Public Expenditure Management
Peer Assisted Learning

MoF/Treasury Interaction with the Central Bank

PEMPAL Treasury Community of Practice

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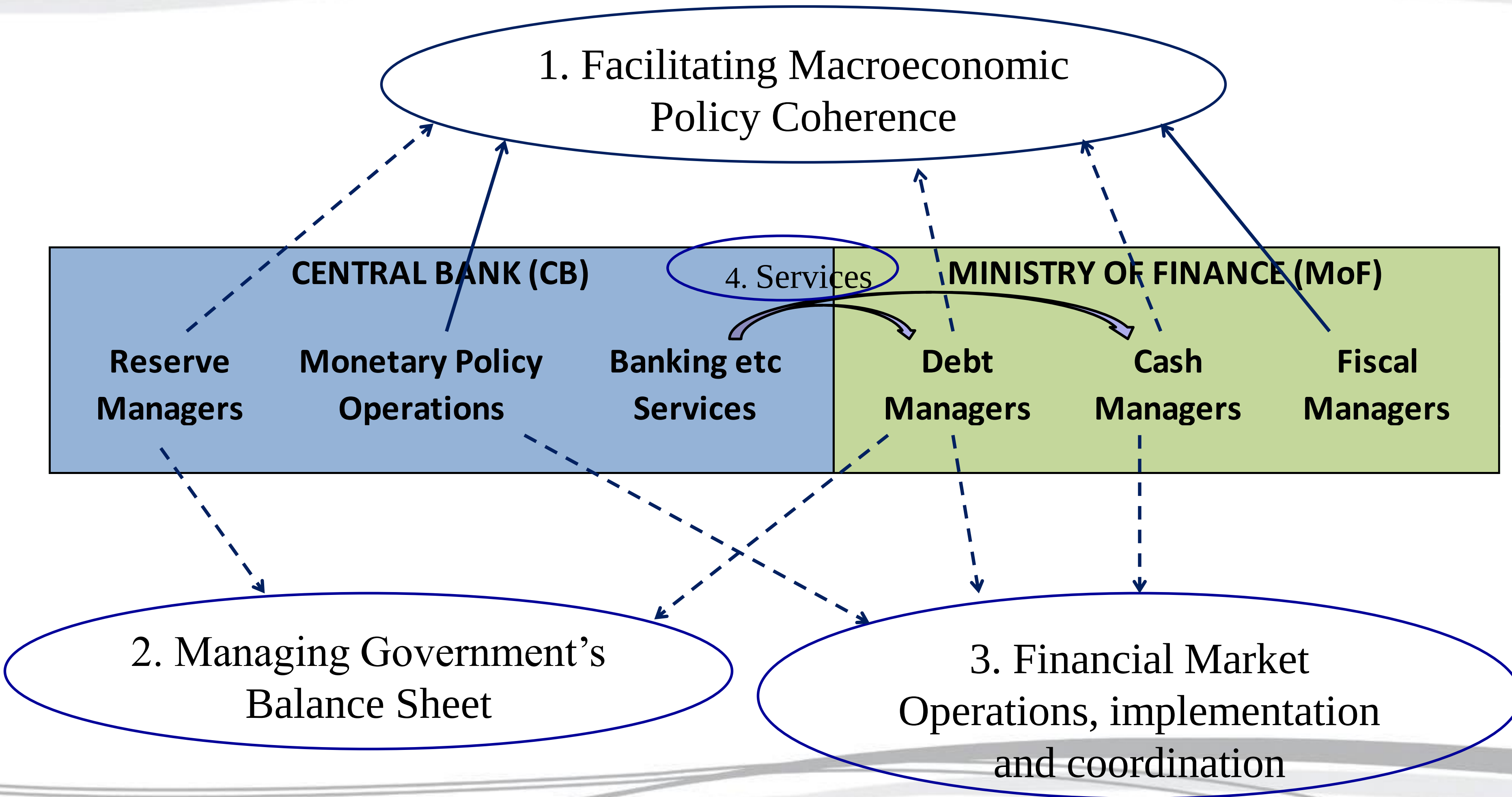
Central Banks and Treasuries: an International Perspective

- Different policy objectives and operational requirements
  - Strains between fiscal and monetary policies
  - Inconsistent objectives for different parts of government balance sheet
  - Operational conflicts or clashes – including central bank reluctance to see MoF taking a bigger role
- Common interests
  - Efficient debt, cash and monetary policy operations
  - Development of the financial market, especially money market
  - Avoiding market disruption or confusion
- Requires

- Clarity and understandings about responsibilities, objectives & interactions
- Backed by effective governance and coordination arrangements

Today's Agenda!

An Overview – Policy and Operational Interaction



The focus today on 3 and 4; but first some brief comment on 1 and 2

Macroeconomic Policy Roles

- Over last 30 years drive towards separating monetary policy from fiscal and debt/cash management policies
  – Reflects need for clarity, strategic focus and accountability
- Using different instruments to meet different objectives facilitates greater transparency and predictability, enhancing policy credibility, effectiveness and accountability
  – CBs focus on inflation.
  – MoFs focus on fiscal policy to manage aggregate demand
  – Debt and cash management support fiscal policy with their own policies and objectives
- Protecting "independence" of CB still requires high level policy coherence

Some Qualifications

- In practice cash and debt operations may affect monetary policy operations & vice versa
  - Particularly in less liquid markets
  - Even in developed markets, model under strain recently from quantitative easing - affects shape of yield curve, may affect debt management operations
- Historically, central banks have had greater involvement in financial markets – and developed capability accordingly
  - Often reluctant to see untested Ministries/Treasuries take over
  - Requires cooperation to avoid roiling financial markets

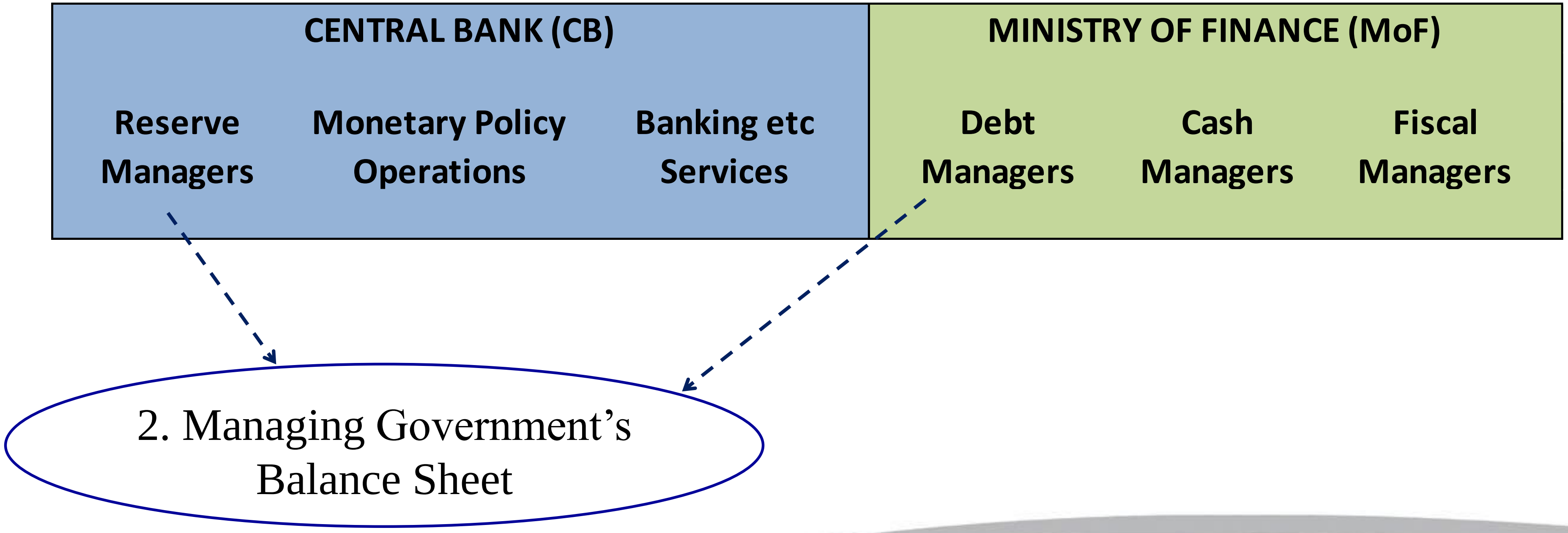
➢ **Policy separation therefore still requires mechanisms**

- ➢ **To facilitate high-level policy coherence**
- ➢ **To underpin financial management strategy (debt & cash)**
- ➢ **To ensure coordination at operational level**
- ➢ **To smooth the transition**

High-level Policy Coherence: Facilitating Mechanisms

- In practice, CB not always completely independent
  - Close to complete independence in Eurozone
  - But Government (or Congress, as in Mexico) may retain some responsibilities, for appointments or target setting, or even policy override
- Different mechanisms
  - Ranging from information exchange to policy coordination
  - Eurozone: the original stability and growth pact is being replaced by an intergovernmental treaty setting tighter budget rules
  - Fiscal Responsibility Laws that include target or ceiling deficit and debt levels
  - MoF observers on Monetary Policy Committee (eg UK, China)
  - Many under strain during financial crisis – and since
- In middle income countries (less so in OECD) potential use of Public Debt Committee (PDC) or similar to facilitate coordination – see later

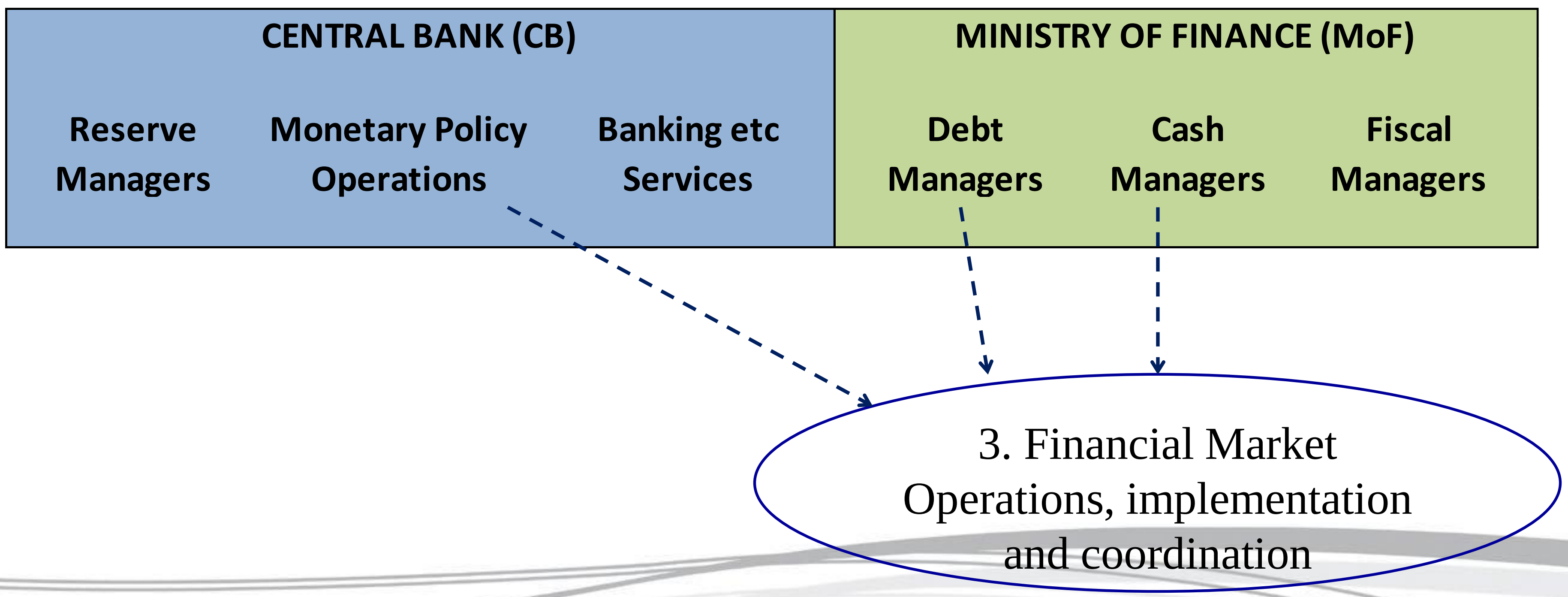
Debt Management Strategy (DMS)



Debt Management Strategy (DMS)

- Development of the Debt Management Strategy
  - All countries increasingly taking account of structure of assets as well as liabilities
  - Risk minimized when characteristics of assets and liabilities match
- Important analytically; but can be problematical
  - Substantial assets (FX reserves) under control of CB not MoF
- CB should be consulted in preparation of DMS
  - Identify conflicts with monetary policy, comment on financial market realism
  - But often reluctant to bring FX assets into purview - a governance challenge
- Annual borrowing plan (ABP) prepared by MoF
  - MoF also prepares more detailed quarterly calendar, and leads on consultation with market and relationship with primary dealers
  - ABP in consultation with central bank; but may be reluctant to leave it at that
- Public Debt Committee (PDC) or similar has a potential role to facilitate coordination – see also below

Coordination Structures: Operations and Services



Changing Roles of CB and Treasury

Traditional Roles → Problems

Traditional Roles

- **Treasury:** Treasury primarily a gov't payment office; TSA incomplete; limited cash management
- **CB:** managing domestic monetary conditions, including impact of gov't cash flows; directly influencing cash and debt management policies through its role as fiscal agent; range of services supplied to treasury

Problems

- Excess government liquidity; lack of interest on balances => a subsidy to banks
- Volatile government cash flows complicate monetary policy operations
- CB's implementation of debt and cash management policy potentially conflicting with monetary policy goals
- CB lending to government risking adding to inflation

The Modern Treasury Framework

Central Bank

Responsible for

Monetary Policy

Services Supplied

Government's banker

Developing the TSA

Treasury

Responsible for

Cash & Debt Management

- Pooling government liquidity
- Managing cash actively
- Financing transactions
- No direct borrowing from CB

Money market

Other core functions

- Budget execution
- Payment processing
- Accounts

Supported by

- Cash Flow Forecasting

Implications for Central Bank

- Movement of liquidity away from the banking system as TSA develops
- But as cash management develops:
  - Treasury will reduce cash balances – recycle to banks
  - Reduced volatility of cash balances will benefit central bank – the counterpart is reduced volatility in banking sector liquidity
  - Bank may remain as fiscal agent – but clarity important
- Coordination and cooperation
  - Clarity on responsibilities and information flows
  - Operational interactions – eg auction timings
  - Mutual development of money market

Active Cash Management and Monetary Policy

- The liquidity of the domestic banking sector depends on:
  - The monetary policy operations of central banks - borrowing or lending to credit institutions, reserve requirements, deposit services, etc.
  - "Autonomous" Influences - demand for banknotes by the public (predictable), net inflow of foreign currency (which depends on the policy of intervention) and changes in government deposits at the central bank (ie, changes in the balance of TSA)
- Less fluctuation in cash flows of the government through the TSA, implies less fluctuating monetary liquidity / market banks (other factors being equal)
  - Less weight should be assigned to monetary operations to control liquidity
  - Active cash management functions and facilitates the task of central banks

The Central Bank's Balance Sheet

Assets	Liabilities
Refinancing facility for banks	Banks' current account deposits
Marginal lending to banks	Banks' required deposits
Net foreign Assets	Bank notes in circulation
Other (net)	Government deposits

Can be rearranged

Liquidity supply through monetary policy operations

Refinancing facility for banks
plus Marginal lending to banks
less Banks' required deposits

Equals "Autonomous" factors

Bank notes in circulation
plus Government deposits
less net foreign assets

Plus Other factors / Residual

Implications for Commercial Banks

- Efficient (electronic) payment systems, internal integration, connectivity to RTGS
  - Reduced need for balances in banking system or intermediate transactions accounts
  - Facilitates use of ZBAs and overnight sweeping
- Implications for finances of banks
  - Less interest free money from government
  - But government should remunerate transactions services
  - Improves transparency and incentives
  - [Immediate loss of liquidity can be eased by monetary policy – or use of standing facilities]
- Commercial banks become direct counterpart of treasury in money market

Coordination

Common Interest in Money and Bond Market Development

MoF

- Efficiency of bond and money market
- UK DMO formal objective "to promote the liquidity, stability and efficiency of the [Government bond and Treasury bill] markets"

Central Bank

- Clear interest in efficiency of money market
- But multiple objectives related to efficiency and security of financial markets

Regulators

- Regulators also often have mixed objectives
- Competition, efficiency, growth, consumer protection, stability…..

Collective but sometimes competing objectives

- Many countries fail to grapple with the challenges -

although may set up a steering committee with e.g. CB chair

Some Specific Sources of Tension

- Central banks do not always accept case for active cash management
  - Active cash management is demanding and risky
  - Concerned about "competence" of government – e.g. in cash flow forecasting, ability to intervene properly, wrongly signalling to market
- Central bank bills (CBBills) alongside TBills risks fragmentation of secondary market liquidity
  - end up costing both institutions more, as liquidity in both is limited
- Timing and amounts of Government auctions should fit with bank's monetary policy operations
  - Avoid draining/supplying liquidity simultaneously
  - Government cash flow forecasts support monetary policy
- Interest on the TSA and impact on central bank's costs

Treasury bills or Central Bank bills?

- Important issue in many countries
  - Build up in domestic liquidly
  - Linked with FX inflows (and unwillingness to let exchange rate float)
  - Central bank issues own bills since lacks other tools to absorb liquidity
- May be possible to mitigate problem by central bank and MoF agreeing to issue paper of different maturity
  - Example: central bank issues CB-Bills of 2 weeks or less and the MoF TBills of 3 months or more
  - Reduces problem but does not remove it
- MoF can overfund the borrowing requirement, by issuing extra TBills or TBonds
  - Depositing the surplus cash in a sterilized account at the central bank
  - In Mexico during the 1990s, the central bank bought the T-Bills issued by the government, selling them into the market as it needed to drain liquidity.

TBills or CBBills, continued

- More tailored approach
  - The MoF sells additional TBills at the request of the central bank, as an add-on to the normal auction,
  - Sterilize the proceeds by holding them in a separate account at the central bank, remunerated at the discount rate set in the bill auction.
  - Arrangement and amounts involved must be made transparent
  - Examples: Mozambique, Macedonia, India, Mexico, Colombia
- This requires
  - Trust between the MoF and central bank. In particular relies on willingness of the MoF always to accept a request from the central bank to issue additional TBills for monetary policy reasons.
  - May also be difficult where the central bank's borrowing requirements are much greater than the MoF's: central bank may want more control over the choice of maturities or conduct of the auctions, not just a simple add-on to the MoF's issuance plans

Payment of Interest on the TSA

- Agreement needed on the rates of interest paid on the TSA balance and any other government's deposits at the central bank.
- International experience varies, but best practice to pay a market-related rate:
  - Improves accounting transparency, avoids the implicit cross-subsidy associated with administered rates.
  - Removes the incentive for the MoF to take economically inappropriate decisions, eg placing funds in commercial banks with low credit ratings.
- Similarly, in the interests of transparency and proper financial incentives the MoF should pay transaction-related fees
- It is not always easy to move fully in this direction
  - There may be legislative constraints.
  - To pay administrative fees room needs to be found within the budget, even if net debt interest payments are reduced by more.
  - Payment of interest on government deposits will affect the central bank's profits.
  - If the central bank is loss-making or government cash balances are large, payment of interest may financially undermine the central bank: long run solution may be recapitalisation

Some Other Policy Issues

- TSA in Commercial Banks
  - Intermediate bank may protect CB from cash volatility, but
    - Potentially weakens Treasury's leverage over management of cash flows
    - Coordination more complicated; information sharing more cumbersome
    - Exposes the government to moral hazard and credit risk
    - Lack of transparency and cross-subsidy may affect development of banking sector
- Any use of overdraft must be defined
  - Term, rate, speed of repayment
- Structural surpluses – wealth funds, fiscal reserve funds etc – may be managed separately
  - On or off CB's balance sheet [Peru, Trinidad, Botswana]
  - In both cases need transparent governance, agreement on objectives, asset allocation, reporting etc
  - Funds on CB's balance sheet complicate ALM analysis – as above

Coordination Mechanisms

- Formalize objectives and understandings
  - Legislation, Decrees, Regulations where needed
  - Terms of reference of committees and working groups
  - Memorandums of Understanding or Protocols on operations
  - Service level agreements (SLAs)

- Treasury "ownership" functions logically separate
  - Financial performance of CB, rules applying to dividend, capitalization, etc
  - Best managed separately from operational interactions

Coordination Structures

- Must cover both policy and operations
- At different levels
  - Minister/Governor
    - Shadowed by regular meetings between senior ministry and central bank officials
    - Handle high level policy issues, firefighting
    - Identify areas for cooperation
  - Formal committee structures, e.g.
    - Public Debt Committee for high level policy coherence
    - Cash Coordination Committee for daily or weekly operations
  - Technical working groups
  - Day to day operational interaction

Role of Public Debt Committee (PDC)

- Main role is approval of DMS [and ABP]
  - Mandating those responsible for strategy execution; setting targets and objectives; and subsequent monitoring of performance
- Chaired by the Finance Minister (or senior official reporting to Finance Minister): includes representatives from relevant functions (Treasury, Macro-Fiscal and Central Bank): Debt management team is Secretariat
- Note that the Committee:
  - Facilitates separation of policy formation from execution – with benefits to clarity and credibility
  - Ensures DMS is consistent with the thrust of macro-economic and fiscal policy more generally – and does not conflict with monetary policy
  - Helps to buttress operational independence of debt managers, reducing risk that CB (or others) will second-guess or intervene in debt management decisions once the strategy has been set
  - [Agree cash management reform program; and operational parameters]
- May meet only half-yearly, to approve the DMS (e.g. at the time of the budget) and a mid-year review

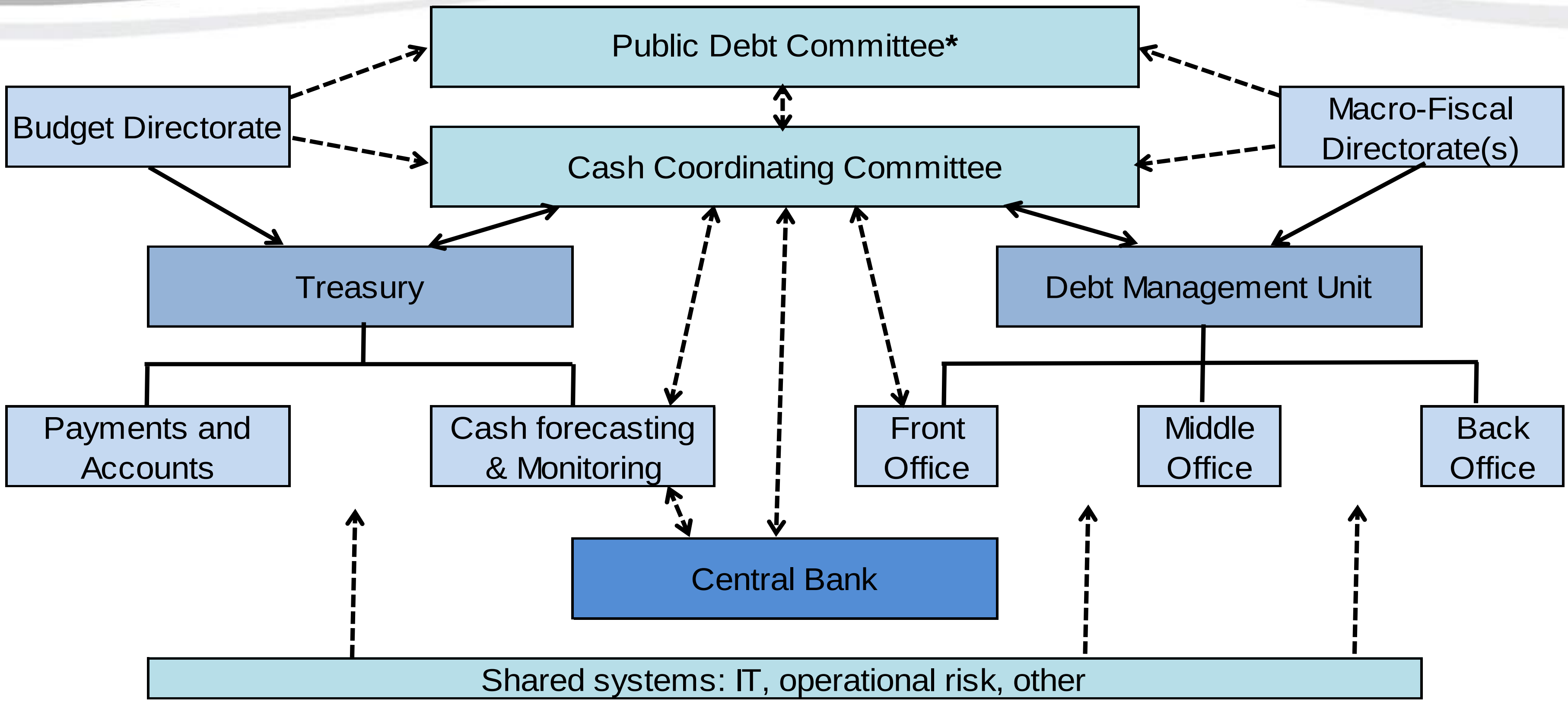
Cash Coordinating Committee

- Useful and widely used coordination mechanism for short-term cash management decisions
- Meets weekly, chaired e.g. by Head Treasury
  - Including also budget division, debt managers, [central bank], tax authorities, possibly large spending ministries
  - Delegated authority for decisions within agreed parameters
- Main responsibilities:
  - Review cash flow outturns, and the comparison with forecasts
  - Review cash flow forecasts for the period ahead
  - Decide on the action needed to ensure cash adequacy over the period ahead [making recommendations accordingly]
- Supported by Cash Management Unit (CMU)
  - Responsible for forecast preparation, database, error analysis etc
  - Also preparation of scenarios and what-ifs

Central Bank and the CCC

- Important that government cash flow forecasts passed to CB
  - Input into CB's own liquidity forecasts informing monetary policy operations
  - CB will still need to handle residual cash flow fluctuations, unless Treasury can accurately fine tune
- Need not be handled through the CCC
  - Communicated separately; updated on the day
- In practice
  - CB knowledge of recent money market can be helpful in deciding financing strategy
  - Politically convenient to include CB on CCC
- <u>But</u>: the decisions are for the MoF/Treasury

Debt and Cash Management: Coordination

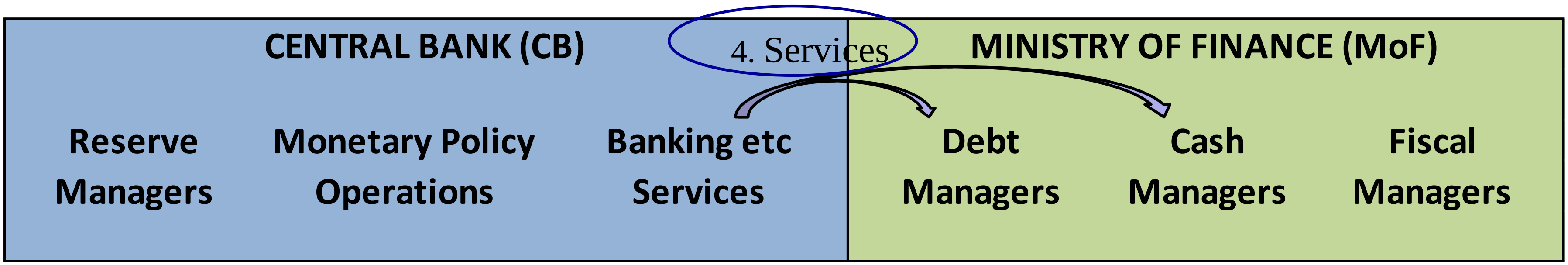


- *PDC: main roles: high-level policy and risk framework for debt [& cash] management; preparation/approval debt strategy; mandating execution responsibilities; target setting and performance monitoring
- CCC may report to Minster or be constituted as a sub-committee of PDC

Some Issues for the MoU(s)

- The joint program for the development of the money market
  - Including policies and operations for bill issuance and the respective roles of CBbills and Tbills
- How the CB reports its and the market's views about the debt and cash management program and operations (might be covered by the PDC)
- Choice of primary dealers or auction counterparties
  - Shared or independent
- The payment of interest on government balances at the central bank
  - Has be agreed at the policy level, but the basis of interest – maturity, relevant market analogues, etc – should also be identified (or in SLA)
- Information exchanges – respective responsibilities
  - Mechanism of communication and issues covered (e.g. the prospective auction schedule, cash flow forecasts, banking information)
- Determinants of e.g. the timing of respective auctions and the associated market announcements and any prior warning
- [Where the treasury is able to borrow from the CB], understandings of the limits (sums, maturities, ability to roll over etc.) of such borrowing

Coordination Structures: Operations and Services



A Range of Services

- The range of services supplied is potentially wide
  - As well as banker, often includes fiscal agent, settlement agent, registrar…
  - Important to clarify roles and responsibilities, and expectations – i.e. a SLA
- Wide variety of SLAs in practice
  - Often several, covering separate policy matters or services
  - Work in progress in many countries
- Services required from CB as banker (and of commercial banks) varies greatly. Depends on:
  - TSA and payment structures
  - Whether there are regional branch networks of MoF and CB
  - Ability to control expenditures through GIFMIS

Service Level Agreements (SLAs)

- Includes performance indicators or quantitative targets
- Some examples of issues covered
  - The notice that both sides would give of any impending change in the auction pattern or timetable
  - The turnaround times by the central bank in handling any relevant transactions, e.g. as fiscal or settlement agent.
  - Details of information flows in either direction, with intended timing, e.g. of cash flow forecasts or transactions across the TSA.
  - The basis of calculation of fees paid for the services (potentially covering compensation for any failure to meet the specified service)
  - Details of the rate of interest to be paid on government accounts
  - Exchange of risk-related information (including audit information)
  - The handling of any business continuity problem
  - The arrangements for handling disputes and for review of the SLA
- SLA normally reviewed regularly , e.g. every year, fees reassessed

Conclusion

- Essential there are mechanisms to ensure consistency at high level between monetary policy, fiscal and debt management
  - In OECD countries and in emerging markets - highlighted by QE
  - CB needs to be engaged in preparation of DMS
- Operational coordination and cooperation between the CB and those responsible for the management of debt or cash is also important
  - The modern management of cash may affect the operations, finance and government balance sheets, the CB and commercial banks
  - Movements of liquidity: but in time reduced fluctuation in cash balances benefits monetary policy
  - Interest payments and transactions fees improve transparency and remove cross subsidy
- Importance of structuring at different levels
  - Areas of contention – but scope for cooperation, especially in money market development
  - MoUs and SLAs bring clarity and remove misunderstanding

Thank You!