The uses of sovereign debt by the state

Q 1-03. What is the principal purpose for sovereign debt issuance?

The primary reason for issuing sovereign debt is to finance budgetary or cash position shortfalls in the government's accounts.

Budgetary shortages are created when macroeconomic forces or national policy actions cause total government receipts to fall below total government expenditures for the unit of time used as a full government accounting period.

Cash position shortfalls are created by temporal mismatches in receipts and outflows, by inefficient banking and cash accounting practices, or by inflexible investments that generate illiquidity. Some shortfalls are the result of circumstances far beyond the control of authorities. These cases might include natural disasters and similar emergencies.

Q 1-03.01. Have sovereign debt securities been issued to achieve Government policy objectives unrelated to debt management?

In using debt instruments for policy goals unrelated to debt management, it is important that the total value of such instruments should not be large enough to interfere with the primary objectives of debt issuance. The principal vehicle for non-debt activities are often small denomination retail government securities because they are affordable by the mass of the population and that their total value, even in large volume of securities, will not overwhelm the main debt issuance of the state. Tax incentives are often tied to such securities.

Some countries have used small bonds to inculcate habits of thrift among the population or certain subgroups, such as the nation's youth or those with modest incomes. Retail securities have also been employed for patriotic purposes, particularly during wartimes, or to highlight policy objectives, such as environmental protection. In countries where there are diverse ethnic groups, investing in state debt can serve to generate a sense of common identity.

Q 1-03.02. Have functional distinctions been made based on the maturity of the securities that are issued?

In some countries, securities commonly referred to as "Treasury bills," are considered to be in the nature of money market instruments and not part of the state debt. A distinction is thus made between medium and long-term obligations, and those that have a maturity of a year or less. It is sometimes overlooked that short-term securities are clearly sovereign debt, and that there may be times when,

because of unacceptably high longer term rates, financing is accomplished largely with short-term obligations, with repetitive rollovers.

Q 1-03.03. How has the issuance of sovereign debt been used to attain economic objectives that are not directly related to financing budgetary deficits?

Properly structured debt instruments can be used to achieve economic objectives while financing budget deficits. Care must be taken, however, to avoid conflict between the goal of finance and the economic objective.

Among the uses of debt for other goals are these three. First, in countries where the banking system has excessive liquidity, e.g., because of the agricultural market cycle, the ministry of finance may issue debt securities to absorb that excess liquidity. Second, tax-anticipation securities may be offered to facilitate the payment of taxes coincident with the tax-due dates. Finally, to broaden the borrower base and to provide assurance of stable monetary policies in the future, some countries have issued securities with an "inflation protection" feature.

Q 1-03.04. What are some examples of "special purpose" securities that have been issued to meet national programmatic needs?

The utility of sovereign debt products for assorted purposes is evident from the fact that they have been used to fund self-administered retirement programs, to control the return on tax-exempt municipal issues by requiring the proceeds of such financing to be invested in specially designed securities, and by the issuance of special series of Government obligations in which trust funds for particular government accounts, e.g., social security, highway construction, airfields, are invested. These examples are taken from the U.S. government experience, but similar utilization is certainly possible in other countries.

Q 1-03.05. How does the issuance of state debt help to meet market needs?

Sovereign debt delivers important services to the market. The regular issuance of such debt provides the private sector with a reliable yield curve for measuring its borrowing costs. Insurance companies and pension funds, particularly given the legal constraints on their exposure, look to the state to provide investment products of acceptable risk.

Q 1-03.06. How are competing needs for state debt to be coordinated?

The government's debt managers, fiscal policy advisors, and central bank staff should share a common understanding of the policy objectives for debt management policy, monetary policy and fiscal policy. Managers with responsibilities in each area should understand the way in which their decisions could reinforce other

macroeconomic objectives and create policy tensions.

Q 1-03.07. If the state has provided guarantees for its own account or for others, how should the contingent liability be treated?

In general, financial guarantees and on-lending should preferably be used only to support projects that are likely, in the end, to be self-sustaining or that are able to generate sufficient income to recoup their costs. Some projects, however, such as those for infrastructure improvements, are likely to result in only expenditures, with no likelihood of any revenue return. The guarantees, in such cases, benefit private borrowers that do public works projects. On-lending projects are often of such a nature, with a financial intermediary usually involved between the sovereign as the original borrower and the ultimate private borrower.

Before issuing a financial guarantee or on-lend funds, however, the state should assess and price the credit risk. It is desirable to spread the credit risk involved in guarantees and on-lending to other market participants, possibly through the establishment of a guarantee risk/sinking fund. One other way that risk can be lessened is through rigorous pre-grant reviews so that awards are only given to those that are technically qualified, and are adequately capitalized. It is also noted that concern about corruption is ever-present in guarantee and on-lending programs.

Contingent liabilities of the governments must be disclosed fully and explicitly. Provision must be made in the state budget for expected losses.

Q 1-03.08. What distinction, if any, should be made in reporting external and domestic debt?

External and internal debt of the state may have different impacts on the state's credit rating[1] and should be reported separately in many circumstances.

Both types of debt should be reported at their prevailing market price when such information is available. Marketable (or traded) debt instruments should be reported at the market price for that instrument on the reference date[2] to which the position relates. The ideal source of a market price is a financial market in which the instrument is traded in considerable volume and the market price is listed at regular intervals. In the absence of such a source, market value can be estimated by discounting future payment(s) at an appropriate market rate of interest.

Some external debt may specify repayment in terms of quantities of commodities or

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[1] External debt will most certainly be counted more heavily in assessing the sustainability of a state's debt burden.
[2] If the markets are closed on the reference date, the closest preceding market date should be used.

other goods. At inception, the value of the debt is equal to the principal advanced. The rate of interest, which will accrue on the principal, is that which equates the present value of the required future provision of the commodity, given its current market price, to the principal outstanding. This type of contract is equivalent to the indexation of a loan. The initial rate of interest that accrues will change as the market price of the specified item changes. When payments are made in the form of the good or commodity, the value of the principal outstanding will be reduced by the market value of the good or commodity at the time the payment is made.

When external debt is issued in a currency different from internal debt, the method of calculating the total of the external debt denominated in a foreign currency by converting foreign currencies into domestic values must be specified explicitly.

Q 1-03.09. How is the nation's indebtedness to the World Bank, the IMF, and to other foreign -governments and entities treated?

Multilateral and bilateral debt, particularly to international organizations or other sovereign states must be acknowledged in national accounts and be included in reports on total debt outstanding. This is particularly useful for discussions of relevant statistics, such as debt to GDP. Such indebtedness, however, should be reported separately from marketable debt and retail debt, and its market value estimated based on any concessional interest rates granted.

Q 1-04. Do broader institutional issues become involved in the issuance of sovereign securities?

In this economic environment, it has become customary to assess a nation's economic health by contrasting its debt with its gross national product. In fact, debt crises that used to be national concerns have spilled over to neighboring countries where they are all members of a regional union of states. In the case of one country, with deep-seated religious and cultural divisions, the need to address the common debt liability of the nation provided impetus to work together and served to ameliorate those divisions. National infrastructure problems appear to be nearly universal and solving them are long-term efforts. Although the financial return may be hard to quantify, it is generally assumed that investing in a country's future is a perennial state concern.