



Domestic public debt in Low-Income Countries: Trends and structure[☆]

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Abstract

This paper introduces a new dataset on the stock and structure of domestic debt in 36 Low-Income Countries over the period 1971–2011. We characterize the recent trends regarding LICs domestic public debt and explore the relevance of different arguments put forward on the benefits and costs of government borrowing in local public debt markets. The main stylized fact emerging from the data is the increase in domestic government debt since 1996. We also observe that poor countries have been able to increase the share of long-term instruments over time and that the maturity lengthening went together with a decrease in borrowing costs. However, the concentration of the investor base, mainly dominated by commercial banks and the Central Bank, may crowd out lending to the private sector.

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1. Introduction

Analyses on government borrowing and debt management in Low-Income Countries (LICs) have traditionally focused on external debt. This scarcity of studies is partly due to the lack of a comprehensive database on domestic public debt and the historical prominence of external borrowing compared to domestic borrowing. Until recently, in fact, foreign liabilities have been the largest component of the public debt in LICs, the target of debt relief initiatives such as Heavily Indebted Poor Countries

(HIPC) and Multilateral Debt Relief Initiative (MDRI), and the main concern of the joint Fund/Bank Debt Sustainability Framework for LICs (LIC DSF). In recent years, however, LICs made substantial efforts to develop their local public debt markets and relied heavily on domestic sources to finance budget deficits during the global crisis, sparking the attention of International Financial Institutions (IFIs) and the academic community.

Because of the constraints indicated above, the existing literature on government borrowing in LICs is relative scant and inconclusive with regard to the benefits and cost of domestic liabilities relative to foreign liabilities. Only few studies assess empirically the rationale (if any) for LIC governments to gradually shift their financing strategies toward domestic sources and away from external sources.

At any rate, domestic financing is plenty of advantages. The literature on public debt management in Emerging Markets (EMs) has shown that, in general, market depth has increased, maturities have lengthened and the investor base has broadened (Mehrotra et al., 2012). As a result, domestic debt may bring some prominent benefits: the lower exposure of the public debt portfolio to currency risk if and when the domestic debt is denominated in local currency (Hausmann et al., 2006; Bacchiocchi and Missale, 2012); a lower vulnerability to capital flow reversals (Calvo, 2005); the possibility to undertake countercyclical monetary policy to mitigate the effect of external shocks (Mehrotra et al., 2012); and the improved institutional infrastructure underlying the organization and functioning of local financial markets (Arnone and Presbitero,

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2010). In general, long-term domestic currency-denominated debt reduces maturity and currency mismatches and hence tends to be safer.

However, the literature also stresses that domestic borrowing brings benefits only in the presence of a sound institutional and macroeconomic framework, and only if the debt structure features certain characteristics (Abbas and Christensen, 2010; Arnone and Presbitero, 2010; Hausmann et al., 2006; Panizza, 2008; Presbitero, 2012b). Many developing countries are, in fact, unable to issue long-term government securities at a reasonable cost, so they are more vulnerable to rollover and interest rate risks. Moreover, domestic currency-denominated debt could substitute inflation risk for currency mismatch. The nature of the credit base may also raise vulnerabilities. Previous studies underlie the importance of a diverse investor base for lowering the cost of government debt and the volatility of market yield, and stress that a lenders' profile strongly biased toward commercial banks might worsen crowding out effects and reduce the efficiency of the banking system. Yet another aspect of the debt structure that influences vulnerability is the type of instruments issued. According to Abbas and Christensen (2010), many of the benefits of domestic debt market – saving assets, collateral function, benchmark yield curve for private lending – apply to securitized domestic debt and not to liabilities issued in captive markets or accumulated due to poor public financial management (such as arrears).

The cost–benefit analysis of financial instruments available to the government, as described above, is largely discussed with regards to EMs, while the lack of data on domestic public debt in LICs – especially the financial terms applied to domestic liabilities – has prevented extending the analysis to poorer countries along similar lines. In particular, it hindered the possibility of discussing the rationale for LICs government to increase domestic borrowing relative to external indebtedness.

Against this backdrop, the main objective of this paper is to fill the void in the literature by constructing a brand new database on domestic public debt in LICs. While the existing datasets mainly provide information on the stock of domestic debt and interest payments, at best, our dataset also includes detailed information on maturity, currency composition, creditor base, and type of instruments. The up-to-date information on domestic debt stock and structure is comparable across LICs.

Based on our dataset, this paper characterizes the recent trends regarding LIC domestic public debt and explores the relevance of different arguments put forward on the benefits and costs of government borrowing in local public debt markets. The main stylized fact that emerges from the data is the increase in domestic government debt during the period 1996–2011 and its larger burden with respect to external public debt, at least since the mid-2000s. Short-term financing is mainly instrumented through marketable and non-marketable securities held by the banking system. Central Bank advances to the Treasury, which are typically rolled over, constitute a relevant source of long-term financing. The breakdown into HIPCs and non-HIPCs highlights significant differences in the evolution and structure of domestic debt between the two groups, with HIPCs relying more on Central Bank advances and

non-HIPCs making progress in issuing securities and lengthening maturities.

The paper is structured as follows. Section 2 revises the existing literature and databases on domestic public debt in LICs. Section 3 describes our dataset and Section 4 presents some stylized facts on the evolution and structure of domestic public debt. Section 5 concludes.

2. Domestic public debt management

2.1. Fiscal deficit financing

Fischer and Easterly (1990) identify four different means of fiscal deficit financing and associate each of them with the risk of building certain macroeconomic imbalances: (1) printing money might fuel inflation, (2) running down foreign exchange reserves might trigger an exchange crisis, (3) borrowing abroad might end up in an external debt crisis, and (4) borrowing domestically might increase interest rates and lead also to a debt crisis.

In theory, the seignorage revenue the government can expect to obtain from printing money is non-linear in the inflation rate, similarly to a conventional Laffer curve. The link between money creation and inflation is well-known. In practice, however, seignorage is often a small source of resources both for developing and developed countries. Empirical evidence shows that in normal times, the maximum amount of seignorage revenue collected over an extended period of time is less than 5 percent of GDP (Easterly and Schmidt-Hebbel, 1991). During fiscal crisis episodes, the seignorage can become an important (albeit temporary) means of deficit financing (Reinhart and Rogoff, 2009). By running down international reserves, instead of printing money, the government can hope to put off the inflationary effects of a fiscal deficit. This policy is also temporary because it can last just until reserves are depleted, or probably collapse even earlier as pointed out by the theoretical and empirical literature on currency crisis.

Foreign borrowing allows to finance the fiscal deficit without creating money supply-driven inflationary pressures or crowding out domestic lending to the private sector. However, external credit flows tend to be volatile, procyclical, and subject to sudden stops (Calvo, 2005). By providing not only financing but also foreign exchange, foreign borrowing may induce a real exchange rate appreciation, thus hampering competitiveness and possibly lowering investment and economic growth (Rodrik, 2008). External debt is typically denominated in foreign currency and this creates additional constraints on monetary policy and exchange rate management. For instance, according to Hausmann (2003), foreign currency-denominated debt lowers the evaluation of solvency because it heightens the dependence of debt service on the evolution of the exchange rate, which is often volatile and subject to shocks and crises. Cespedes et al. (2004) underline that, when there are currency mismatches in the balance sheets of local agents, currency devaluations are contractionary since they induce negative net wealth effects. Under these circumstances, Hausmann and Rigobon (2003) maintain that central banks are reluctant to let the exchange rate float and

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