

The background of the slide features a grayscale image of a building's steel framework, showing a complex network of beams and girders. This image is centered and overlaid on a solid blue background. The text is positioned over the blue background, with the main title centered over the top half of the image and the date and author information centered over the bottom half.

Building Supply for Government Debt Securities

June 12th, 2001

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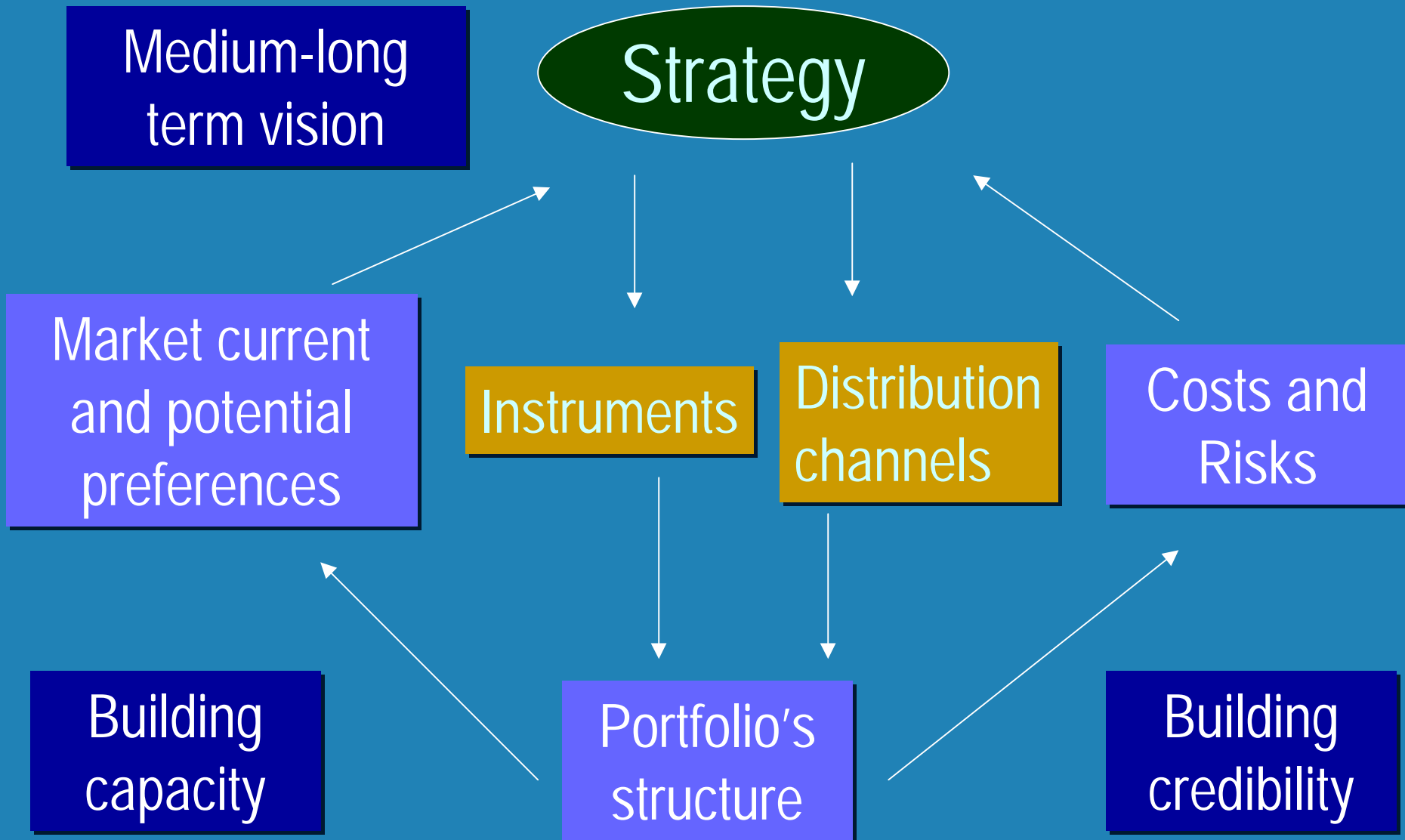
Questions

- What are the appropriate **objectives** for government debt management?
- What is the best **strategy** to reach these objectives?
- Developing the strategy:
 - What are the main **trade-offs** in developing the strategy?
 - What is the most efficient way for government to **access** the debt market?
 - What are the benefits and drawbacks of using **primary dealers** to issue government securities?
 - What are the optimal **characteristics** of government securities?
 - Should the government establish **benchmark** securities?

What are the appropriate objectives for government debt management?

- Provide timely funding to the budget
- Minimize borrowing costs while keeping risk of portfolio at tolerable levels
- Support the development of the local bond market
- Build a benchmark yield curve

The importance of developing a strategy



What is the best **strategy** to reach these objectives?

Government must develop a comprehensive strategy in consultation with market participants

- Establish a market-oriented funding strategy based on broad market access, fairness and transparency
- Bear in mind current market limitations and....
- Potential trade-offs during implementation
- Base strategy on investors' current and potential needs and desired portfolio structure
- Strategy with a medium to long term vision

What is the best **strategy** to reach these objectives?

Guiding principles:

- Need of consistency between macro framework and denomination of issue.
- Need of risk sharing between issuer and market
- Maintaining flexibility

Common tradeoffs:

- Reducing funding costs by concentrating liquidity but increasing rollover risk
- Reducing refinancing risk by reducing duration of portfolio or increasing F/X exposure.

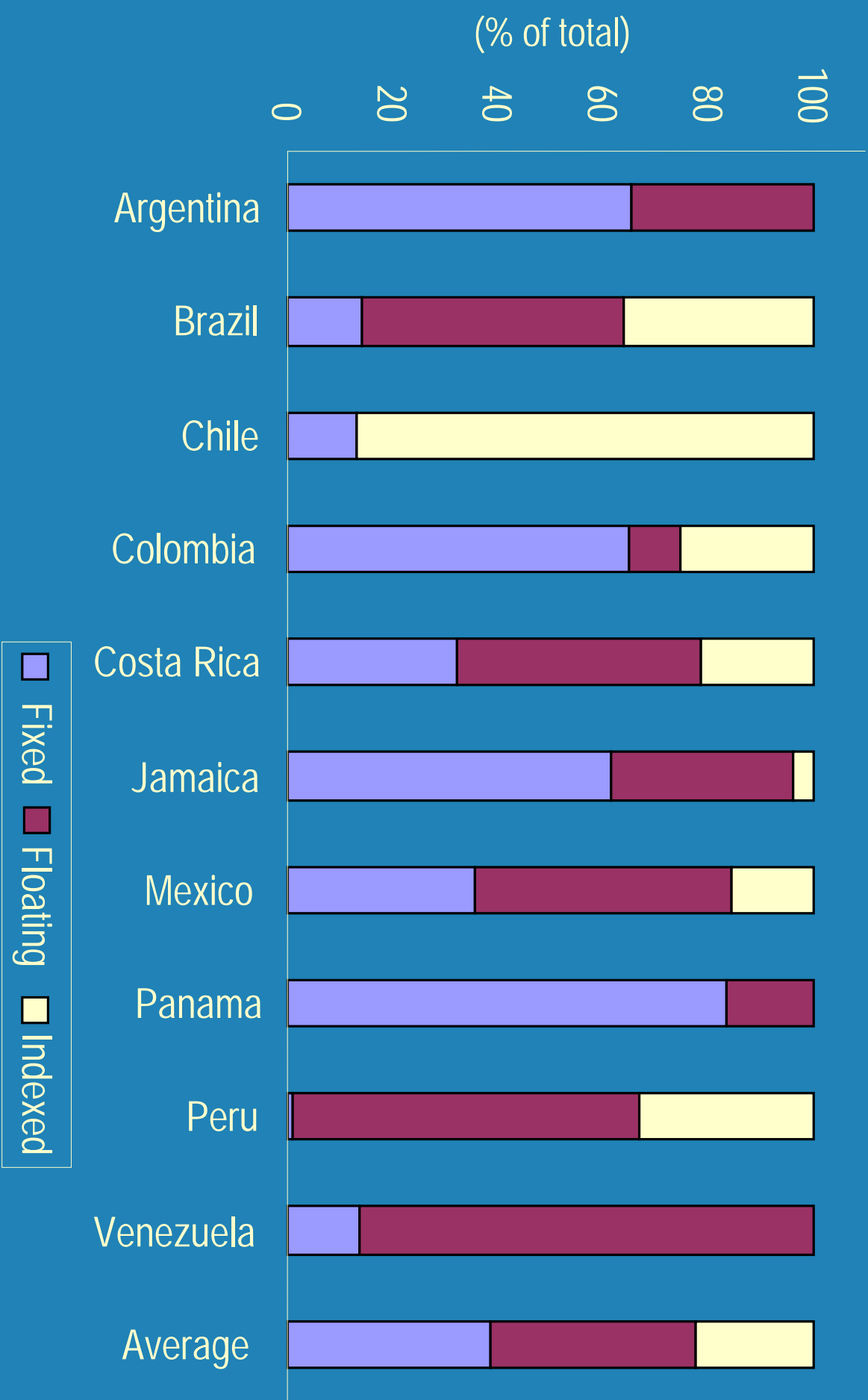
Keep the risk at sustainable levels and then focus on cost minimization

What are the optimal characteristics of government securities?

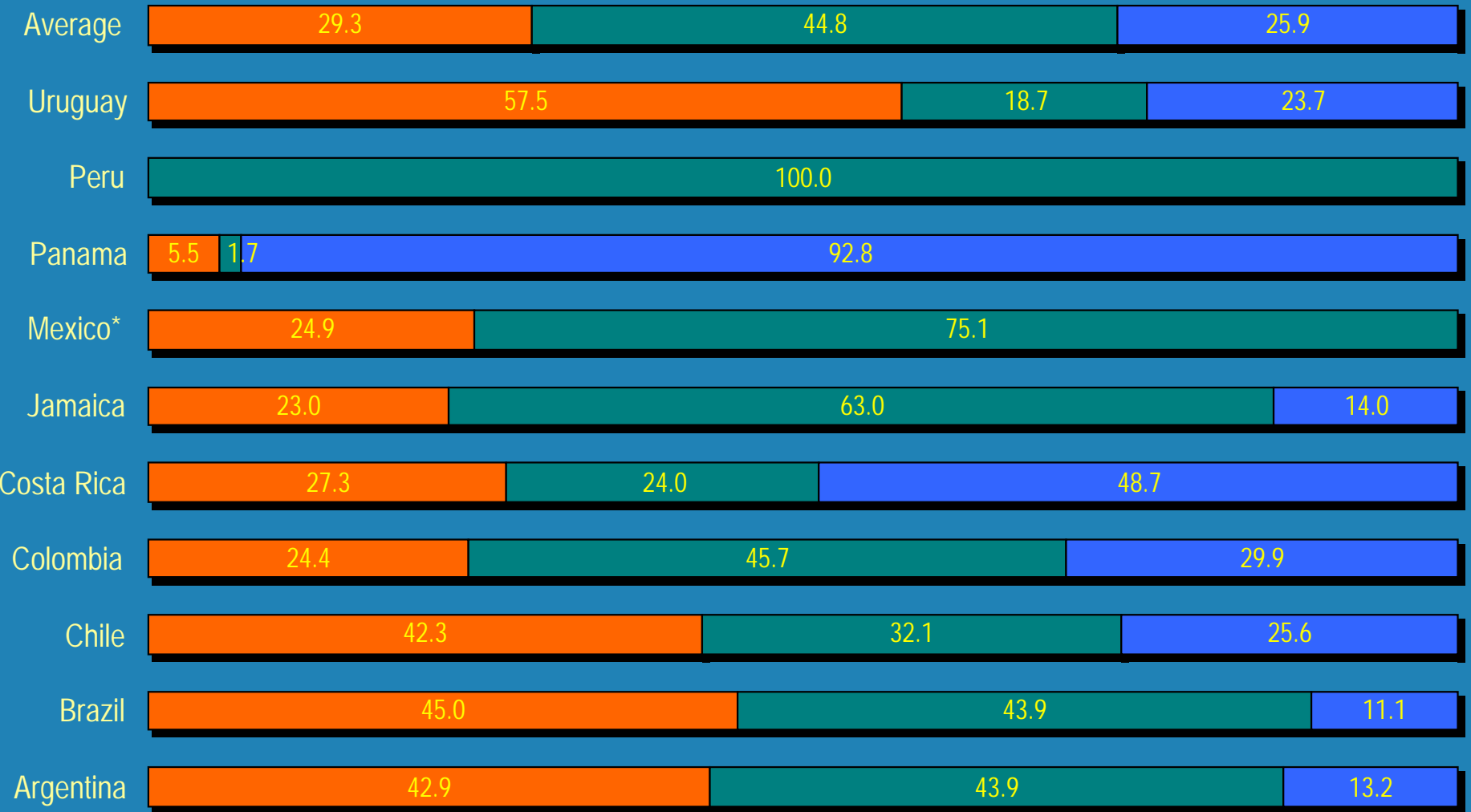
The funding strategy should specify appropriate instruments and its appropriate volume:

- Fragmentation of its portfolios (many issuers, many instruments)
- Need to concentrate in one “issuer” and on marketable debt
- With an adequate frequency and size
- Fungibility should be increased by reopening and buybacks .
- Instruments should be standardized in local currency fixed-rate
- At nascent stages, only short term debt can be issued at fixed-rate

Internal Public Debt by interest rate (Dec. 2000)



Internal Public Debt by term



(% of total)

Short term (<1 year) Medium term (>1 year <5 years) Long term (>=5 years)

Dec. 2000

Should the government establish **benchmark securities**?

Main benefits:

- Development of broader financial market
- More accurate market pricing
- Development of secondary markets
- Lower service debt costs (liquidity premium)

Government should:

- Provide enough supply of instruments (small country dilemma)
- Appropriate maturity (sequence) and frequency of issues
- Use reopening and buybacks

Should the government establish benchmark securities?

Maturity Distribution of Debt Instruments and Benchmarks in some G-10 Countries

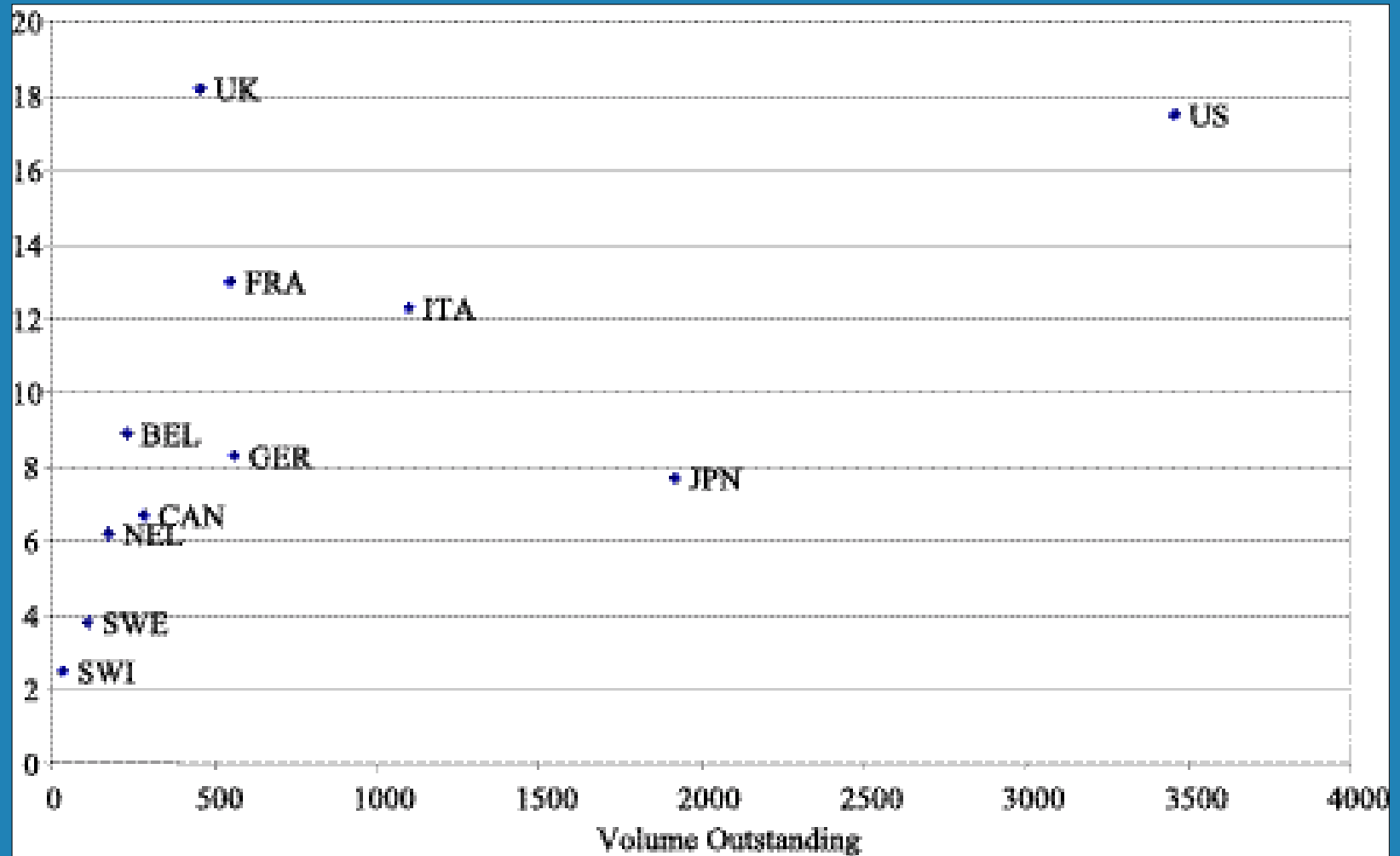
	Canada	Italy	Japan	France	United States
Number of original maturities	7	10	8	8	7 ¹
Original maturities (M – month, Y – year)	3, 6M, 1, 2, 5, 10, 30Y	3, 6M, 1, 1.5, 2, 3, 5, 7, 10, 30Y	3, 6M, 2, 4, 5, 6, 10, 20Y	3, 6M, 1, 2, 5, 10, 15, 30Y	3, 6M, 1, 2, 5, 10, 30Y
Distribution by original maturity ²					
1 yr and under	32%	17%	5%	10%	21%
1 – 5 years	29%	32%	8%	27%	62%
5 – 10 years	27%	48%	78%	53%	
Over 10 years	12%	3%	9%	10%	17%
Number of benchmarks	7	5	1	4	7

¹ The number of original maturities in the United States dropped to 7, after it stopped issuing 3-year securities in 1995.

² Distribution is based on the volume outstanding. Note: Indexed bonds are not included in table

Sources: BIS (1999) and Inoue (1999)

Volume of Government Bonds Outstanding vs. Benchmark Issue Size (US\$ billion)



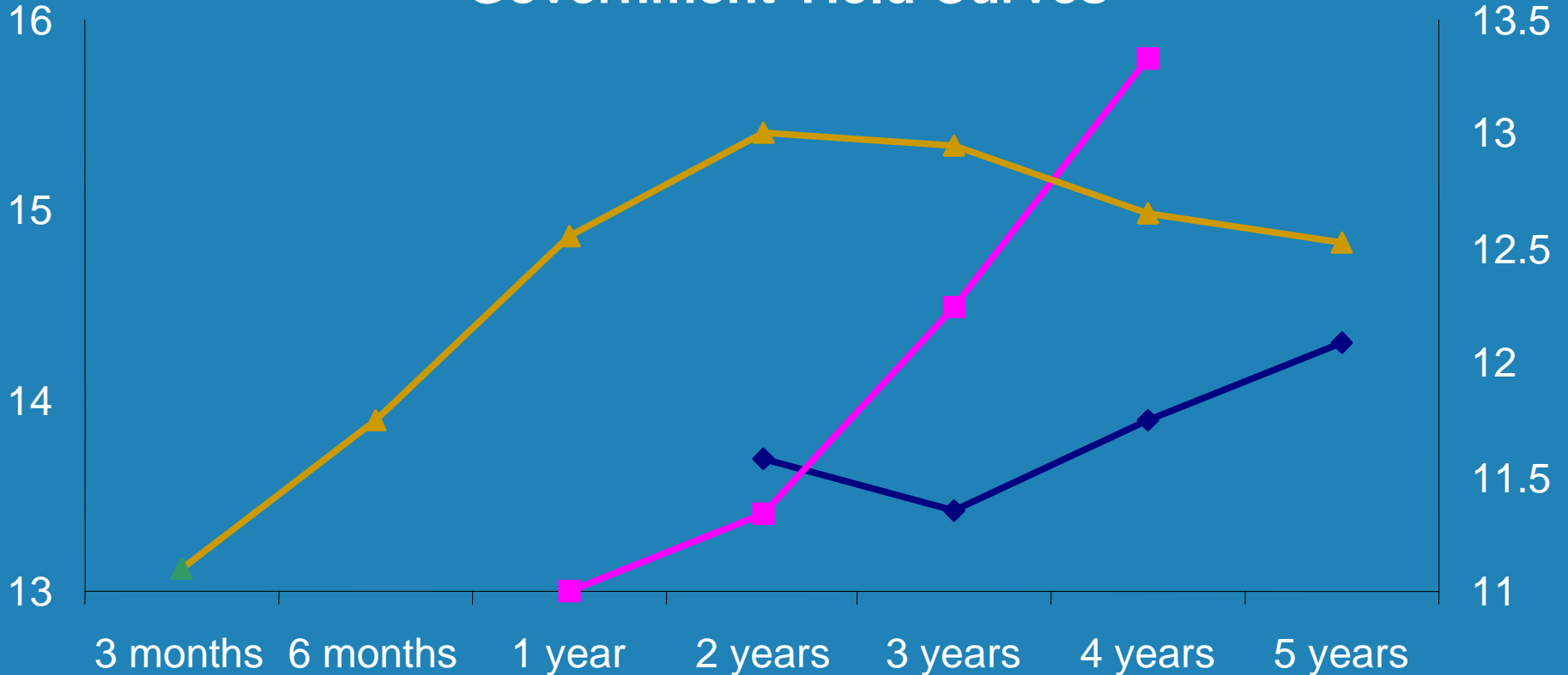
Sources :BIS (1999); and French Ministry of Finance staff (2000)

Short and Steep Yield Curves in Latin America

7/6/2001

Mexico

Government Yield Curves

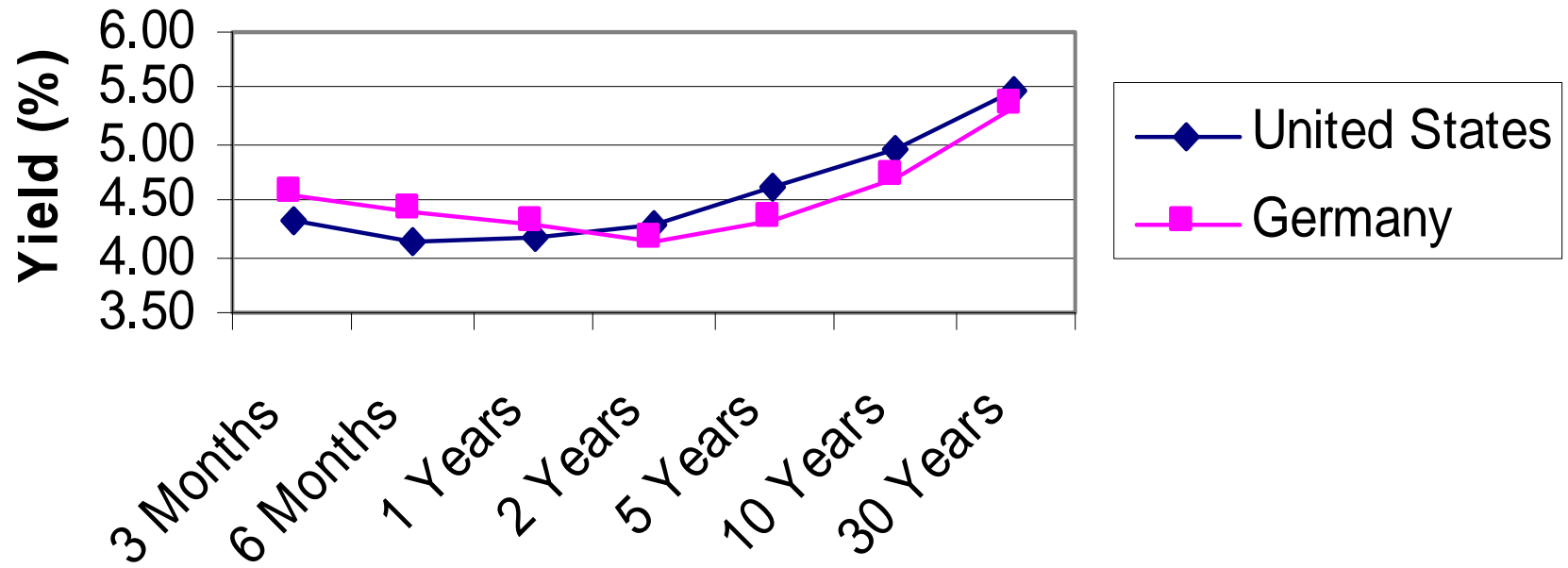


Source: Bloomberg



Extended and gradual yield curves in developed markets

Yield curve



What is the most efficient way for government to access the market?

Auctions have become the predominant distribution technique

- Multiple price vs. Uniform price (more competition or more participants)
- Competitive and Non competitive bids (limits)
- Openness (primary dealers support vs. broader access)
- Frequency
- Announcement (calendar and results)

....though **other** could be more appropriate at a nascent stage

- Syndicated issuance
- Tap sales
- Private placements
- Combination

What is the most efficient way for the government to access the market?

Auction Techniques for Selling Government Securities				
	<i>Bidding Method</i>			
	Uniform Price	Multiple Price	Other	Total
Discount	--	8	--	8
Price	2	21	1	24
Yield	--	10	--	10
Total	2	39	1	42

Source: Bartolini and Cott arelli (1997)

Benefits and drawbacks of **primary dealers**

- Primary dealer system may facilitate change to an environment of market-based funding.
- Its main role:
 - ensure the absorption of newly issued securities
 - and distribute securities to final investors
- Obligations must emphasize secondary market trading
- As market matures, privileges should be revised
- There are preconditions for the system to succeed
- Balance with policy of market openness
- There is a risk of collusion in small financial sectors

Benefits and drawbacks of using primary dealers

Primary Dealers in Selected Developed Countries		
Country	Number	Obligations/comments
<i>Developed markets</i>		
Canada	12 for T-bonds 10 for T-bills 20 distributors	<ul style="list-style-type: none"> · Participation in auctions above a threshold · Participation in auctions above a threshold · Participation in auctions
France	20	<ul style="list-style-type: none"> · Act as market makers on secondary markets · Need to minimize bid/ask spreads based on preset limits
Italy	32, among which 15 market makers	<ul style="list-style-type: none"> · Primary dealers are required to take up stock in the auctions · Market makers are, in addition, required to provide two-way quotes.
Sweden	10	<ul style="list-style-type: none"> · None since 1998; dealers not required to quote 2-way prices
United Kingdom	16	<ul style="list-style-type: none"> · Provide tight bid/ask quotes · Have 1 percent average market share on 6-month rolling basis
United States	37	<ul style="list-style-type: none"> · Not obligated to make markets for each other or customers · Required to make reasonably good markets with Federal Reserve's trading desk

Strategy: Building Credibility

Strategy



Government debt
management
capacity and risk
management



Credible

Transparent



Information



**Process may be gradual but direction
of change must be irreversible**



**MARKET
CONFIDENCE**

A major drawback to the implementation of the new funding strategy: “Lack of institutional capacity”

Common institutional problems :

- Disperse responsibilities and limited coordination
- Limited awareness on the financial risk exposures of the portfolio.
 - No risk management framework (e.g:ALM)
- No experience operating in the market (pricing, hedging, communicating with the market)
- Inadequate IT systems to support the new requirements
 - operational and analytical
- Low salaries and very high rotation of staff

Sound debt management framework

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graph TD; A[Sound debt management framework] --> B[Coordination with monetary and fiscal policies]; A --> C[Prudent risk management framework]; A --> D[Institutional framework]; B --> E[Supporting the issuer's strategy and its credibility]; C --> E; D --> E;
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Coordination with monetary and fiscal policies

- share an understanding of the objectives of their respective policies.
- separation of debt management and monetary policies objectives and accountabilities
- share information on government's current and future liquidity needs.

Prudent risk management framework

- To enable debt managers identify and manage trade-offs between expected cost and risk.
- Stress test on the basis of economic and financial shocks to which the government is potentially exposed.

Institutional framework

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

Supporting the issuer's strategy and its credibility

Points for discussion

- Should macro credibility be an objective of debt management policy?
- How important is having a medium-term strategy?
- How best should the market agenda be sequenced?
- Special needs of emerging markets – developing risk management framework. Which countries are the best examples to look at?

Points for discussion

- The importance of establishing portfolio benchmarks What are the best ways to concentrate issuers and instruments?
- What can smaller countries do to generate volume?
- Should tap sales be used to reduce monopolistic pressure in markets with limited participants?
- Is there a net benefit for the issuer of supporting PD's by reducing access to auctions?