1. Effective Domestic Debt Management in Developing Countries

In the 1980s the major problem facing many developing countries was how to deal with external debt. Domestic debt was relatively insignificant and little discussed. This situation has changed. Domestic debt levels have risen, often in the very same countries which faced acute external debt problems. This has implications for both stabilisation and policies aimed at dealing with external debt. How to manage domestic debt, therefore, has become an important issue.

Public domestic debt is the debt a government incurs through borrowing in its own currency from residents of its country. Government bonds or bills represent assets to their holders, but they are simultaneously a liability to the taxpayers who must ultimately redeem them. This basic idea admits of considerable variations:

Domestic debt transfers resources within a country

- The definition could be widened by including the debt not just of central government, but also that of local or provincial governments, state-owned enterprises and agencies whose borrowing is guaranteed by central government. This would be the consolidated debt of the public sector, including the monetary authorities.
- One may wish to exclude the central government's debt to the central bank, which in practice is often not repaid, and is a measure of monetisation.
- One may wish to make a distinction between gross debt and net debt, where we net out of gross debt capital assets of the government and its loans and advances to other sectors.

It does not increase real resources

The key distinction is between internal borrowing by the state authorities and external borrowing. Internal borrowing does not increase the real resources of the country: residents of that country merely give up purchasing power in return for government securities. There is therefore a transfer of purchasing power within the country over the same stock of real resources. External borrowing, on the other hand, allows the import of real resources from abroad. Internal borrowing leads to domestic debt.

However, this clear distinction is somewhat complicated by the fact that foreign investors sometimes invest in the domestic debt

instruments of the government. The government's obligations, therefore, are to foreigners, but in its own currency.

Governments use a number of instruments to raise funds. They include the following:

- **Treasury bills**: these are short-term obligations of up to one year.
- **Government notes and bonds**: these are debt instruments over one year or more.
- **Loans**: many governments borrow from banks and residents in their countries.
- **Promissory notes**: these are conditional promises to pay a specific sum on specific dates which some governments in developing countries issue to their creditors and suppliers.
- **Overdrafts or advances from the central bank**: in some countries this can constitute a large proportion of the debt.
- **Savings certificates**: these are non-marketable debt instruments, usually for the retail public.

Government debt is typically held by the central bank, the commercial banks, institutions such as insurance companies and pension and provident funds, and private individuals.

Why domestic debt levels have risen

The external debt crisis is one reason why domestic debt has grown

There are a number of reasons why domestic debt levels have risen to dangerous levels. The external debt crisis has been an important source of the problem for many countries. Governments have had to squeeze domestic demand in order to generate surpluses on the current account of the balance of payments in order to service large external debts. This has led to lower wages and profits, and thus lower tax revenue. Many governments have also encountered deep-seated problems in levying and collecting taxes. Moreover, the moves many have made to liberalise their financial markets have entailed paying higher interest charges on their existing debt, thus exacerbating the pressure on public finances. Finally, many countries have a vast portfolio of loss-making and heavily indebted public sector companies; this puts an additional burden on government debt.

Consequences of excessive borrowing

It is not sound to assume that because domestic debt is owed by the government to its own people and its servicing therefore simply

entails a transfer of income from one group to another within the country, it has no undesirable economic consequences. Excessive government borrowing and debt can have a number of bad effects:

The debt burden can slow down the economy

- If the cost of servicing the debt accounts for a large part of government revenue – as it does in many countries – the scope for public spending on desirable items such as health, education and infrastructure is correspondingly diminished.
- If the government pre-empts a large part of the savings of its residents, it may reduce the amount the private sector can borrow or raise in the capital market, thus crowding-out private investment.
- Excessive borrowing can also increase interest rates, thus deterring investment by making it more expensive.
- If the government finances its deficit by borrowing too much from the central bank – through money creation – it stokes up inflation.
- The building up of excessive debt today entails higher servicing costs on future generations who thus suffer higher taxation.
- Excessive domestic debt can affect a country's credit rating and therefore the cost of its future borrowing.
- Finally, domestic debt levels can be built up to levels where they become unsustainable, precipitating an economic crisis.

Objectives of debt management in developing countries

Domestic debt management has different goals in developed and developing countries

It is therefore important for developing countries to learn to manage their domestic debt efficiently. They cannot do so, however, by setting themselves the same objectives as those of debt managers in the advanced countries. Most developing countries are in a radically different situation from advanced countries. In advanced countries, markets for debt securities are highly developed; independent investment institutions have the purchasing capacity and the appetite for government debt; and although there too domestic debt levels have generally risen, macro-economic indicators of fiscal deficits and inflation are not so daunting.

In advanced countries, it is possible to set debt managers a relatively straightforward objective: to cover the government's borrowing needs at the lowest cost. They need not concern themselves with other objectives of government, such as price stability. In practice, in many advanced countries debt management and monetary policy are conducted by the central bank, and the goal, therefore, for debt

managers is to minimise the cost of government debt without jeopardising the aims of monetary policy. But in principle at least the two can be separated, and there is a strong argument for thinking that they should be separated institutionally: that the responsibility for debt management should be placed on an independent debt management office and the responsibility for monetary policy should rest on the central bank. In such an arrangement, which exists in Ireland, Sweden and New Zealand, the debt management office aims to minimise the cost of the government's debt, and the central bank aims to keep inflation down to a specified target. They act independently of each other, using different instruments to achieve their ends. Their objectives can be reconciled optimally through the operation of market forces.

A number of objectives have to be reconciled

Such a system is not possible in developing countries, where financial markets are undeveloped, and instruments of both debt management and monetary control are primitive. There will typically be a conflict between borrowing for the government as cheaply as possible and keeping inflation down. Often the right thing to do is to raise interest rates and thus the cost of borrowing.

Moreover, in many developing countries managers cannot simply sell a given quantity of stock of varying maturity and organise the government's portfolio so as to minimise cost and reduce risk. Primary markets for debt securities, if they exist at all, tend to be only for very short-term instruments, such as Treasury bills. Interest rates are typically controlled by the authorities. Secondary markets rarely exist, so there is a lack of the price information that deep and liquid markets provide. The investment institutions such as pension and insurance funds tend to be captives of the authorities: being government-owned, they hold its debt because they are told to. The commercial bank is undercapitalised, bloated with bad loans and typically state-owned.

Close co-ordination with monetary policy is essential

In these circumstances, the operation of debt management is bound to be intimately linked to the operation of monetary policy. Both will initially use the same instruments. Their objectives, therefore, need to be co-ordinated institutionally. That is not all. As remarked above, in many developing countries debt and money have to be managed in an environment where public budgets and inflation are far from stable, and where financial markets are undeveloped. Therefore debt management and monetary policy must also support the common objectives of stabilisation and market development. Specifically, debt managers in developing countries, apart from their primary objective of selling government debt at least cost, should:

- ensure the liquidity needs of the economy are met, as debt management operations have the potential to disrupt the money markets causing short-term interest rate fluctuations;

- support monetary policy by limiting the inflationary impact of deficit financing;
- promote the development of money and capital markets;
- not jeopardise investment by crowding-out the private sector;
- encourage saving by households; and
- act in harmony with external debt management.

Both need to support stabilisation and market development

Conflicts are bound to arise between these objectives. Policy makers need to formulate a clear strategy, taking into account their macro-economic situation and the stage of their market development. And as the situation changes and markets develop, their objectives should change too. Debt management is not a once-and-for-all affair, but an evolving enterprise.

Functions of debt management

Debt management involves a number of inter-related functions:

- **Planning of financing requirements**: projecting government borrowing requirements in the context of fiscal and monetary targets and sustainable levels of debt.
- **Policy**: formulating debt management objectives and strategy; deciding on volume, type of instruments, timing, frequency and selling techniques; where feasible, developing a benchmark debt structure.
- **Primary market organisation (new issues)**: organising distribution channels and selling procedures; managing debt operations including auctions, subscriptions, etc; maintaining close contacts with the market.
- **Secondary market organisation**: actively managing the secondary sales of government's outstanding portfolio; developing these markets; maintaining contacts and intervening in them; encouraging the dealing and dealer systems.
- **Issuance/Redemption**: administration of new and old issues, e.g. delivery and redemption of securities.
- **Administration and accounting**: maintaining an accounting system for debt operations; managing records of debt holders and stock; servicing of government debt; maintaining a register of government debt instruments.
- **Establishing systems**: establishing efficient payments systems, trading procedures and smooth clearing and settlement systems.

Linkages between public debt and fiscal deficits

Several sorts of deficits should be distinguished

The source of public debt lies in budget deficits. If a government spends more than it gets in revenue, it has a deficit. It meets this by borrowing. The cumulative total of its past borrowings is its debt. This is a simple schema, but for practical purposes we need to employ somewhat more complex ideas. To begin with, there are several related concepts of fiscal deficits:

- **Fiscal deficit**: This is the difference between total government spending and total government receipts except those that come from borrowing. On the expenditure side it includes all current non-interest payments, interest payments, capital spending, and net lending. On the income side it includes all tax and non-tax revenues, grants, and receipts from the sale of public sector assets. In other words, it does not distinguish between capital and current income, nor between interest and non-interest expenditure.

The primary deficit is a key policy target

The scope of 'government' is unclear in the definition. Is it just the central government, or does it include other parts of the public sector? The World Bank recommends that the borrowing requirement of the whole non-financial public sector should be taken into account, that is, it should include not just the central government, but state or provincial governments, public sector enterprises and the central bank, but exclude financial institutions such as commercial banks which might be owned by the government. This is the measure of deficit adopted by the International Monetary Fund (IMF) as its policy target in its Structural Adjustment Programmes.

- **Revenue or recurrent deficit**: This leaves out from the expenditure side capital items – expenditure which creates assets for the government. The idea is that while current spending and interest payments should be financed from current revenue, capital spending could safely be financed by borrowing.
- **Primary deficit**: This excludes interest payments – the cost of financing past borrowing – from expenditure. This is a key concept in assessing whether a country's debt is sustainable, an issue discussed below.
- **Operational deficit**: This adjusts the fiscal deficit for inflation. Inflation reduces the real value of debt and therefore the interest cost does not reflect the true cost to the government. The operational deficit is the fiscal deficit minus the government's outstanding debt at the beginning of the year multiplied by the inflation rate during the year. This concept is relevant for countries with high rates of inflation where the difference

between the fiscal deficit and the operational deficit can be large. (For example, in 1985 Brazil had a fiscal deficit of 27.1 per cent, but an operational deficit of only 3.5 per cent.)

Ways of financing deficits

Fiscal deficits can be financed by borrowing abroad, printing money or borrowing domestically. The sum of these three in any particular year necessarily equals the fiscal deficit for that year. Each of these methods of financing, if carried to excess, can lead to a crisis:

There are three ways of financing a deficit

- **External borrowing** from, for example, foreign governments, multilateral organisations or private institutions, allows a country to import real resources to consume or invest. But the servicing of the debt generated in this way involves transferring resources abroad. Thus the country has to generate an export surplus or borrow further. If the country cannot pay the interest or return the principal when it falls due, it faces a crisis. This is what has happened to several countries during the debt crisis that began in 1982.
- **Borrowing domestically**, within moderate limits, is not inflationary, nor does it have the problems of external borrowing. However, the consequences of excessive domestic borrowing are, as we have mentioned above, undesirable. Moreover, the accumulation of domestic debt as a result of persistent domestic borrowing could reach unsustainable levels. Then the government would have to take painful measures on taxation and spending to bring the debt back to a sustainable level or be plunged into crisis.
- **Borrowing from the central bank** through the sale to it of government securities or other ways such as overdraft advances is a form of money creation: it is just like printing money to pay one's bills.

Carried to excess each leads to problems

There is a degree to which a government can do this without cost and with no bad consequences. In a growing economy the demand for money increases, typically, in proportion to the growth. The government usually has a monopoly over issuing money. It can satisfy this increase in demand by printing money. The profit it makes on this is called seignorage. If, however, it prints more money than the increase in demand for money resulting from growth, it will cause inflation.

To the extent the public accepts this inflation and adapts to rising prices by saving more and increasing its money holdings, the government can get away with this. In effect, the public is willing to be taxed in this way – it is willing to pay an inflation tax. But governments would be foolish to use this form of taxation to

excess, for three reasons. First, there is a limit beyond which the yield on this tax falls because the public starts to economise on its money balances. Secondly, high rates of inflation can easily slide into hyper-inflation. Finally, even relatively low rates of inflation disproportionately hurt the poor, an important fact for developing countries.