External debt management

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A clear and persistent lesson of the debt crisis has been that adequate debt management is essential if external resources are to be used efficiently in an increasingly complex financial environment. During the past decade the central government and public sector entities have been the major external borrowers in many countries. Typically, however, statistical information and centralized control over external borrowing, which should provide the basis for appropriate macroeconomic policies, have been inadequate. Where such control did exist, it was often exercised without a medium-term borrowing plan or an overall balance of payments target. Even in countries with greater experience in external borrowing and with fairly sophisticated external debt management systems, the increasing complexity of international transactions, especially the growth of short-term interbank and trade credits, placed great strain upon debt control and monitoring efforts. Consequently, debt management tended to be ad hoc. This article briefly reviews the five basic aspects of debt management: policy coordination, regulatory environment, operations, accounting, and statistical analysis.

Policy coordination. The diverse ramifications of foreign borrowing mean that external debt policy affects planning, balance of payments and budget management, and all government agencies involved in investment decisions. Coordination among these agencies is essential.

Treasuries usually formulate the budget or medium-term plan, while central banks implement monetary and exchange rate policy. In countries that undertake planning, project development is quite often the responsibility of a centralized commission that assesses and ranks the viability of different projects. The plan or the budget is approved by parliament, which traditionally guards its authority jealously. (In some countries, each loan requires separate authorization by parliament; in others a national debt office is supervised by parliament, but detailed regulation is not enforced.) To coordinate the activities of these agencies most countries have a central unit, which normally comprises representatives from the planning and finance ministries, the treasury, and the central bank. In countries without planning, and where some of these functions are combined in one ministry, the membership is limited to the officials of that ministry and the central bank.

Regulatory environment. A well-defined regulatory environment should provide for the well-coordinated, and where necessary centralized, administration of external debt at both the technical and the operational level. This in turn needs to be supported by a comprehensive reporting and monitoring system and a centralized data base. Countries differ in the degree of control exercised by the authorities, the strictness of the regulatory environment, and the nature of the reporting system—which can be mandatory or voluntary, and may require either prior authorization or only ex post reporting. The majority of debtor countries have exchange controls under which prior authorization is required for all medium-term and long-term debt. For public debt, the prior authorization of the ministry of finance is usually required, although this may be delegated to, or exercised jointly with, the central bank. Private sector debt is normally within the purview of the central bank, which regulates foreign exchange; in some countries, it may also be subject to the approval of the ministry of trade. In several countries, authorization to contract debt is automatic, provided certain conditions regarding maturities, purpose, or size are met.

Operations. Operationally, debt management entails the adoption of a strategy to approach and participate in international financial markets. Unfortunately, all markets have not been open to all borrowers, and one of the results of the recent debt crisis has been greater segmentation and quality consciousness in financial markets due to a growing tendency among suppliers to follow market perceptions en bloc. By the same token, market conditions have significantly improved for the more creditworthy countries—particularly for those with good technical skills and the ability to keep abreast of market developments.

For many countries the best mix of financing would be one that minimizes the medium-term debt service by including the highest possible grant element or long-term investment, or the minimum amount of market finance, and has a smooth time profile for debt repayments to facilitate the rolling over of maturing debt. Determining the mix involves, among others, decisions regarding currencies, interest rates, the timing of borrowings, and the choice of lead managers (which coordinate and direct syndicated operations), borrowing agencies, and a ranking of borrowers.

The search for an optimum currency composition must weigh hedging, which is designed to minimize risk, against the potential benefits, but also the greater risks, of taking positions in certain currencies in order to gain from market developments. An interest rate strategy requires the same choice: between taking a position and spreading the risk. Timely borrowing in advance of need can avoid giving the impression of crisis borrowing when the need is genuinely there. This type of flexibility could mean higher interest costs in the short run, but in the long run it can reduce overall costs.

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The choice of lead managers can be useful in securing market acceptance. Managers can be selected from reputable houses, brokers, or major banks with the financial power to support an issue. The choice of borrowing agencies is equally important, and involves deciding whether the central government should be the sole borrower or whether regional governments or other public and private agencies should also enter the market. Introducing different agencies subjects them to market discipline and scrutiny, thereby helping to establish their standing in the market. But a highly centralized operation, which then lends to other agencies, may reduce costs, avoid bunching, and increase market acceptability.

Who should conduct negotiations on behalf of the borrower? Where public corporations are authorized to negotiate on their own behalf, most countries normally have a clearance procedure under which the acceptable terms and conditions of the debt are known to the negotiators and loan agreements are subject to the approval of the agency with primary responsibility for external debt. In many countries, the timing of market entry is also subject to prior authorization—or queuing—to ensure that the market is not flooded simultaneously by numerous borrowers from the same country.

The debt management unit must continually assess the amounts of each type of credit available and likely to be available, and the impact of new borrowing on the overall structure of debt, so that maturities may be spread as evenly as possible, combining both large and small loans. It must also always be aware of payments obligations. To meet external payments and debt-service commitments it may have to coordinate draw-downs of external credits with the management of reserves. For this, adequate information on contracted debt is essential. Moreover, the unit has to take into account other factors, such as market perceptions of the region, exchange rate guarantees, accumulation of unrecorded debt arrears or trade credits, and private sector capital outflows.

**Accounting.** The fundamental decision in devising an accounting framework for external debt is the determination of what constitutes an external debt. A government’s immediate interest is, of course, its own external liabilities and its contingent liabilities. However, government responsibility for foreign exchange reserves and regulations may also imply responsibility for providing foreign exchange to service private sector debt.

The commonly used narrow definition of external debt includes all medium-term and long-term debt (of one year or more) owed by the public sector to nonresidents. A broader definition adds short-term public sector debt, direct investment, and private sector debt (both short and long term). The International Compilers’ Working Group on External Debt Statistics (which includes representatives of the IMF and the World Bank) has agreed that external debt should be defined as liabilities on which a contractual obligation to repay existed. This excludes direct investment and corporate equities.

There are also institutional decisions: what should be the legal status of an external debt accounting unit? Should it be autonomous? Should it form part of the treasury or the central bank? The treasury should clearly contain an integrated accounting system to trace and authorize external payments. Similarly the central bank must have its own unit to cover transactions arising from external debt obligations. In most countries the two systems seem to live side-by-side, but the problem of reconciling the two when they do differ often remains.

**Statistical data base.** Data on debt have to be reasonably comprehensive and timely to contribute to policy making and to provide early warnings of possible debt servicing problems. The statistical and analytical aspect of debt management involves assembling summary figures on foreign borrowing, tabulating outstanding debt, and projecting debt service. From these statistics, data are prepared for the government budget and for the balance of payments accounts.

Statistical and analytical functions are therefore essential complements to the accounting exercise. Most credits from commercial banks now carry variable interest rates; when these are coupled with the volatility of exchange rates, a matrix of projections is needed to test the sensitivity of debt-service payments to changes in the movement of these variables. The basic requirement is to establish comprehensive statistics on debt that include information on a loan-by-loan basis, identify all transactions on loans, and compile complementary data on market and economic variables. The information needed consists of the original amount of all loans, amounts drawn and outstanding: details on loan terms, maturities, currency, fees, and spreads; due dates for payments of interest and repayments of principal: identification of borrowers and lenders, as well as the guarantors on both sides; and the purpose, or the end use, of the loan.

Reports can then be prepared both for current operations, such as payments of interest and repayments of principal, and for planning future borrowing and overall debt management strategy. The latter reports would describe the structure, maturity, currency composition, and creditor groupings of the debt and the sensitivity of the debt structure to various options. The debt figures should be expressed in terms of macroeconomic variables so that policy makers can determine the sustainable level of external borrowing. The ratios commonly in use include total debt outstanding to exports of goods and services, debt service to exports of goods and services, interest payments to gross domestic product, and so on.

The complex nature of debt management, its dependence on consistent and timely data, and the sheer magnitude of operations have encouraged many countries to computerize data management systems. Unfortunately, however, many authorities rely on a computerized system to solve all their debt-related problems. The result is often an incomplete system—part computerized, part manual—in an environment of fragmented responsibilities, inconsistent debt treatment, varying definitions, and no policy coordination. While most countries need computerization, such a system must be based on a comprehensive inventory of existing debt supported by an efficient administrative and technical infrastructure. No computerized system can function effectively in a vacuum.

International agencies, such as the Fund, the World Bank, the Bank for International Settlements, and the OECD, have also in recent years taken steps to improve the data available on international capital flows. This can serve as a rough cross-check for country data. In addition to BIS data on international banking flows, the Fund’s *International Financial Statistics* has recently started publishing a new set of tables that draws together data on external debt intermediated by banks either as creditors or debtors. In another recent initiative, the BIS and the OECD have begun publishing information on short-term trade-related credits. The World Bank’s *Debtor Reporting System*, from which its *World Debt Tables* are drawn, remains the principal source of information on developing country public and publicly guaranteed debt of one year or over. There is, of course, considerable scope to improve the geographical coverage, timeliness, and accuracy of data as well as its reconciliation from different sources.

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Many debtor countries cannot rely on international markets alone to regulate access to external finance. By the time market signals indicate a country has exceeded a "prudent" level of borrowing, it is too late to take corrective measures on a voluntary basis. The creditworthiness of the country has already been impaired and the market is closed to it, perhaps for an extensive period of time. To prevent this, borrowers have to stay abreast of market developments. In addition to appropriate macroeconomic policies, this requires an effective debt management system.