more complicated debt structures with accompanying capacity requirements for debt offices.

11. Understanding is needed on how countries can attract and leverage private sector financing, and how to persuade private sector to participate in funding development. This includes integration into the international financial markets, further development of domestic debt markets, and financial engineering
It was stressed that multilateral development institution could play a major role in facilitating private sector involvement and in promoting new financing instruments. In addition to promoting sound practices, these institutions can provide blended funding where grants are combined with loans.

There has been a substantial increase in the number of African countries acquiring credit ratings, especially in non-investment grade categories, and not always with a specific purpose of issuing international bonds. From a debt management perspective, exposure to foreign exchange risks and past repayment performance are important factors in determining ratings.

D. Fiscal Risks from Contingent Liabilities

The forum highlighted the importance of: a sound risk management framework (including defining the main risk characteristics related to implicit and explicit contingent liabilities); knowledge of how to undertake risk analysis and quantify the risks, plus an ability to conduct impact analysis. Several examples, such as score cards in Indonesia, or rating exercises by international credit rating agencies for companies in Sweden, were proposed as risk measurement tools. Risk management tools include regular monitoring of risks, guarantee fees, collateral and budget provisions for potential losses originating from government guarantees.

The case of Tanzania’s CL management highlighted that most risks in Tanzania originate from guarantees issued to parastatals and public enterprises, as well as credit guarantee schemes (credit lines), litigations and on-lending. Additional liabilities have also arisen from the public service pension fund’s guarantees, which have actually materialized in 2015 and are in the process to be covered through the issuance on medium to long term government bonds. More fiscal risks are expected to arise from the PPP and guarantees to SOEs.

The experience of the LAC region highlighted the importance of management of explicit CLs and building capacity to the management of implicit CLs. The recent trend from DMF member countries is focused on increased demand for capacity building and institutional strengthening for risk management of CLs.

Management of CLs such as government guarantees is often covered by the DMO, but there is no clear-cut advice on which entity in the government should be responsible for CL management- other than it is advisable for the government to assign such role to one entity. Risks of CL arising from subnational debt requires clear delineation of responsibilities for each level of government and close coordination.

E. Debt Sustainability Status and Risks

Increasingly, low-income countries are accessing new sources of financing, especially on market-based terms, both domestically and internationally. At the same time, the availability of concessional financing is constrained for many LICs. In a number of countries, debt levels have risen significantly in the
past few years. Thus, it is timely that the debt sustainability framework for LICs is currently being reviewed, in order to ensure that it remains relevant in an environment of evolving risks.

19. More specifically, there is recognition of the need to (i) better incorporate domestic debt into the assessment of debt vulnerabilities and the likelihood of debt distress; (ii) account better for liquidity risks, not simply solvency; and (iii) assess better the risks associated with natural disasters, contingent liabilities, and public-private partnerships. But these analytical improvements should be accompanied by streamlining, where possible, aspects of the DSF, such as the range of indicators and stress tests. Importantly, debt sustainability analysis should provide adequate early warning of problems, and country authorities must continue to increase their capacity to carry out DSAs themselves.

20. The review will continue to be done in consultation with stakeholders. The next step will be to present preliminary findings and proposals to the World Bank and IMF boards in mid-2016, with formal presentation by the end of the year.

F. The Role of the Debt Management Office

21. Following the development in OECD countries in the 1980’s, some developing countries created specialized debt management offices (DMOs) organized along functional lines - often on the background of a crisis leading to increasing debt levels and high market risks. A key aspect of the DMOs is a strong focus on delegation and accountability, including developing debt management strategies, reporting to parliament etc. Roles and the scope of responsibilities typically change over time.

22. There is no empirical evidence that an independent DMO is a better solution than having debt management in the MoF or central bank – the choice of organizational structure depends on country circumstances, available funding choices etc. Advantages of an independent DMO include a high degree of flexibility regarding timing and types of debt management transactions, clear responsibilities, and ability to hire professional staff. Potential disadvantages include that the DMO is removed from high-level decision-making, and that the flow of information from the MoF may be minimal. No matter how debt management is organized, formal coordination between the involved parties – MoF, CB, DMO - is important.

G. Subnational Fiscal and Debt Rules
23. Fiscal ill-discipline, debt accumulation, and risky debt structures at the subnational government (SNG) level can undermine macroeconomic stability for a nation as a whole. Fiscal and debt rules are no panacea; they do not eliminate the fundamental need for sound public financial management (PFM) policies and practices. But increasingly they are recognized—and deployed—as a mechanism for controlling and anchoring public finances over the medium to long term, including at the SNG level.

24. The optimal design of fiscal and debt rules for SNGs depends on the nature of fiscal decentralization and the extent autonomy over borrowing policy and operations in a country. In all cases, though, sound coordination among the different levels of government is essential for their successful implementation, as well as for their effectiveness.

25. In Latin America, fiscal and debt rules have helped strengthen the credibility of PFM arrangements and have contributed to greater fiscal transparency. In India, starting around the mid-2000s, fiscal responsibility laws began to be enacted by the states, and their adoption has coincided with fiscal consolidation across SNGs, while also fostering greater accountability on the part of SNGs for their public finances; exposure to market discipline has been useful too. In a similar vein, cross-country points to the certainty of the investment environment as being important for stimulating SNG debt markets. National efforts to deepen credit information and disclosure are conducive to a greater supply of capital market finance for SNGs.

H. Trends and Policies to improve Funding via Domestic Debt Markets

26. Domestic debt issuance by governments has increased substantially in low- and middle-income countries over the past decade and a half. Governments have turned to domestic markets to obtain financing for ambitious investment programs that cannot be met through external borrowing alone, especially as the availability of financing on concessional terms is limited. In addition, governments have sought to reduce the vulnerabilities associated with exchange-rate risk and a heavy reliance on inflows of capital. Another common motivation has been to provide a catalyst for development of the financial market more widely, including markets for private-sector debt. In some cases, the need to have instruments available to support the implementation of monetary policy has been a driver behind the development of government securities markets.

27. Although there is much consensus on sound practices for developing domestic government debt markets, there is no single recipe that assures success. In all cases, though, it is important to have a well-defined vision of what is desired in terms of market development, to have agreement among key stakeholders as to that vision, and to ensure that there is effective coordination of policies and reform efforts. For instance, market development typically calls for diversifying and deepening the investor base for government securities, especially for longer-dated bonds, to include pension and insurance funds. But for this to be possible, complementary reforms are often needed on the part of regulatory and prudential authorities as to rules that govern the investible assets of those funds.

28. Macroeconomic stability is critical to the development of well-functioning domestic debt markets. Transparency and good communication are important too. There should be mechanisms in place for not only active, but also pro-active, consultation among government stakeholders—ministries of finance, debt
management offices, central banks, and financial sector regulators—as well as with commercial banks, institutional investors, and market intermediaries. Information on macroeconomic performance and outlook, government finances, the government’s borrowing intentions, operational-level rules for the primary and secondary market, and so on, need to be readily available and in formats that are user-friendly and that satisfy the information expectations of current and potential investors and market participants.

29. Debt managers, understandably, are concerned foremost with having a primary market that can absorb the government’s borrowing requirement. But a key question for them is what should be their role—as chief instigator, as adviser, as enabler, or as simply observer—in developing secondary markets. In a similar vein, they need to decide to what extent debt management will encompass not only debt issuance but also active liability-management operations in the secondary market. Even with a well-functioning primary market, it is still possible that the secondary market is illiquid. Thus, debt managers need to think carefully about how to incentivize primary dealers to act as market-makers and intermediaries and not become simply buy-and-hold investors for their own account.

30. Turning specifically to Africa, the region presents an interesting mosaic of domestic government debt markets. In most countries, the market is still relatively nascent. There are exceptions, however. In Nigeria and Kenya, for instance, the markets are already reasonably developed and vibrant. In South Africa, the government securities market has many of the characteristics of markets in advanced countries. WAEMU and CEMAC are both undertaking ambitious efforts to develop regional, not simply national, government securities markets. Experience across all these countries has shown that sustained commitment on the part of the government to develop the market is essential, even when this means accepting an increase in the “headline” costs of financing. This points to the critical role of an effective medium-term debt management strategy in terms of managing cost and risk, as well as for supporting other debt management objectives, such as market development.

I. A Two-tiered Approach to MTDS?

31. The session focused on getting feedback and input on the MTDS AT that has been in use for some years. It demonstrated that country circumstances, specifically the degree of financial choices available, is an important factor for the usefulness of applying quantitative analysis to provide the basis for the medium term debt management strategy. A key feature of the MTDS AT and similar models is the ability to undertake stress tests.

32. The presentations revealed substantial differences in the way debt management strategies are expressed and the tools applied for the analysis, spanning from the Kyrgyz Republic, where the strategy is largely expressed through broad guidelines, to South Africa, where specific targets for a large number of risk exposure indicators are defined. The latter started applying the MTDS AT, and then later decided to develop stochastic models that allow a richer analysis. In the case of Benin the structured approach to strategy development using the MTDS approach had triggered institutional reforms.

33. It was highlighted that even if financial choices are limited, the MTDS AT play an important role in supporting intuition and in checking the feasibility of alternative ideas, e.g. introducing international
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bonds or inflation linked instruments, and in identifying the preferred direction for the debt structure, e.g. reducing short term domestic debt. In addition, the MTDS AT is applied to undertake a simplified and short-term DSA-type analysis.

34. Ideas to improve the quality of MTDSs include:
   - Closer integration of the methodologies and targets of the MTDS AT and DSA
   - Add to the list of cost/risk measures (e.g. exports and remittances as denominators) and/or make it easier to define custom-indicators
   - Estimated amounts of marginal financing that leads to breach/deviation from reference limits/targets under each strategy
   - Higher granularity, e.g. monthly or quarterly, to facilitate the identification and monitoring of risk exposure targets

J. Reform Plans – What happens after they are developed?

35. From the cases of Vietnam, Uganda, Madagascar and South Africa the main message was that reform implementation takes time. With the increase in complexity of government debt management and significant demand for financing, the improvement of DM functions is critical.

   Table 1: Messages from Reform Plan Efforts

<table>
<thead>
<tr>
<th>Main Elements of reform</th>
<th>Key criteria for success include</th>
<th>Persisting challenges</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;Legal framework, and secondary regulations</td>
<td>&gt;Strong country ownership at technical level.</td>
<td>&gt;Efficiency of the use of borrowed funds (investment management)</td>
</tr>
<tr>
<td>&gt;Development of the domestic market</td>
<td>&gt;Political support to push reform.</td>
<td>&gt;Clarification of the DM function, with creation of single DMO and clear functional delineation with between DMOs and central banks</td>
</tr>
<tr>
<td>&gt;Establishment of the consolidated debt management office to cover all key responsibilities</td>
<td>&gt;Support the DMO with necessary resources / training to enable reform implementation</td>
<td>&gt;Get ready for IDA graduation</td>
</tr>
<tr>
<td>&gt;Debt recording</td>
<td></td>
<td>&gt;Development of risk management tools</td>
</tr>
<tr>
<td>&gt;Debt management strategy development and annual borrowing plan</td>
<td></td>
<td>&gt;Capacity building</td>
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<td></td>
<td></td>
<td>&gt;Quality of the debt data</td>
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</tbody>
</table>

K. Results and Outcomes from the Technical Assistance provided under the DMF

36. Donors and clients were all appreciative of DMF activities and particularly of the programmatic approach. They also commented on the effectiveness in coordination between different TA providers including the IMF under the DMF - this upstream coordination has proved useful for all clients. Clients with two DeMPA missions have particularly benefitted more as the follow up mission allows for monitoring of progress - Bangladesh, Nigeria and several countries in the MEMFI region benefited with a follow up DEMPA. Clients have also benefitted from continuous capacity building and technical assistance.
on development of MTDS, DSA and addressing other operational risks. DMF helps client countries access to TA that would otherwise have to come through expensive international debt experts.

37. Early findings from a study on impact of DMF interventions and performance\(^1\) in debt management produced interesting findings and lessons for the next phase of the TA program. Some countries that had received high DMF interventions exhibited high performance while others did not. This raised questions to understand what had worked well in some cases. Discussion centered on whether changes were needed in the delivery of the program, or was the absorption capacity low, and what would ensure sustainability of the capacity building initiatives.

![Figure 4: DMF Interventions versus performance in debt management](image)

L. Government Debt Data and Quality constraints

38. Quality and coverage of public debt data have improved significantly over recent years. Several cross-country comparable databases exist - including QEDS, DRS, QPDS, JED and DMFAS. However large gaps in coverage and quality remain, particularly in Africa and Middle Eastern countries and continued technical assistance is required.

39. Challenges with developing debt data are related to: poor staff capacity and training opportunities, weak and fragmented debt management entities, complex and dynamic debt environment, use of different sources to report different debt statistics and existing operational risks with respect to data storage. IMF, World Bank and UNCTAD have been engaging with counties by providing hands on and training support. Conflict affected countries like Somalia have faced large challenges in reconstruction of their debt statistics and require continued support and capacity building from international financial institutions.

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\(^1\) Index of CPIA scores, risk of debt distress, publication of debt strategy and DeMPA findings.
M. Discussion on Primary Dealers

40. Primary dealer systems are a feature of government securities markets in many countries. A well-functioning primary dealer system can contribute to decreasing funding costs, as well as to mitigating refinancing risk, for the government. Primary dealers can also play a key role in developing the market itself, as they are the counterparts to the “real money” investors who are the ultimate target. Even so, there are often frictions—valid both ways—between primary dealers and the debt management office. Thus, it is important to ensure that the design of a primary dealer system—especially the incentives for good performance on the part of primary dealers—is carefully thought out and is appropriate for the nature of the market in a country.

41. One key question was at which stage of market development should ‘primary dealers’ be introduced. The answer depends in large part on the obligations that will be imposed on primary dealers. Obligations to act as market-makers in the secondary market are unlikely to be meaningful in very immature markets, and privileges in the primary market need to avoid exacerbating the potential for collusion.