



THE WORLD BANK

World Bank Sovereign Debt Management Forum

Harmonizing the Sovereign Domestic Debt Market The Roles of Central Banks and Treasuries

Washington, D.C. December 2014



Outline of the Presentation

- *In theory, central banks and treasuries are assigned well defined and separate instruments to pursue their shared goals of macroeconomic growth and stability, they are “independent”*
- *In practice, the line between institutional responsibilities and instruments can become blurred, leading to inefficiencies*
- *Treasury and central bank foreign asset and domestic liability management diverge from the textbook model—why it matters*



Debt Management and Monetary Operations

“ in theory”

- *Monetary operations focus on a short term interest rate “ i ” while fiscal policy chooses taxes, expenditure and bond financing*
- *The central bank balance sheet is largely forgotten*
- *Neglecting the central bank balance sheet is fine as long as it is small in relation to treasury debt. In an stable mature economy, bank reserves and central bank debt are small compared to treasury debt.*



Bank of Canada: close to the “ideal balance sheet”

Bank of Canada Balance Sheet

(end 2006 in percent of GDP)

Assets		Liabilities	
Government Securities	3.3	Banknotes	3.4
Liquidity-providing Repos	0.2	Deposits	0.2
Other Assets	0.0	Other Liabilities	0.0
Total	3.6	Total	3.6



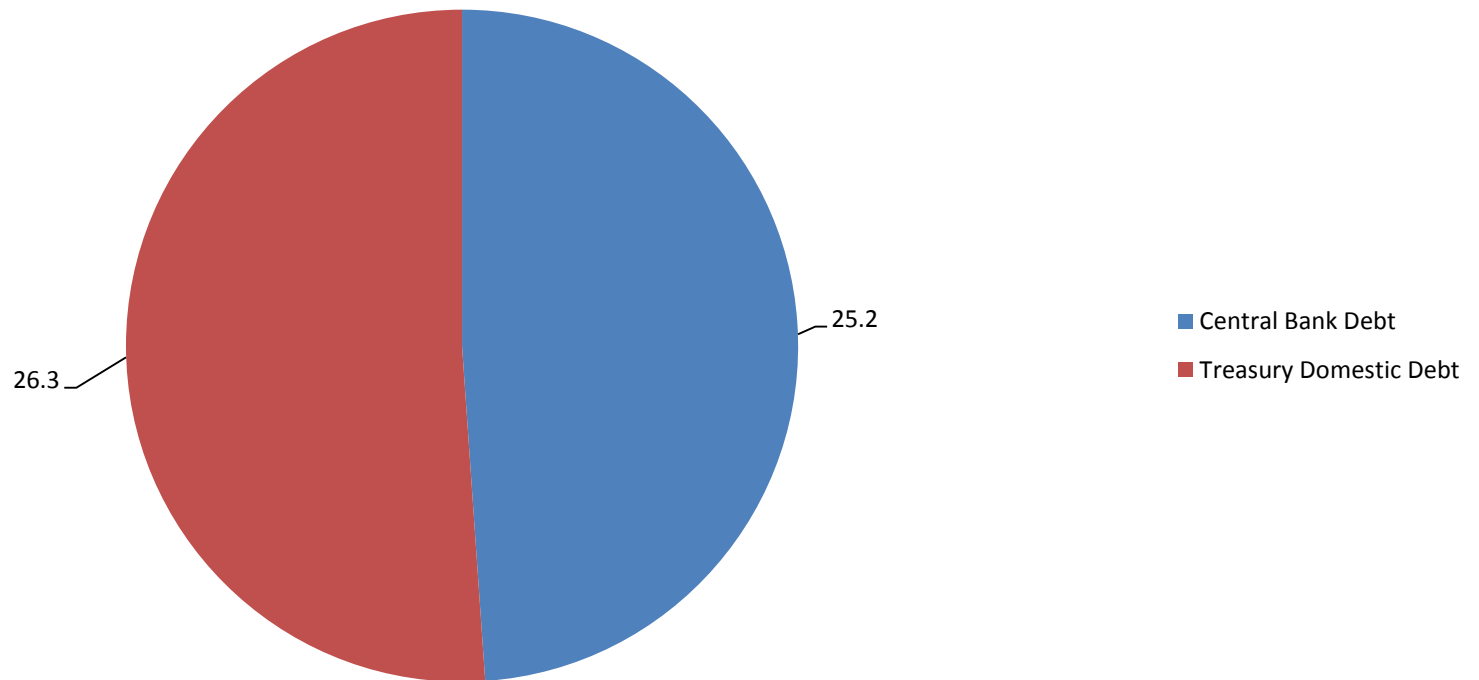
*Central bank of Chile is closer to the “median”
Inflation Targeting balance sheet*

Central Bank of Chile Balance Sheet					
(end 2012 in percent of GDP)					
Net Foreign Assets		14.9	Banknotes and coin		4.7
Domestic Financial Assets		2.3	Treasury Deposits		0.5
Net Other Assets		0.0	FI and other Deposits		5.4
			Central Bank Debt		9.9
			Equity		-3.4
Total Assets		17.2	Total Liabilities		17.2



Chile: Segmentation according to Issuer

Chile: Fragmentation of the Domestic Debt Market 2012
(debt in USD billions)



Sources: Stella (2014)



Debt issued by the Central Bank of Chile: Segmentation according to instrument

Composition of Central Bank of Chile Debt (in billions of pesos)	2012	2011	2007	2002
Discountable Promissory Notes (PDBC)		985	852	2983
Bonds in UF (BCU)	8535	8055	2556	227
Bonds in Pesos (BCP)	3906	3533	1935	374
Indexed Promissory Notes (PRC)	234	300	1488	4606
Optional Indexed Coupons in UF (CERO)	230	313	663	1149
Bonds in US Dollars (BCD)			198	1026
Indexed Promissory Notes USD (PRD)				2622
Optional Indexed Coupons in USD (CERO)				592
UF Promissory Notes Restructured (Res. 990)				327
Redenominated Forex Commercial Notes				112
CB Indexed Promissory Notes (PRBC)				60
USD CDs				4
UF Promissory Notes (Res. 1836)				1
Floating Interest Rate Promissory Notes (PFT)				1
Exchange Differential Notes	.021	.021	.021	.021
Total	12905	13186	7694	14084

14
Securities

5 Securities



The primary policy question is whether improvements are possible in the management of the consolidated sovereign domestic debt

- *Large foreign reserves imply a large quantity of financing instruments (liabilities).*
- *Is the structure, currency, and duration of the liabilities appropriately matched from an asset liability management perspective? For example, are risks accurately measured and hedged?*
- *Do the domestic liabilities represent the most efficient set of instruments from the standpoint of market development?*



Many emerging market countries have taken measures to strengthen domestic debt management and markets in recent years

- Although the specifics vary from country to country the general strategy involves the replacement of central bank domestic debt instruments with treasury instruments in a coordinated way—Mexico, Israel, Brazil, Singapore.*
- The reduction of market fragmentation increases liquidity in the market for the remaining instruments.*
- Moving to a single sovereign debt manager facilitates taking a comprehensive approach toward managing sovereign domestic and foreign debt and allows monetary policy to operate without the distraction of having a “dual” operational role. This clarification of roles improves the ability of both the treasury and central bank to communicate strategies and review results with stakeholders*
- Actions taken in the light of strategic insights obtained from an ALM perspective, as well as the enhanced use of treasury instruments for structural liquidity absorption, often result in lessened central bank losses and risk exposures. This clarifies inter-institutional fiscal relations and facilitates the presentation of central bank financial results.*



The Case of México—One Example

- *Although Banco de México has adopted a floating exchange rate regime, by law it must buy all of the foreign exchange earnings of the state petroleum company, PEMEX.*
- *The increase in petroleum product prices that began 10 years ago led to a large increase in foreign exchange inflows and, on the other hand, generated high peso liquidity in the Mexican financial system.*
- *The Banco de México used to issue its own bonds, called “BREMs” to conduct monetary policy, that is to say, to absorb the excess liquidity caused by the foreign exchange purchases.*
- *Since the interest rates that the central bank paid on its debt were much higher than the yield obtained on its foreign reserves, the central bank made large losses and suffered from negative equity.*

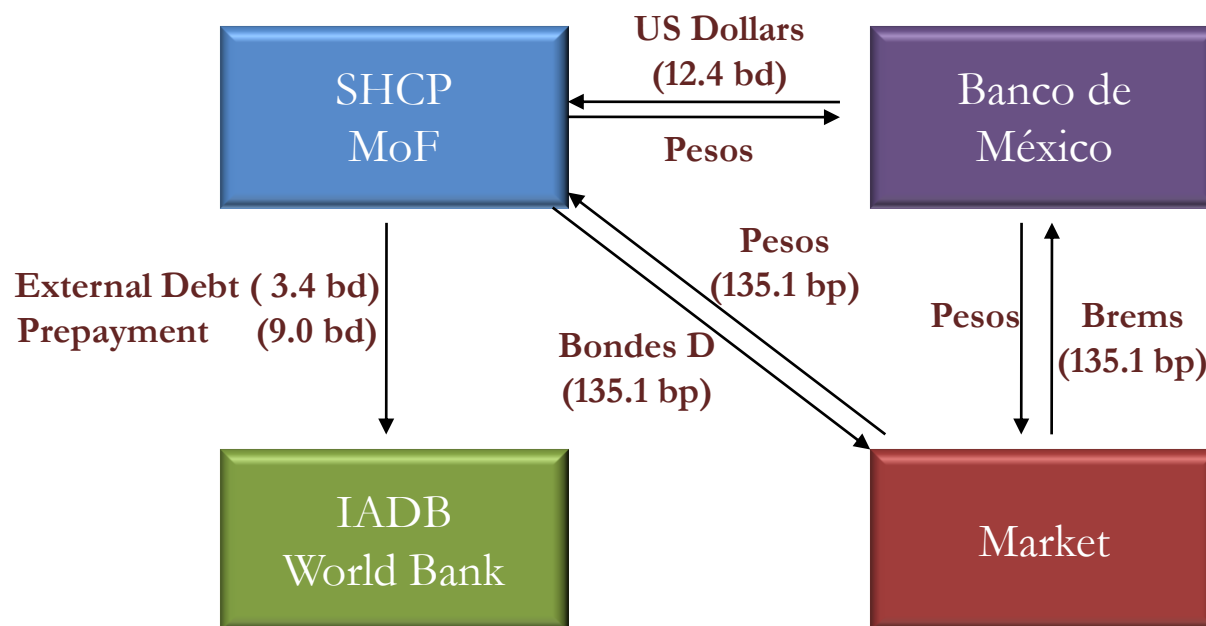


México: The Transaction

- *In June 2006, the Ministry of Finance bought US\$12.4 billion from the Banco de México using pesos that it had obtained from a special auction of a series of the its main domestic financing instrument (known as BONDES D).*
- *The Ministry of Finance used the foreign exchange obtained to prepay debt owed to the World Bank, the Inter American Development Bank (US\$9 billion) and to buyback sovereign debt trading in the international capital market (US\$3.4 billion).*
- *Simultaneously, the Banco de México used the pesos obtained from the Ministry of Finance to buyback an equivalent amount of its monetary policy bonds (BREMS), which had very similar characteristics to the BONDES D. Furthermore, the central bank announced that going forward, it intended to use only government debt in its monetary operations.*



Reshaping the central bank balance sheet to improve the efficiency of macroeconomic policy



Source: Julio Santaella, Banco de México, "Central Bank Capital and Earnings within a consolidated Public Sector Balance Sheet: the case of México" April 23, 2012 Washington, D.C.



México: The Results

- *The central bank realized a reduction in its sterilization costs greater than the reduction in interest income caused by its lower foreign reserves (sold to the treasury). Consequently, its losses fell. That is to say it saved the difference between the interest rate it paid on its domestic debt and the rate it received on its foreign reserves (multiplied by US\$12.4 billion).*
- *The Ministry of Finance obtained a superior debt profile (in terms of exposure to exchange rate risk) and a reduction in the cost of its debt—the rates on its external debt were higher than the rate paid on its domestic debt (BONDES D).*



México: Current Mechanism dealing both with forex sterilization and monetary management

- *El Banco de México is provided with treasury bonds (los BONDES D) and bills (CETES) to conduct sterilization operations.*
- *The proceeds of the BdM actions are placed in a blocked Treasury account...same mechanism as in Colombia & Israel.*
- *Every quarter the Treasury and BdM hold a joint meeting announcing their issuance strategy for BONDES D. BdM uses the issuance primarily for sterilizing foreign exchange purchases.*
- *For short term operations, Banco de México uses CETES*



Issues for Discussion

- *When central banks have large balance sheets it is important to take them into account when considering sovereign asset and liability management.*
- *What gains are possible from taking both an integrated and consolidated approach to asset and liability management?*
- *Although there are common themes, various countries have approached reform in different ways according to their particular legal framework, market conditions, and economic history.*
- *How can institutional coordination mechanisms be designed to conform to local circumstances yet achieve the common goals of improving debt management and developing the market?*