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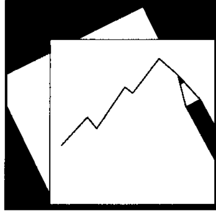

IMF Working Paper

Public Debt Markets in Central America, Panama, and the Dominican Republic

Hemant Shah, Andreas A. Jobst,
Laura Valderrama-Ferrando, and Ivan Guerra

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Public Debt Markets in Central America

Prepared by Hemant Shah, Andreas Jobst, Laura Valderrama-Ferrando, and Ivan Guerra

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Abstract

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This paper—consisting of a regional study and seven country studies—reviews the state of domestic public debt markets in Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua, and Panama as at end-2005. Although they account for the lion's share of capital markets, regional public debt markets remain underdeveloped for a variety of reasons. The problems of small scale, dollarization, and weak public finances in many countries are compounded by poor structure and composition of debt (with sizeable non-standard and non-tradable components), fragmentation of public debt between central banks and the sovereigns and across instruments, poor debt management practices, weaknesses in securities market, and small investor bases all of which result in high transaction costs and a lack of liquid benchmarks. The paper also briefly discusses efforts towards and impediments to regional integration of public debt markets. The authorities recognize these problems and the paper takes note of the regional efforts to harmonize debt standards and improve issuance practices. It offers several recommendations to improve strategic debt management, issuance mechanics, and secondary trading.

JEL Classification Numbers: E62, F34, G18, G28.

Keywords: public debt management, public debt markets, sovereign debt, Central America, financial integration, and capital market development.

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I. Public Debt Markets in Central America, Panama and the Dominican Republic[1]

1. This paper[2] examines the strategic context of public debt management and the functioning of primary and secondary markets for domestic public debt. It proposes measures to improve the functioning of these markets and promote a more efficient regional market in public debt.[3] The main text focuses on the functioning of domestic debt markets in Central America from a regional perspective, based on the seven country studies that follow.[4]

2. **Development of Central American public debt markets is critically important to the overall development of regional capital markets.** As with many emerging markets, the Central American capital markets are somewhat, underdeveloped. Problems in public debt management and underdevelopment of capital markets are related. The underdevelopment of capital markets particularly, institutional investors limits the amount and maturity of funding available to the government locally and can substantially increase the rollover and currency risks in managing public debt. At the same time, weak debt management practices which result in fragmented issuance and a lack of a liquid benchmark yield curve makes it difficult for all borrowers (including corporate and home loan borrowers) to obtain long-term funding, and for institutional investors to undertake appropriate risk management. The broader development of capital markets is a complex and multifaceted problem that also needs to be addressed, but given the dominance of public debt in capital markets in the Central American countries, improving the public debt market is their logical first priority.

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[1] The principal author of this Chapter is Hemant Shah.

[2] This study was undertaken at the request of the regional authorities. The drafts of this study and the appendices were presented to the technical staff of the Central Banks and Ministries of Finance at a conference in Guatemala in June 2006 and then to the senior policy-makers at another conference in Dominican Republic in June 2006 and their comments have been incorporated. In addition to the large number of public and private sector officials in the seven countries studied who generously provided information to the team. We would like to thank Alfredo Blanco, Jorge Barboza, Catiana García Kilroy (Central American Monetary Council), Elizabeth Curry (World Bank), Eliot Kalter, Ceyla Pazarbasioglu, Guy Meredith, Dominique Desruelle, Alfred Schipke, Humberto Arbulu-Neira, Ousmene Mandeng, Hunter Monroe, Erik Offerdal, Anthony Pellechio, and Parmeshwar Ramlogan for extensive assistance. For their comments on the paper, we would like to thank Alfred Schipke, Humberto Arbulu-Neira, Francesc Balcells, Alona Cebotari, Ana Lucia Coronel, Luis Cubeddu, Rodrigo Cubero, Vikram Haksar, Geoffrey Heenan, Luis Jacome, Gabriel Lopetegui, Carla Macio, Rodolfo Maino, Rogelio Morales, Marina Moretti, Christian Mulder, Marco Rodriquez, Neil Saker, and Wendell Samuel.

[3] Generally, the paper reflects data and public debt market conditions in Central America as at end-2005.A more in-depth examination of both institutional and market-related issues concerning debt management can be found in World Bank reports on Guatemala, Costa Rica, and Nicaragua. Related work by the Central America Monetary Council and the Inter-American Development Bank promotes harmonization of technical standards of public debt issuance, and provides diagnostic analyses and technical assistance, much of which has benefited this paper.

[4] In this paper, the term "Central America" includes Panama and the Dominican Republic.

3. **Even for the relatively small Central American economies, developing local public debt markets is important.** Sovereign issuers in smaller economies suffer from many problems in terms of a limited local investor base, higher transaction costs, limited trading, and economies of scale. El Salvador and Panama are dollarized and several other countries have a significant amount of de facto dollarization. A high degree of domestic dollarization may force issuers—including sovereign—to rely on foreign currency funding for a significant part of their financing requirement, and create some preference for doing so from the more developed external markets and investors.[5] A country with current account deficits may also need to rely on external capital flows to close the balance of payments. However, external debt financing in foreign currency cannot be obtained without incurring some risks of currency mismatch and sudden capital outflows. Recognizing this, virtually all sovereigns in the region have already undertaken domestic issuance programs and from a sovereign debt management perspective, it would be appropriate to strengthen rather than abandon them, even if external debt issuance has to continue.

4. **Development of a more integrated regional capital market, including that in public debt entails complex benefits and difficulties that require further study.** Given the small size of the Central American economies, a more integrated financial market may seem to offer substantial benefits to investors and issuers alike. For investors, it might mean more efficient capital allocation and risk diversification. For issuers, it might imply greater and more liquid access to regional savings. However, despite the relative openness of regional capital accounts and the substantial presence of regional financial groups,[4] sovereign debt markets (and, more generally, capital markets) remain divided in important respects by currency, creditworthiness, regulation, restrictions on domestic institutional investors, and the absence of a regional exchange. To advance towards a regional sovereign debt market requires significant convergence and cooperation in terms of economic policies and regulation of financial markets, and potentially creation of regional exchange or at least regional trading platforms. A full examination of such issues is worthwhile but beyond the scope of this study, which focuses on the more pressing task of improving individual sovereign debt markets. Of course, several aspects of development of national debt markets discussed here, and in particular standardization of issues will facilitate a more active regional debt market.

5. **While developing an integrated regional market remains a longer term goal, substantial progress is being made under a project to harmonize public debt market standards**. Under a project of the Central American Monetary Council, supported by the Inter American Development Bank, the authorities of the seven countries have signed a resolution to advance adoption of common standards in public debt issuance across the region in November 2003.[6] The effort involves promotion of common standards and good practices

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[5] In addition, a country incurring current account may need to rely on external funding, some of it the form of debt.

[4] See "Central America: Structural Foundations of Regional Financial Integration," International Monetary Fund, 2006, which discusses regional integration issues relating to consolidated supervision, the insurance sector, and payment and securities settlement systems.

(continued…)

in such areas as organizing the primary market, public debt management, money markets and monetary policy operations, wholesale secondary market in public debt, payment and settlement systems, and conventions in calculations relating to public debt, regulation of collective investments and secondary markets in public debt, and developing a regional wholesale/OTC market in public debt. The program has led to important advancements in establishing common market conventions and calculation standards, adoption of standardized securities in new issuance, building consensus towards analytical approaches and solutions to common problems, and offering training to debt managers. Further progress in implementing the 2003 resolution would depend on substantial additional technical and political support.

A. Financial Sector in Central America

6. **The financial sector in Central America is dominated by banks which are the largest financial intermediaries throughout the region** (Table 1). The Dominican Republic and Guatemala have somewhat, low levels of financial penetration in terms of a bank-assets-to-GDP ratio of around 35 to 40 percent. The numbers for Costa Rica, El Salvador, Honduras, and Nicaragua range from 50 to 90 percent and compared well with other emerging or developing markets. Panama, with a dollarized and open economy has very high levels of financial penetration (250 percent), reflecting its offshore activities. Deposit levels are typically about 60–80 percent of total assets, except in Costa Rica where they are only a third of the assets. Private credit generally accounts for about half of the assets.

7. **By contrast, capital markets are underdeveloped throughout the region.** Except for Panama, the number of equity and corporate bond listings are generally in the single digits and market-capitalization-to-GDP ratios are quite low. While complete data are unavailable, institutional investors (pension funds, mutual funds, and insurance companies) also are underdeveloped. In some countries, the enabling laws and regulation for important sectors such as pension and mutual funds need to be significantly upgraded or remain to be implemented altogether. In all cases, these institutions intermediate a relatively small share of national savings. Thus, the principal investors in government securities are commercial banks and public sector entities such as pension funds.

8. **Issuance of corporate securities is stymied by a variety of factors.** Leading Central American businesses are often family-owned, and their reluctance to share even minority control or to comply with extensive transparency and disclosure requirements seems to be the principal hurdle. Anecdotal evidence suggests that the large majority of local businesses needing financing of under $10 million find it cheaper to seek bank financing while the larger companies seeking from $25 million to $50 million source it overseas. Thus, domestic bond markets are approached for a relatively narrow range of financing needs. Bank loans are preferred because they have fewer information disclosure requirements and those requirements are private rather than public. At times, this situation has been compounded by cyclical excess liquidity in the banking system that lowers bank lending rates. In some cases,

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[6] See Consejo Monetario Centroamericano, Secretaría Ejecutiva, Resolución CMCA/CMH-RE-02/11/03, “Aprobación de los Estándares para la Armonización de los Mercados de Deuda Pública,” November 2003 and progress reports. http://www.secmca.org/Proyectos_DeudaPublica.htm.

brokerage and exchange fees and procedural requirements of the exchange are also deterrents to corporate debt or equity issuance. Mortgage- or asset-backed securities have yet to emerge in these markets. While the private financial sector has issued some bonds, this activity is also limited in light of the relatively liquid condition of many regional banking systems.

Table 1. Central America: Structure of the Financial System
(As of December 2005, except for *, which indicates December 2004)

Country	Costa Rica	Dom. Rep.	El Salvador	Guatemala	Honduras	Nicaragua	Panama
Financial Institutions							
Number of:							
Banks							
Official	3	2	2	1	2	1	2
Domestic-majority owned	12	9	9	26	9	6	17
Foreign-majority owned	0	3	3	1	7	1	22
Branches of foreign banks	0	n.a.	2	n.a.	2	n.a.	31
Insurance companies	1	n.a.	17	18	10	5	18
Collective investment institutions	31	7	5	35	6	n.a.	18
Financial holding corporations	22	n.a.	9	16	9	n.a.	n.a.
Financial System Indicators							
(In millions of U.S. dollars)							
Bank assets	13,037	10,009	10,709	11,653	6,990	2,601	36,225
Total deposits of banking system	4,167	8,144	6,612	8,830	4,285	2,026	25,118
Deposits (in percent of assets)	32.0	81.4	61.7	75.8	61.3	76.9	69.3
Private credit	6,784	4,393	7,027	6,344	3,405	1,107 *	21,918
Insurance sector assets	n.a.	n.a.	353	410	272	93	107
Mutual funds AUM	1,400 *	n.a.	n.a.	n.a.	n.a.	n.a.	527
Pension funds AUM	1,075 *	880	2,600	n.a.	n.a.	n.a.	72
Trading volume	34,585	7	7,511	24,518	2,039	153	1,681
Primary Issuance	5,229	6	665	8,150	0	11	1,227
Secondary Market	29,356	1	6,846	16,368	2,034	142	454
Volume of repo transactions	19,528	0	5,227	16,109	0	34	23
(In percent of GDP)							
Banks assets	66.7	34.1	63.1	36.3	83.6	50.9	234.2
Private credit	34.7	15.0	41.4	19.8	40.7	21.7	141.7
Insurance companies	n.a. *	n.a.	2.1	1.3	3.2	1.8	0.7
Mutual funds AUM	7.2 *	n.a.	n.a.	n.a.	n.a.	n.a.	3.4
Pension funds AUM	5.5 *	3.0	15.3	n.a.	n.a.	n.a.	0.5
Trading volume	176.8	0.1	44.2	76.3	24.4	3.0	10.9
Volume of repo transactions	99.8	0.0	30.8	50.2	0.0	0.7	0.2
Memorandum items							
GDP (in millions of USD)	19,558	29,333	16,974	32,119	8,365	5,105	15,467
Exchange rate (local currency in USD)	497.71	34.70	1.00	7.63	18.90	17.15	1.00

Source: IMF estimates based on official sources.

9. **Thus, public debt issues dominate Central American capital markets.** The capital markets of Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua consist almost entirely of public debt instruments and public debt also dominates capital markets in Panama. Despite this, problems of fragmented domestic debt issuance and the large stock of nontradeable public debt mean that there is insufficient trading and liquidity in domestic public debt markets.

B. Structure and Composition of Public Debt

10. **Public debt levels in Central America remained fairly high at end-2005.** They exceeded 40 percent of GDP in all countries, except Guatemala and the Dominican Republic (Figures 1 and 2, Table 2). The Dominican Republic restructured its debt with the Paris Club in 2004, its sovereign debt in 2005, and most of the debt falling due with commercial banks during 2005. Since end-2005, Honduras and Nicaragua have benefited from debt reduction under the Multilateral Debt Relieve Initiative, which has resulted in a marked fall in their levels of public debt.

Figure 1: Public Debt Composition in Central America, 2005
(Millions of US dollars)

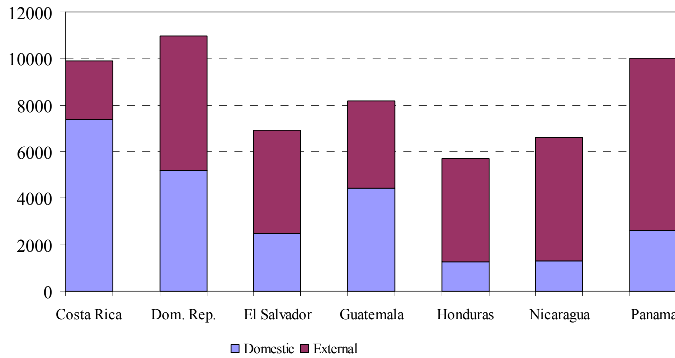

Figure 2. Outstanding Public Debt in Central America, 2005
(In percent of GDP)

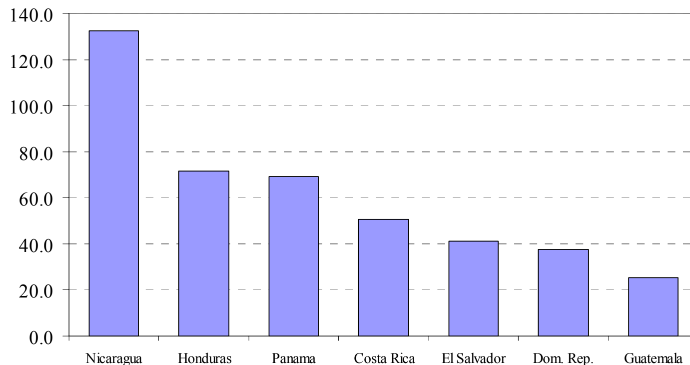

Table 2. Central America: Public Debt Composition
(As of December 2005, except for *, which indicates September 2005)

	Costa Rica	Dom. Rep.	El Salvador	Guatemala	Honduras	Nicaragua	Panama
	Total Public Debt (In millions of U.S. dollars)						
Issued by							
Central government	7,189	6,744	6,456	5,948 *	4,820	4,372 *	10,029
Central bank	2,719	4,233	464	2,230 *	882	2,257 *	-
Total	9,908	10,977	6,920	8,178 *	5,702	6,629 *	10,029
	(In percent of GDP)						
Total	50.7	37.4	40.8	25.5	68.2	129.8	64.8
	Domestic Public Debt (In millions of U.S. dollars)						
Central government	4,822	953	2,164	2,199 *	368	972 *	2,593
Of which: securities	4,797	249	2,147	2,199 *	339	18 *	1,176
Central bank	2,550	4,233	309	2,230 *	882	336 *	0
Of which: securities	2,550	4,233	309	2,230 *	882	336 *	-
	External Public Debt (In millions of U.S. dollars)						
Central government	2,367	5,790	4,292	3,749 *	4,453	3,400 *	7,436
Central bank	169	0	155	0 *	0	1,921 *	0
	Ratios						
Central Bank Domestic/Govt Domestic	0.53	4.44	0.14	1.01 *	2.40	0.35 *	-
External Debt/Total Debt	0.26	0.53	0.64	0.46 *	0.78	0.80 *	0.74
Memorandum items							
GDP (in millions of U.S. dollars)	19,558	29,333	16,974	32,119	8,365	5,105	15,467
Exchange rate (local currency in U.S. dollars)	497.71	34.70	1.00	7.63	18.90	17.15	1.00

Sources: Central banks and ministries of finance.

11. **In the region, a substantial share of public debt is held by non-residents.** In five countries, external debt accounts for 60 to 80 percent of total public debt (central government and central bank combined).Only Guatemala (12 percent of GDP) and Costa Rica (26 percent) have moderate levels of external debt levels with most of their debt provided by domestic markets (Figure 1). However, the level and type of access to external debt varies considerably. While Costa Rica, the Dominican Republic (after restructuring), El Salvador, Guatemala, and Panama are able to secure external commercial funding, including through bonds, other countries (notably Honduras and Nicaragua) rely primarily on concessional loans from international financial institutions.

12. **Government debt is primarily, but not exclusively, issued in the form of securities.** The central bank debt is always issued in the form of securities. As Figure 3 shows, the bulk of government debt has been issued in the form of securities in Guatemala, Costa Rica, El Salvador, and Honduras, but not in Nicaragua, Dominican Republic, and Panama. The nonsecuritized debt is not tradable. Moreover, as discussed later, a significant part of the securities issued by some governments is also not tradable, particularly those issued to the central bank, to public at large for compensation for properties taken over by the state, or to suppliers for past arrears.

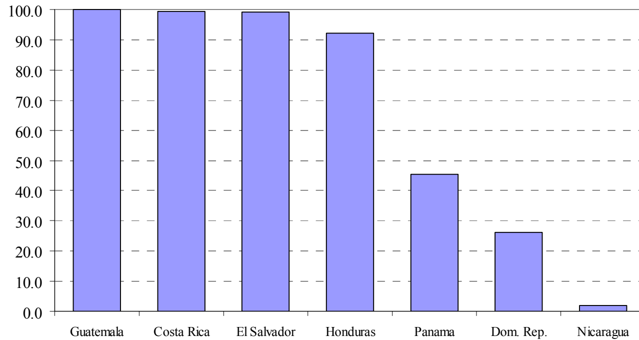

Figure 3: Domestic Debt Issued as Securities, 2005
(Percent of total issuance)

C. Organization of Public Debt Management

13. **None of the countries in the region has yet developed a clear debt management strategy that articulates the long-term role of domestic markets, domestic currency, and resident investors in funding public debt.** Many countries depend heavily on external sources of funding or on foreign currency funding, and lack clarity regarding the strategic role of local currency and resident investors in funding public debt, goals regarding the amount of domestic currency issuance, and the preferred tenor up to which the sovereign desires building a yield curve. In the absence of a well-developed strategy, domestic debt issuance decisions are taken in a somewhat ad hoc fashion. There is little systematic dialog between issuers and investors concerning the medium-term goals of the former or the problems facing the latter.

14. **The capacity of the Central American countries' debt management units needs to be substantially strengthened.** Most units have grown out of traditional back-office operations. They typically have a weak front office and lack a clearly identifiable middle office charged with risk management. They do not generally have a regular investor relations program that involves meetings with key investors and institutions to incorporate market views or resolve problems relating to public debt issuance. That said, debt management unit staff are aware of the need to standardize debt issuance, facilitate secondary market trading, extend yield curve. They also meet regularly at the regional level to discuss these issues as part of the Central America Monetary Council's harmonization program.

15. **By and large, debt management does not adequately aim to manage the stock of existing debt.** Except for Panama and, to some extent, Costa Rica, debt managers focus primarily on securing current funding needs, and secondarily on standardizing future issuance or extending the maturity of the yield curve. Most debt management units have limited capacity to undertake the more complex management of the overall stock of existing domestic

debt. This is particularly important given the high debt-to-GDP ratio in many countries and the sizable nonstandard and nontradable domestic debt that requires restructuring.

16. **Coordinating debt issuance of the sovereign and the central bank is an important challenge.** In many ways, the debt management problems of the smaller Central American economies are more complex than those of the larger emerging markets. One problem is the sizable debt issuance by the central banks (see Section D below) that requires considerable coordination with the ministry of finance. While some coordination is the norm, it is typically confined to operational issues such as the issuance calendar, standardization of instruments, and auction logistics.

17. **In several countries there are some problems in the structure of authority and responsibility between the legislature and administration.** First, debt managers sometimes have only limited clarity or authority for conduct of debt management operations. In the Dominican Republic, Honduras, and, to a lesser extent, Nicaragua, issuance is authorized under somewhat restrictive laws that define the operational terms but can clash with current market conditions, leaving debt managers limited discretion.[7] Second, in most countries debt managers lack the authority to conduct overall liability management operations that go beyond the financing of current cash flow needs. Third, as much of the nonstandard debt has been issued under provisions of specific laws, restructuring of that debt is likely to require more than general authority to finance the government or conduct liability management operations. Finally, the transfer of central bank losses to the sovereign is not routine and involves significant intervention by the legislature.

18. **These problems are reflected in the differences between domestic and external market access.** Several countries have access to external bond markets, and thus to advice from international underwriters and advisors. Their successes in the external markets often stand in sharp contrast to their efforts in domestic markets. For example, Panama has possibly the best developed domestic financial sector in the region, with considerable success in issuing Eurobonds globally and in arranging a $980 million global bond swap in January 2006, issuing a 30-year bond in the process. At the same time, Panama is actually curtailing its domestic medium-term issuance program. Similarly, the Dominican Republic successfully issued a 20-year $300 million Eurobond in March 2006, attracting the lowest coupon in the country's history and an oversubscription of 3.3 times. However, the Dominican Republic has not made a single "regular" debt issue in the domestic market.

D. Dual Sovereign Issuers: Government and the Central Bank

19. **Public debt issuance is complicated by the simultaneous and often competing presence of the sovereign and the central bank as issuers of public debt.** Ideally, public debt should be issued by the sovereign alone, with the central bank using a stock of sovereign public debt instruments to conduct open-market operations for monetary policy purposes.

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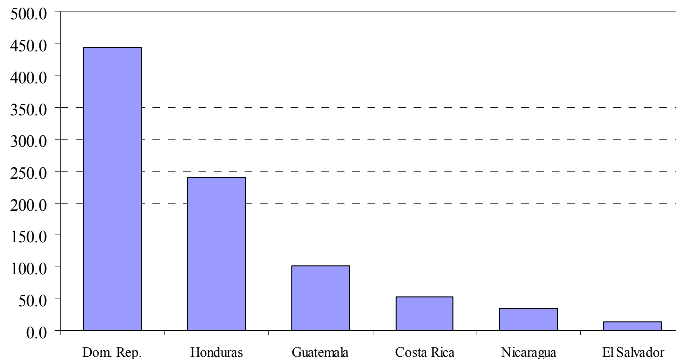
[7] In Honduras, the parliament required issuance of bonds by a public electricity company specifying low (below-market) interest rates, resulting in failure of the issue. In the Dominican Republic, individual debt contracts need to be authorized by the Congress.

With the exception of Panama, the central banks in all five countries (Costa Rica, the Dominican Republic, El Salvador, Honduras, and Nicaragua) have sizable accumulated deficits arising from previous financial crises, financial system bailouts, and even just from normal central bank operations. This makes the central bank a frequent issuer of debt in its own name. For example, in the Dominican Republic, the stock of central bank domestic debt is about 4.5 times as large as that of the government (Figure 4). Moreover, as bulk of government debt is not issued in the form of securities, the outstanding stock of central bank securities is about 17 times as large as the stock of government securities. In both Honduras and Nicaragua, the central bank is a far larger issuer, while in El Salvador and Costa Rica, central bank issuance is between a quarter and half that of the sovereign. Such large issuances by central banks, coupled with the frequency of issuance and a concentration in short-term tenors by both issuers, creates a number of problems.



20. **First and foremost, debt issuance by a central bank to finance its own operations compromises monetary policy operations.** The continuous need for the central bank to issue debt to finance its own operations or to roll over maturing debt may cause doubts in the markets about the bank's ability to conduct monetary policy consistent with the objectives of price stability and the proper choice of instruments and interest rate paths.[8] While this paper does not focus on such monetary policy issues, this is perhaps the most important reason to recapitalize the central bank to a point that it can have a stock of suitable public debt instruments with which to conduct open market operations.

21. **The substantial and simultaneous issuance by central banks also forces a significant burden of coordinating issuance of public debt.** While all the countries of the region seem to have the will to cooperate effectively, the need for extensive coordination on a calendar of issues, demarcation of maturities, issuance terms, eligible issuers, issuance/trading platforms, and the manner in which auctions are conducted adds many layers of complexity relative to a situation in which the sovereign is the sole issuer and the central bank at best a fiscal agent. In many countries, there are gaps in technical sophistication, familiarity with market conventions, and in some cases pay scales between central bank and finance ministry staff that deal with debt issuance, with the latter usually lagging behind. Often there are differences in the issuance practices of the two issuers, and the sensible need to harmonize them, even when addressed, nonetheless slows down the adoption of desirable innovations.

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[8] Note that the rollover of debt to finance accumulated losses is more problematic than, say, debt issuance to mop up excess liquidity and build up reserves, in which case the rollover risk is mitigated by the presence of reserves.

For example, in Guatemala, while the ministry of finance can issue standard instruments (carrying a common coupon), such issuance has been delayed until the somewhat greater legal difficulties in issuance of similar standard instruments by the central bank can be resolved.

22. **The sizable issuance of central bank debt creates a potentially large rollover risk and a short-term orientation toward public debt in the market.** For monetary operations, Central banks have a preference for issuing short-term debt. This bias tends to be carried over in financing of central banks' quasi-fiscal deficits that are not quickly or fully compensated by the sovereign (which is the root cause of central bank debt issuance in Central America). Such decapitalized central banks are generally resource-constrained and loath to issue longer-term debt that, all else being equal, entails higher interest rates and thus larger deficits. The sovereign authorities also are generally wary of issuance by the central banks at longer maturities, as they themselves intend to tap these maturities and prefer not to have competing paper from the central bank.

23. **Resolution of a central bank's accumulated losses is typically delayed and inefficient.** In many countries, the authorities do recognize the need to recapitalize the central bank, and, in turn, transfer the central bank losses to the fiscal accounts. However, this is not an easy process given the politics involved, the level of public deficits, and legislative complexities. Thus, such transfers—if they occur at all—are delayed. In some cases, they are still ad hoc—in the Dominican Republic, for example, the first such issuance of the recapitalization bond was authorized for 2005, but its terms are not yet determined. Even in countries where transfers are now more routine (e.g., Costa Rica, Guatemala, and Honduras) and losses are supposed to be transferred annually, the accounting and legislative process of determining the actual central bank losses and authorizing the issuance of government bonds nonetheless takes one to two years. As recapitalization entails a considerable legislative effort, a partial recapitalization that does not eliminate future operational losses allows a difficult problem to persist.

24. **When it does occur, recapitalization of central banks is more often apparent than real.** Typically, recapitalization bonds have unusually long tenors of the order of 25 to 100 years, with zero or below-market interest rates. In present value terms, this results in an effective recapitalization well short of the face value of the bond. For instance, in Guatemala, a recapitalization bond issued in 2005 to cover losses incurred in 2003 had a 30-year maturity and a 3.87 percent coupon rate, well below the 9.6 percent rate on the 10-year bonds issued during the same period. Another bond expected to cover central bank losses for 1982–2002 is expected to have even more off-market terms: a maturity of 100 years and a zero interest rate, resulting in a bond with a present value of approximately 1 percent of the face value. In Honduras, central bank losses in 2003 were covered with a 50-year bond with zero interest rate, while 2004 losses were covered with a 25-year bond, paying a market interest rate only on one-tenth of the bond issued.

25. **Partial recapitalization with deep discount bonds may actually inflate the *nominal* level of public debt, while creating weak incentives to check future public deficits.** Positive capitalization of a central bank is desirable to ensure full recognition of its

losses by the sovereign and to preserve the central bank's independence.[9] The current practice of recapitalizing central banks with zero coupon or deep discount bonds not only fails to adequately reduce future central bank losses, but also overstates the widely followed nominal debt-to-GDP ratios than would have been the case with bonds paying current market interest rates.[10] The resulting reduction in future interest bills also probably weakens fiscal discipline.

26. **The issuance of deep discount debt to the central bank has created a sizable stock of nonstandard and nontradable debt that reduces the liquidity of public bonds.** Such debt is rarely traded due to its unusually long maturity, absence of liquid yield benchmarks at such maturities, and, above all, the central bank's incentives to not recognize the large capital losses if it were to sell such debt.

27. **The division of sovereign debt issuance between the two issuers hinders development of larger benchmark issues and lowers liquidity.** Central American sovereign debt markets are small, and the market for longer tenors has yet to develop adequately. Liquidity of most bonds is related to the size of individual tradable issues and aggregate tradable stock. The division of issuance between the two sovereigns and the nontradable nature of debt issued to the central banks prevents most issues from reaching volumes needed to become liquid benchmarks and reduces liquidity. These factors are also generally detrimental to development of a long term yield curve and widening the investor base, particularly to foreign investors in local issues.

E. Primary Issuance of Public Debt

28. **The primary debt issuance process throughout Central America suffers from several problems.** Despite the progress made under the harmonization project, many problems remain in the form of poor issuance mechanisms, issuance of nonstandard debt; fragmentation of issuance; and weak auction practices.

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[9] However, this may often be a higher standard of capitalization than needed solely to eliminate future central bank losses. As central banks do not always pay market interest rates on all their liabilities (due to reserve requirements), the level of recapitalization needed to eliminate future deficits may be lower than that implied by full transfer of their accumulated losses.

[10] While the true value of the net public debt of the central bank and the government remains unchanged, such an increase in the nominal debt-to-GDP ratio may add to lack of transparency about public debt, and possibly to the cost of public debt and problems of access.

Issuance Mechanisms

29. **Several countries use multiple issuance mechanisms, thus draining volume, liquidity, and competitiveness from auctions.** In addition to regular auctions, several issuers (Costa Rica, the Dominican Republic, Guatemala) also rely on post-auction windows (Table 3) offered by the central bank or the ministry of finance.[11] The presence of such windows, for extended periods of time, drains liquidity from auctions themselves, and complicates the bidding and acceptance strategies for investors and issuers, respectively. In the Dominican Republic, the window creates a further segmentation of the market, as the fixed interest rates offered in the window are only loosely guided by the preceding auction or current secondary prices, the window is open only to retail investors, and longer tenor maturities are offered through the window than are auctioned. Securities issued through these windows are typically nonstandard and nontradable. Interestingly, in Costa Rica, the finance ministry takes advantage of the statutory restrictions on nonfinancial public sector entities by issuing public debt outside the competitive auction process at "negotiated" below-market yields and tenors, creating an additional source of nonstandard debt.

30. **There are no primary dealer systems in Central America, although issuers often rely on brokers and exchanges to conduct primary auctions.** None of the countries employ a true primary dealer system with clear market-making obligations. Nor are broker or dealers capable of many of the functions performed by the primary dealers in larger government securities markets. However, reflecting the traditional dominance of exchange brokers (the largest of whom are typically affiliated with major banks), many countries employ a somewhat unusual process for public debt issuance by relying on brokers and exchanges to conduct the auction. These arrangements vary widely. In Panama, all auctions must be conducted through exchange brokers. In Costa Rica, banks can participate directly in an auction, while other investors must submit their bids through brokers and pay related commissions. In El Salvador, ministry of finance auctions are open not only to brokers but to other approved investors, including domestic and foreign banks, whereas central bank auctions are only open to brokers. As a general rule, it is difficult to make the case for value added by brokers during the primary auction process, particularly for institutional investors. As the banks typically have in-house brokers, as a group they tend to be neutral about the exclusive rights of the brokers and the fees charged by them, with the pension funds objecting most to such a monopoly.

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[11] Often such windows are used for noncompetitive bids, although the here pertains to their separation from the regular auction rather than the noncompetitiveness of the bids.

Table 3. Central America: Securities Issued by the Ministry of Finance and the Central Bank

	Auction Frequency	Types of Securities Offered at Each Auction	Scheduled Number of Auctions	Actual Number of Auctions	Average Auction Issuance Amount (In millions of U.S. dollars)	Median Auction Issuance Amount (In millions of U.S. dollars)
Costa Rica						
Government/Ministry of Finance						
Títulos de Propiedad (TP), zero coupon	biweekly	1	26	7	37.6	18.8
Títulos de Propiedad (TP), fixed rate	biweekly	1	26	21	28.7	22.5
Central Bank						
Bonos de Estabilización Monetaria (BEM), fixed rate	biweekly	1	26	9	93.2	84.8
Bonos de Estabilización Monetaria (BEM), zero coupon	biweekly	1	26	18	38.9	24.7
Dominican Republic						
Central Bank	weekly	2	52	52	35.1	32.9
El Salvador						
Government/Ministry of Finance						
Letras del Tesoro (LETES)	biweekly	3	24	31	2.0	0.9
Government Bonds	monthly	2	24	1	35.5	35.5
Central Bank						
Certificados Negociables de Liquidez (CENELI)	weekly	5	52	22	3.4	1.7
Guatemala						
Government/Ministry of Finance						
Certificado Representativo de Bonos del Tesoro	biweekly	3	26	24	24.0	17.1
Central Bank						
Certificados de Depósito a Plazo	3-5/week	3	156-260	155	6.3	5.7
Certificados de Depósito a Plazo	daily	3	260	247	0.1	0.1
Honduras						
Government/Ministry of Finance	biweekly	4	26	17	3.0	3.0
Central Bank	weekly	5	52	37	16.0	14.4
Nicaragua						
Government/Ministry of Finance						
Bonds	biweekly	1	26	3	3.5	1.0
Central Bank						
Letras	weekly	3	52	49	2.2	1.9
Panama						
Government/Ministry of Finance						
Notas	monthly	1	12	12	32.0	25.0
Letras	monthly	1	12	9	17.0	19.0

Sources: Central banks and ministries of finance.

Issuance on Nonstandard Debt

31. **The issuance of "nonstandard" debt without suitable characteristics that facilitate trading has been diminished, but not eliminated.** In addition to issuance in irregular transactions (such as compensation for properties taken over by the state, arrears to suppliers, and issuance to central banks at off-market terms), several countries issue debt carrying amounts and interest rates specific to each holder (such as bank term deposits) rather than through standardized debt instruments; and/or issue debt in physical (not dematerialized) form. The last two problems are directly addressed by the Central America Monetary Council's harmonization project. While all countries have agreed to start issuing standardized securities, the Dominican Republic, Costa Rica, El Salvador, Guatemala, and Nicaragua continue as of this writing to regularly issue some nonstandard securities. In addition, all recapitalization bonds issued or planned for issuance by the sovereign to the central banks in the Dominican Republic, Costa Rica, Guatemala, Honduras, and Nicaragua remain nonstandard.

Fragmentation of Public Debt Issuance

32. **Despite the relatively small volume of domestic issuance, public debt is issued in an extremely fragmented fashion across Central America for a variety of reasons** (Table 4). First, as discussed earlier, debt issuance is undertaken by the sovereign and the central bank in five countries. Second, there is a high frequency of issuance—all countries schedule auctions on a weekly or biweekly basis, except for Panama, which conducts auctions monthly (see Figures 5 and 6).

33. While many issues are re-opened and consolidated, their eventual total size is unclear. Third, Central American public issuers attempt to issue a large number of maturities relative to their total domestic issuance. Fourth, some of the nondollarized issuers (e.g., Nicaragua) are unable to issue all of their financing requirements in local currency, and while attempting to develop a local currency market, have to divide their local issuance in different currencies. Finally, issuance of nonstandard debt with different interest rates to winning bidders (rather than different prices) obviously creates extreme fragmentation.

Conduct of Auctions

34. **Investors throughout the region complain of gaps in information regarding primary auctions.** As part of the harmonization initiative, in all countries, there is now a pre-announced calendar of issues from both issuers. However, the overall annual calendar announcement is rather generic, and the amount offered is typically announced only about a week before the actual auction. There are considerable uncertainties about the actual issuance volume, as in some countries (e.g. Costa Rica and Honduras), the government and central bank often issue the same paper jointly. Allocation rules are not always fully formalized, and at times are perceived as murky by both investors and issuers. Investors are not always assured which issuer's securities will be awarded to them, which is a nontrivial problem in markets where the prices differ, or of the eventual size of a particular bond issue.

35. **Fragmented and frequent issuance of a small quantity of debt appears to be partly driven by the desire of issuers to systematically capture the most aggressive bids or beat down the yields**. Issuers routinely complain that the market is not sufficiently competitive, and that domestic investors, particularly those in the private sector, "overcharge" the government. There is thus a widespread reluctance on the part of the issuers to offer larger auction volumes, or commit to issue the announced volume when auctions are fully subscribed. Some of the most aggressive bids often come from banks that temporarily are very liquid, or from pension funds that, for regulatory reasons, must heavily invest in government paper. From time to time, this results in bids that other market participants regard as unrepresentative for the full spectrum of investors. Debt managers with weak authority and lacking a clear strategy to develop domestic markets and investor base find it easier to defend small issuances or large rejections, than a higher interest rate.

Table 4. Central America: Auction Mechanisms for Public Debt Securities

Issuers		Auction Mechanism			Issued Securities			
		Competitive Auction ?	Non Competitive Bids Allowed?	Post-Auction Window?	Standardized Security?	Dematerialized Security ?	Directly Placed with Creditor?	Exchange-Based Primary Issuance?
Costa Rica								
MOF	Pagarés del Tesoro	N	-	N	N	N	Y	N
MOF	Títulos de Propiedad Cero Cupón (TPCER)	Y	Y	N	Y	Y	N	Y
MOF	Títulos de Propiedad Interés Fijo Colones (TPC)	Y	Y	N	Y	Y	N	Y
MOF	Títulos de Propiedad Interés Fijo Dólares (TPS)	N	-	N	Y	Y	N	Y
MOF	Títulos de Propiedad (Interés Variable Dólares)	Y	N	N	N	Y	N	N
MOF	Títulos de Tasa Básica (Interés Variable Colones)	Y	N	N	N	Y	N	N
MOF	Títulos de Propiedad en Unidades de Desarrollo (TUDES)	N	-	N	N	N	Y	N
CB	Short-term Certificates (Inversiones de corto plazo)	N	-	Y	N	N	Y	N
CB	Bonos de Estabilización Monetaria (BEM) 1/	Y/N	-	Y	Y/N	Y/N	Y/N	Y/N
CB	Deposit Certificates (Certificados de depósito a plazo US$)	Y	N	N	Y	Y	Y	Y
Dominican Republic								
CB	Certificados de Inversión	N	-	Y	Y	Y	Y	N
CB	Certificados Cero Cupón	Y	Y	N	N	N	N	N
CB	Certificados de Plazo Fijo	Y	Y	N	Y	Y	Y	N
CB	Notas de Renta Fija	Y	N	N	N	N	N	N
CB	Certificados de Largo Plazo	Y	N	N	Y	Y	N	N
El Salvador								
MOF	Letras del Tesoro (LETES)	Y	N	N	Y	Y	N	Y
MOF	Government Bonds	Y	N	N	Y	Y	N	Y
CB	Certificados Negociables de Liquidez (CENELI)	Y	N	N	N	Y	N	Y
Guatemala								
MOF	Certificado Representativo de Bonos del Tesoro	Y	Y	Y	N	N	N	Y
CB	Certificados de Depósito a Plazo	Y	N	Y	N	N	N	Y
Honduras								
MOF	Valores gubernamentales	Y	Y	N	Y	Y	N	Y
MOF	Bonos Presupuesto	Y	Y	N	Y	Y	N	N
CB	Certificados de Absorción Monetaria (CAMs)	Y	Y	Y	Y	Y	N	Y
CB	Certificados de Absorción Denominados en US$ (CADDs)	Y	Y	Y	Y	Y	N	Y
Nicaragua								
MOF	BPI 2/	D	N	N	N (Y)	N	Y	N
MOF	T-bills	Y	N	N	Y	Y	N	N
MOF	Bonds	Y	N	N	Y	Y	N	N
CB	Letras	Y	N	N	Y	Y	N	N
CB	Bonds	Y	N	N	Y	Y	N	N
CB	Bank bonds	D	N	N	N	N	Y	N
CB	TEI	D	N	N	N	N	Y	N
Panama								
MOF	Letras del Tesoro	Y	Y	Y	Y	Y	Y	Y
MOF	Notas del Tesoro	Y	Y	Y	Y	Y	Y	Y

Sources: Central banks and ministries of finance.

[1]The auction of BEMs in Costa Rica is competitive for zero cupon and fixed rate BEMs denominated in local currency, and non-competitive for variable rate BEMs denominated in U.S. dollars.

[2]BPIs in Nicaragua are partially standardized.

Figure 5: Central America: Potential Debt Auctions per year
(number)

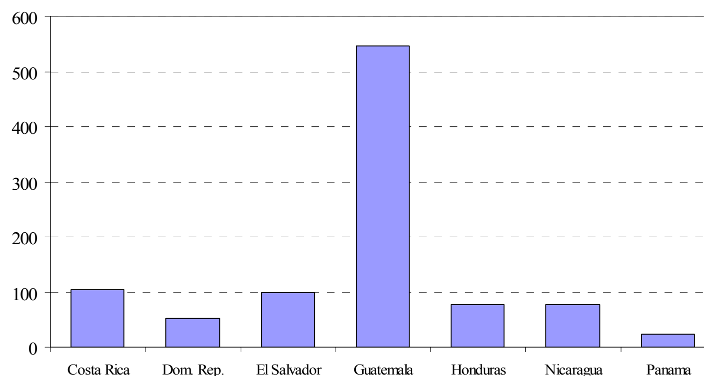
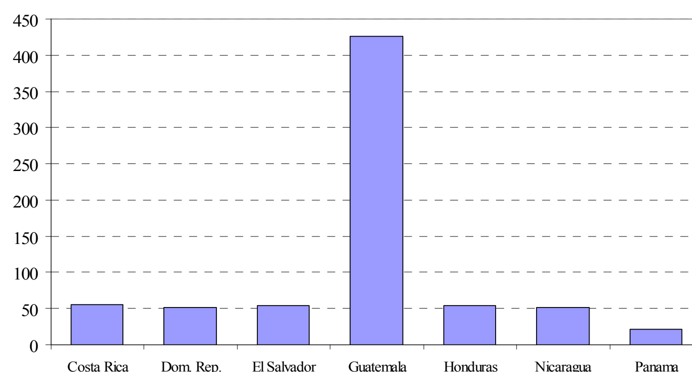


Figure 6: Central America: Actual Debt Auctions per year
(number)



36. **While there may be some validity to these concerns, they ignore the fact that investors will eventually factor in such defensive behavior of the issuers and adjust their bids accordingly.** Smaller volumes can be placed at seemingly lower yields from time to time. But unless the overall volume of sovereign and domestic issuance is reduced, smaller issuance in individual auctions itself cannot reduce interest rate in the long run. Moreover, as smaller issues are less liquid, the market is likely to charge a premium for such issues. As the domestic rates in both primary auctions and secondary markets are generally higher than the yields for comparable Eurobonds, where they exist, small and fragmented local issues ultimately appear to carry a higher cost.

37. **This widespread lack of agreement on "market clearing prices" between issuers and investors results in frequent auction failures or rejections.** Auctions are often undersubscribed and at times are "deserted" (especially in Nicaragua)—that is, they receive no bids at all. Neither is it uncommon for the issuers to reject many bids in a fully or oversubscribed auction, while not filling the entire amount offered (e.g., in Panama). Apart from the uncertainties they imply in public financing, such auction failures or rejections signal market-wide disequilibria that should best be avoided.

38. **There are also concerns about the role of dominant public sector investors.** There is some consensus that public sector investors should be excluded from competitive bidding, as they could be influenced by the issuers and may result in an unrepresentative market-clearing interest rate or at least the perception thereof. However, the Central American experience indicates that there may not be a simple solution to this situation. In Panama, public sector bidders are allowed to participate only through noncompetitive bids, whereas elsewhere they are allowed to participate with competitive bids as well (e.g., in Costa Rica). Frequent and sizable participation of public sector investors through noncompetitive bids is likely to influence the issuer's acceptance of competitive bids, and, in turn, the competitive bids by the private bidders. There thus may be a need to frankly discuss the role of the public sector vis-à-vis the private sector, provide public sector investors enough regulatory leeway and operational autonomy to bid as much on an arms-length basis as possible, and encourage the largest possible participation in competitive bids.

F. Secondary Markets

39. **Public debt securities account for the lion's share of secondary market trading throughout Central America.** Given the relative underdevelopment of corporate securities markets, trading in public securities dominate the overall trading in regional exchanges (Table 5).

40. **However, the bulk of domestic issuance in Central America is in short-term paper, and most of the domestic trading is in repo transactions, resulting in a lack of liquid, long-term secondary market yield curve.** Few of the issuers (barring Panama and Guatemala) have managed to issue domestic debt for longer than a few years. This failure contrasts with the issuance of up to 30 years in the Eurobond markets by Costa Rica, the Dominican Republic, El Salvador, Guatemala, and Panama. Moreover, bulk of the trading is in repo transactions of a few days. Thus, despite accounting for 90 percent or more of local exchange trading, government securities do not provide a meaningful benchmark yield curve, and even for the short durations involved, secondary prices and yields are not sufficiently current.

41. **Transaction costs in the smaller local securities exchanges—including brokerage and exchange fees involved in trading public bonds—as a rule, are extremely high.** On an annualized basis, they amount to 1 to 3 percentage points in the Dominican Republic, 1 to 2.5 percent in Nicaragua for an outright transaction and 1.25 percent for a repo transaction, and 0.1 to 1 percent in Guatemala.[12] Transaction costs are somewhat lower in Costa Rica, Guatemala, and Panama. High brokerage and bolsa fees may be justified by the low trading volumes and the small size of many issues, but they create a chicken-and-egg problem. More importantly, low liquidity eventually must raise the market clearing interest rates demanded by investors.

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[12] By comparison, the bid-ask spreads for government securities in the larger, well-developed emerging markets are of the order of 5 to 10 basis points.

Table 5. Central America: Secondary Trading of Fixed Income Domestic Securities
(In millions of U.S. dollars, 2005)

	Public Debt		Private Debt	Equity	Others	Total
	Outright	Repo				
Costa Rica						
Trading volume	4,881	19,528	-	28	4,919	29,356
In percent of GDP	25.0	99.8	-	0.1	25.2	150.1
Dominican Republic						
Trading volume	-	-	0.8	-	-	0.8
In percent of GDP	-	-	0.0	-	-	0.0
El Salvador						
Trading volume	407	5,227	408	80	724	6,846
In percent of GDP	2.4	30.9	2.4	0.5	-	40.3
Guatemala						
Trading volume	259	16,109	-	-	-	16,368
In percent of GDP	0.9	58.9	-	-	-	51.0
Honduras						
Trading volume	2,034	-	-	-	-	2,034
In percent of GDP	25.5	-	-	-	-	24.3
Nicaragua						
Trading volume	108	34	-	-	-	142
In percent of GDP	2.1	0.7	-	-	-	2.8
Panama						
Trading volume	120	23	74	203	34	454
In percent of GDP	0.8	0.2	0.5	1.3	0.2	2.9

Source: National Stock Exchanges.

42. **Central American brokerages and exchanges face an uncertain future given their limited viability and difficulties in terms of consolidation.** It should be kept in mind, of course, that brokers and exchanges may have played an important role historically in raising the transparency of government securities trading and, to a limited extent, popularizing investment in public securities by retail investors. In an environment of extremely limited

private sector security issuance, exchanges may not have developed without some support from public issuers. Nonetheless, continued support of Central American exchanges and brokerages through higher charges and fees on public debt issuance and trading may have questionable value, especially considering the ownership of many brokerages by banks. The low trading income, the opposition of institutional investors to paying fees, and the growing reluctance of public issuers to pay issuance fees may make consolidation both necessary and desirable. There is a need to examine the consolidation of the brokerage industry within the region and encourage well-capitalized foreign brokerage houses, cross-listings across countries, and, eventually, consolidation of the trading platforms themselves. Consolidation of domestic exchanges is also worth considering in Guatemala, where there are two competing exchanges within a small market. However, cross-border consolidation entails many important challenges (see Section G below) within countries without a common currency or regulatory bodies. While these issues need to be examined in detail, the global impetus toward consolidation of smaller bourses needs to be recognized and harmonization of listing and trading practices within the region needs to be speeded up.

G. Investor Universe and Regulation of Investments in Public Debt

43. A preliminary examination of the regulation of principal institutional investors in public debt markets finds three broad problems: inadequacies in the regulatory framework for the securities markets themselves, limitations on the institutional investors, and limitations on their investment portfolios.

44. **The enabling framework for securities issuance, markets and regulation of markets themselves is either lacking or in need of upgrading in many countries.** In Nicaragua, a draft securities market law pending congressional approval for some years would allow the dematerialization of securities and the issuance of asset-backed instruments, thereby widening the set of available securities and facilitating development of a liquid secondary market. In cases such as Guatemala, weak institutions (e.g., a securities registry) act as a temporary substitute for a proper securities regulator.[13] The absence of a superintendency of securities has also seriously hindered the creation of a central depository of securities.

45. **Throughout the region there are also gaps in the legal and regulatory framework for institutional investors.** In turn, these gaps affect development of local government securities markets. In particular, the regulation of private pension funds and mutual funds is inadequately developed in most countries. In Nicaragua, design of a law to regulate creation of private pension funds was abandoned in 2003 following a vigorous debate in Congress. In the Dominican Republic, pension funds are not permitted to invest in government or central bank securities, mainly because of opposition from other investors who fear losing a lucrative investment opportunity. In the absence of well developed mutual funds, brokers in many countries are offering less well-regulated variations such as participations in the so-called “investment portfolios.” Investors are not always aware of the liquidity and pricing of such investments, and at times bank deposit clients are drawn into such investments (e.g., in Costa

[13] A securities law was passed in 2006.

Rica) without fully realizing the possibility of capital losses or illiquidity of such products. Introduction of well-developed mutual fund laws, together with sound governance, pricing, and mark-to-market practices would help develop investor base for government securities in the long run.

H. The Challenge of Creating a Regional Market

46. **Despite trade and political links, Central America's regional public debt markets and capital markets more generally are not well integrated.** There are many benefits of greater regional integration of financial markets, but getting there involves addressing several important challenges and complex issues. The paragraphs that follow sketch some of the issues involved in the context of sovereign debt.

47. **Smaller economies such as those in Central America appear to have much to gain from regional financial integration.** Small financial markets suffer from high transaction costs, small volumes, a small investor base, and a small universe of investment products and instruments. For issuers of securities, including the sovereign, small domestic markets may limit the size and tenor of issues, competitive pricing, or the speed of execution. For investors as well as financial intermediaries, the limited investment universe may result in suboptimal diversification and risk concentration. Brokers and markets, particularly security exchanges, may find it difficult to survive or grow without a critical mass of trading. Smaller economies can partly offset these well-known problems by integrating within a common financial space. Within Central America, these benefits are relatively easy to obtain given the geographical proximity, shared language, common time zones, relatively free trade and capital movements, presence of several regional financial groups, and political will to promote regional ties.

48. **But in the absence of further economic and regulatory convergence, significant problems hamper further integration of regional capital markets in general and the sovereign debt markets in particular**. Central America remains divided by currencies. Macroeconomic policies, debt burdens, sovereign ratings, and debt sustainability are materially different across countries. Thus, sovereign debt issued by different countries remain securities with very different risk characteristics. Eurobonds issued by the regional sovereigns can be easily invested in and traded by regional investors. But underwriting and over-the-counter trading of such issues will remain located largely in global financial centers, given the advantages of the large global investor universe, speed of execution, competitiveness, and low cost they offer. Thus, it is more meaningful to think of regional integration within sovereign debt markets in terms of a common market and investor base for sovereign debt issued in regional currencies. As the situation currently stands, further integration of the regional currency debt is likely to be hampered by two important factors, the separation of regional security exchanges, and the restrictions on institutional investors such as banks, insurers, and pension funds.

49. **First, tradable domestic debt of each issuer is typically listed only in local bourses and often in local currencies.** In the absence of any centralized links between regional exchanges themselves, and absence of regional brokerage firms, nonresident transactions in such locally listed securities typically entail working through a local broker. Such transactions generally are less efficient than the purchase of Eurobonds through a broker based in Miami

or New York. Listing of government securities across regional exchanges is often cumbersome, as the exchanges do not have completely common listing standards. While some bilateral arrangements to overcome these problems have been undertaken,[14] they fall short of a regional securities exchange, coupled with a regional custodian and clearing and settlement systems. The latter is a major initiative that would require substantial effort, study, and cooperation by the private sector participants.

50. **Second, institutional investors face substantial restrictions on the purchase of regional foreign government securities that cannot be readily harmonized.** Pension funds, and sometimes banks, are subject to prohibitions or tight limits on purchase of foreign government securities. In all cases, banks face higher capital adequacy requirements on foreign than domestic government securities, which carry zero risk weighting. In Nicaragua, the 1995 regulatory framework on the investment portfolio of commercial banks requires the prior authorization of the bank regulator to acquire sovereign securities (with the exception of Nicaraguan and U.S. instruments). Similarly, the 2005 bill regulating the investment portfolio of insurance and reinsurance companies requires the prior authorization of the regulator for the acquisition of all foreign sovereign securities. In a nutshell, prudential restrictions on foreign government securities are tight. Capital adequacy standards cannot be readily harmonized given the substantial differences in sovereign credit ratings, as well as implications for currency risk. As for pension fund investments, most countries would have to carefully balance the cost and benefits of foreign investments and consider the interests of the fund beneficiaries rather than sovereign debt issuers. While Eurobond issues may be readily sold to a global investor base, local currency issues cannot be so seamlessly sold to the regional investor base.

I. Key Problems and Recommendations

51. **Central American countries face many important challenges in developing local public debt markets and establishing ready sovereign access to domestic funding and a liquid and efficient domestic secondary market are at best medium-term goals.** This section highlights the key problems in public debt management and steps needed to resolve them.[15] While the problems are not unknown to the regional officials, significant political, legal, and fiscal constraints have prevented more effective resolution thus far. Thus, it is worth emphasizing at the outset that successful implementation of the recommended measures would require strong macroeconomic performance, political stability, a clear political consensus for the desired reforms between the legislative and executive branches, and substantial technical capacity and/or technical assistance.[16] The measures recommended

[14] Various bilateral agreements have been enacted to facilitate cross-listing of securities, as in the case of El Salvador, Costa Rica, and Panama.

[15] While this regional study naturally focuses on the more common problems of the region, and the authorities have a strong interest in regional solutions, a full program of local sovereign debt market development would address individual country situations.

[16] The authorities have accepted most of the recommendations of this study and formally requested further technical assistance to improve the region's debt management capacity and debt structure. In early 2007, there

(continued…)

below are grouped thematically, and while certain key actions are singled out as particularly important, further detailed work must be done to identify a more precise country-specific action plan and timing for implementation. While full implementation of these measures may well take 2–3 years, it is important to establish a clear, ambitious and unambiguous goal leading to restoration of ready sovereign access to domestic markets at a reasonable cost, and efficient functioning of the secondary markets.

52. **The most critical and strategic steps for improving public debt management in virtually all the countries in the region involve** (1) developing a medium-term debt management strategy and formally defining and building capacity for debt management units; (2) eliminating the central bank's quasi-sovereign deficit; (3) converting a large stock of nontradable and nonstandard domestic debt through liability management operations; and (4) eliminating future issuance of nonstandard debt. These four steps need to be undertaken as an integral and well-coordinated package that can be labeled "strategic debt management." A variety of other measures are also needed to simplify and improve primary market issuance, make price discovery more efficient, and improve secondary market trading. But without the four strategic debt management measures, additional measures would only make a marginal contribution to solving the larger problems at hand.

Strategic Debt Management

53. **It is important for all countries to develop a formal, medium-term debt management strategy, as advocated by the Fund as part of a debt sustainability framework.** Several Central American countries have large debt problems relative to their economic aggregates. Moreover, their debt problems are exceedingly complex. The present approach of managing these problems through routine issuance decisions with inadequate debt management units does not fully recognize the gravity of the problem. The inability of virtually all countries to place in local markets, say, issues of the order of $100 million for five years with a reasonable assurance of full subscription, is a strategic limitation. It also stands in sharp contrast to improvements in domestic market access by some other highly-indebted countries (e.g., Jamaica and Uruguay) and to the considerable successes of Panama, Guatemala, El Salvador, and the Dominican Republic themselves in accessing Eurobond markets. Again, while highly desirable and feasible, the task of developing an adequate medium-term strategy cannot be underestimated. It would need substantial country-specific technical assistance, with an important role again for the international financial institutions.

54. **The overall capacity for debt management needs to be significantly strengthened in all Central American countries.** While this paper has not focused much on institutional aspects, it is generally clear that the regional debt management units within the ministries of finance suffer important weaknesses in terms of mandate, skills, staff size, and resources. Strengthening these entities requires adequate formal recognition of them as debt management units, definition of their mandate and accountability requirements, and adequate staffing and

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was an agreement in principle between the Fund and the regional authorities on a multi-year technical assistance program with potential participation of the World Bank as well.

budget support. Such units need not require large staff; most offices may not need more than five employees. But staffing with the right personnel is critical.

55. **The five countries with significant accumulated central bank debt or continuing central bank deficits—Costa Rica, the Dominican Republic, El Salvador, Honduras, and Nicaragua—need to consider full recapitalization of central banks at market terms, so as to eliminate or substantially reduce central bank debt issuance in a phased manner.**[17] While the sustainability of overall public finances is an important macroeconomic challenge beyond the scope of this paper, recognition of central bank debt is more of a political, legal, and technical problem. While such problems ought not to be minimized, recapitalization of the central bank should be addressed as part of a comprehensive strategy to eliminate future central bank losses and integrate the fragmented sovereign debt market. Most countries have already taken important first steps in recognizing such losses and establishing precedents for recapitalization. It is now desirable to speed up this process, issuing marketable bonds in future recapitalizations, and replacing existing recapitalization bonds with marketable instruments. Both new issuance at market terms and conversion may need to be suitably phased to accommodate certain fiscal and legal constraints. But the goal should be to clearly restore the central bank's solvency and future profitability, and eliminate the perpetual problem of dual sovereign issuers in medium term. Designing appropriate options, assessing the related evolution of central bank profit and capital and of sovereign debt, and reconciling the latter with the current program targets of international financial institutions may require substantial technical assistance. IFIs, including the IMF, can play an important role in supporting this effort.

56. **Where needed, central banks could be provided tradable government securities for open market operations.** In some cases, recapitalization of the central bank (i.e., transfer of losses) may not leave it with a sufficient stock of public debt with which to carry out monetary policy operations effectively. In these circumstances, consideration could also be given to issuing a stock of "sequestered" government securities to the central bank for such purposes, in lieu of additional capital injection or issuance of central bank securities. Important details (including the appropriate treatment for fiscal accounting, public debt statistics, and debt issuance authority) would need to be customized and fleshed out for individual country situations. But the broad outline of such an operation would entail issuance of standard government securities to the central bank, with the central bank maintaining "contra" accounts in its books. The latter would reflect both the acquisition of government securities as assets as well a corresponding liability to repay the government with identical interest and amortization terms. The transactions between the central bank and the government would thus not entail any net cash flow. The central bank could then use these

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[17] While we do not deal with the central bank autonomy issues here, such recapitalization should be part of an overall plan to ensure adequate independence of the central banks.

special government securities, which would be identical to other public debt, for open market operations or repos.[18]

57. **Conversion of existing nonstandard debt issued to the central bank and other creditors is another highly promising but technically challenging effort that warrants high priority.** In addition to the nonstandard debt issued to the central bank, virtually all countries have a substantial stock of nonstandard and nontradable debt issued to private holders in lieu of arrears, confiscation of property, and other measures. In the rare instances that such debt trades, it carries huge discounts. Trading benefits primarily the few market intermediaries, typically at the expense of the often unsophisticated holders of such debt. While conversion of such debt into marketable debt is not easy, several recent examples of complex domestic debt transformations by Brazil, Colombia, and Mexico, and of external debt by the Dominican Republic, and Panama, suggest the fundamental feasibility of such transactions. Conversion of current nonmarketable also holds major benefits for the sovereign. First, most conversion has the potential for significant reduction in the *nominal* value of public debt, thus reducing the well-published level of debt. Second, conversions could be particularly useful to introduce new longer term maturities in the domestic market and extend the current yield curve gradually.[19] Fleshing out such internal debt restructuring may also require substantial country-specific technical assistance for designing appropriate options and implementing the same.

Issuance Process and Auction Mechanisms

58. **In countries that continue to issue securities under a discriminatory price auction, the practice of issuing *nonstandard* securities with different rates of interest** (rather than at different prices) should be stopped forthwith. Technically, this change is easily accommodated in the existing auction arrangements, and market participants would be able to adapt to it easily. Internal procedural rules or laws could be modified—with interim decrees, where needed—to expedite the transition.

59. **Concurrent issuance of government and central bank paper in a single series and auction should be phased out.** While central bank issuance in its own name should be eliminated altogether, if it does have to be continued, the two issuers should not seek to force a single auction upon investors. Such commingled auctions, such as those in Costa Rica, are more likely to raise the cost of funding for both issuers and cannot prevent secondary market prices from diverging. That said, in several countries, at present, the sovereign faces a considerably more difficult access to the market than the central bank, and this transition would take time (perhaps a few years) to improve market access. However, there needs to be

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[18] In fact, such securities of an appropriate tenor may be issued to the central bank at market clearing prices determined in the relevant standard competitive auctions.

[19] For instance, suppose it is difficult to introduce a 10-year maturity local bond because the domestic market is illiquid and so far, the sovereign has issued bonds only up to 5-year maturity to investors. Conversion of, say, a 30-year bond issued to the central bank into 7- and 10-year bonds with reasonable extrapolation of current yield curve could start some trading up to 10-year maturity, allowing the "market rates" for 7- and 10-year maturities to be gradually discovered.

a recognition that improved sovereign access to the market must come about from fundamental improvements in debt sustainability, developing a strict culture of honoring debt-service payments, and more generally all sovereign payment obligations, rather than "association" with the central bank in a joint auction.

60. **Throughout the region, the issuers should slowly develop a commitment to accepting market discipline.** Regional sovereign issuers should naturally retain the legal right to reject bids they consider inconsistent with market rate. There are also concerns in many markets that the bidders, both from public and private sector, could exercise oligopolistic power, and raise interest rates payable by the sovereign. However, the issuers' behavior at auctions must also be guided by a long term commitment to open and transparent auctions as the principal mechanism to raise funding domestically. Most sovereigns also have a compelling financing need that requires them to re-enter the auction market in a matter of days after undersubscribed or even deserted auctions. Thus, all considered, there seems to be a stronger case for issuers to phase in greater acceptance of market bids, developing a long term and steady investor base, and developing a convergence about appropriate level of interest rates. In particular, once an auction amount is announced and is covered (i.e., bids cover the amount offered), rejection of competitive bids short of the offered volume (minus any noncompetitive bids) should be an exception rather than the rule. To avoid excessive uncertainty and costs for competitive market participants[20] and the resulting long term loss of investor interest, convergence of interest rate expectations of issuer and investors should be encouraged through several measures (as discussed below). These include developing a more liquid secondary market that would provide continuous quotations on current interest rates, a regular dialog with market participants, especially concerning new maturities, widening investor pool by developing domestic institutional investors, and attracting regional and foreign investors. Where rejections are considered necessary, an effort should be made to explain the issuers' stance and provide guidance to the market for future auctions. Again, while such commitment to market discipline would be an appropriate medium term goal for most countries, the pace of transition would need to be carefully analyzed and implemented in a country-specific manner.

61. **Multiple avenues of noncompetitive bids should be closed, while encouraging all noncompetitive bidders to participate in the announced auctions.** As a rule, the reliance on separate post-auction windows should be stopped. At times, issuers justify such windows on the ground that auctions are insufficiently competitive, and such specialized windows[21]

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[20] Market participants compain of the need to maintain very short term liquidity ahead of auctions and the opportunity cost thereof in case of rejection of their bids.

[21] Some issuers justify the use of windows on the ground that the windows use the immediately preceding cut-off or average interest rates in the preceding auctions as reference rates. In active trading environments, the rate determined in an auction a week or two ago would not necessarily constitute current "market" rate. More importantly, the existence of post-auction windows either provide incentives to eligible private participants in the window to drop out of auctions, thus compounding the loss of competitiveness in auctions, or create mechanisms to place to public sector investors at below market interest rates. In some cases, windows are used to offer securities not generally available in regular auctions, e.g. in retail window for longer term central bank paper offered by Dominican Republic.

(say, to retail investors or public sector investors) enable issuers to fulfill financing needs at more reasonable interest rates. However, when it is a routine practice, such windows eventually drain interest and competitiveness from the "mainstream" auctions, reduce the volume of securities issued in large, competitive and publicly announced auctions, and signal the unwillingness of issuers to accept market rates in competitive auctions. While noncompetitive bids per se can be allowed, noncompetitive bidders should be encouraged to participate in the *same* auction. This should also apply to the forced placement of government paper with public sector enterprises, as in Costa Rica.

62. **Consideration should also be given to allowing competitive bids by public sector borrowers.** The standard advice to keep public sector investors out of competitive bids, and thus prevent them from influencing market clearing prices, has validity in certain situations. However, in the specific context of the region, and Panama in particular, it appears not to serve a useful purpose, as the participation of such bidders is large and indirectly affects the cutoffs set at competitive auction as well. Accordingly, it appears preferable to allow all public sector investors—including banks and pension funds—to participate in competitive bids, but with enough operational autonomy for them to set their own bids without "guidance" from the government.

63. **Countries that use discriminatory price auctions—Costa Rica, El Salvador, Honduras, and Panama—could consider adopting uniform price auctions**. While there is enough precedent for both auctions globally, there is a stronger theoretical justification on balance to adopt uniform price auctions. While discriminatory price auctions need not involve nonstandard issuance, adoption of uniform price auctions would allow a faster transition away from nonstandard issuance. Again, it is important to recognize the variation in convergence on market rates across the region, take measures to educate and consult with market participants, and phase in the adoption of such changes at a pace appropriate to specific country circumstances.

64. **Several steps are needed to eliminate fragmentation of current securities issuance and extend yield curves.** As discussed, an important step would be the recapitalization of central banks with the issuance of longer-term, standardized, and tradable bonds, and the elimination of short-term central bank issuance for its own financing purposes. Second, conversion of the large stock of existing nontradable securities would enable most governments to jumpstart the creation of medium- to long-term securities of up to 10 years, which would start generating secondary market quotes and a benchmark yield curve. Subsequent medium- to long-term placements could be considered through the re-opening of these issues. Issuance calendars could be consolidated, particularly for longer-term securities. As sovereigns become the principal issuers of long-term debt, they need to commit to issuance in minimum volumes, which is one of the key goals of the Monetary Council of Central America's harmonization project. For the region, a minimum domestic issuance size of $100 million equivalent would seem an appropriate target.

Secondary Market Trading

65. **Brokerage fees need to be reduced in most countries.** The simultaneous solution to the chicken-and-egg problem of low trading volume and high transaction costs requires a

multi-pronged approach including (1) reduction of exchange and brokerage fees; (2) equal access to all institutional investors in primary auctions with uniform participation rules for government and central bank auctions; and (3) other measures outlined above for extension of the yield curve and conversion of nonstandard government debt into more standardized and tradable instruments. Using stock exchanges and brokers for primary auctions of sovereign or central bank debt is of somewhat dubious value. While the still-limited stage of development of local securities exchanges must be kept in mind, it would be preferable to shift attention to promoting secondary market trading through the measures discussed above.

66. **Certain institutional problems in specific markets need to be resolved expediently, perhaps with some gentle public encouragement.** There may be merit in encouraging the various parties involved in Guatemala to consider uniting the two exchanges. Authorities in the Dominican Republic need to facilitate a solution to the dispute between the two competing custodial agencies. Issuance of dematerialized securities needs to become the norm in countries that do not yet issue them in this manner.

Other Measures

67. **There is a need to expedite the passage of broader securities market legislation in several countries.** Across the region, there are bills to improve the regulatory framework for the securities market, replace ad hoc presidential decrees, create interbank trading platforms, dematerialize securities, introduce asset-backed securities, and facilitate the formation and regulation of institutional investors. These measures would have profound beneficial effects on the depth and efficiency of public debt markets.

68. **In the Dominican Republic, the authorities must remove the current restrictions on pension fund investment in public securities.** The present restriction on pension fund investment in government securities is far from the best practice and needs to be expeditiously removed, if necessary by executive power.

J. Conclusions

69. **The countries of Central America face substantial challenges in managing their public debt burden and ensuring debt sustainability.** Development of domestic public debt markets is of crucial importance for developing capital markets. While macroeconomic and fiscal discipline are of fundamental importance, regional public debt managers also face several important technical problems in achieving reliable access to domestic financing and creating wider, more liquid public debt markets. The most important responses include developing and implementing a medium-term debt management strategy, building the technical capacity of debt management units, transferring the quasi-fiscal debt of central banks to the government, restructuring nonstandard and nontradable debt, and taking a series of steps to promote capital markets generally and pension and mutual funds in particular. While such a comprehensive reform must be implemented carefully, over the medium term, and at a pace consistent with the particularities of individual markets, a clear vision and political commitment at the highest levels are needed in most countries. Taking action on the measures that have been proposed may require substantial technical assistance to individual countries and sustained political will. Developing an efficient regional public debt market that

overcomes the limitations of size and scale is an important long term goal. Development of a more solid domestic debt market would provide the foundation on which to such an integrated regional market could be built in the future.

II. The Public Debt Market in Costa Rica[22]

70. **Costa Rica has recorded robust average annual economic growth of about 4.4 percent since 1990.** The contributing factors have been a stable social and political environment, fiscal prudence, trade liberalization, and a probusiness environment that has boosted investment and total factor productivity (TFP). After a deep recession in 1982, economic recovery was slow, and inflation has remained at comparatively high levels. Growth has picked up significantly during the past decade, averaging 2.5 percent per annum in per capita terms, and peaked at 6.5 percent in 2003 before tapering off to 4.1 percent in 2005. Although the crawling peg exchange rate regime has helped anchor inflationary expectations, inflation climbed 14 percent in 2005 (up from 10.3 percent in 2000). The consolidated public sector deficit was approximately 3.5 percent of GDP in 2005, while the debt-to-GDP ratio stood at 51.2 percent. The external current account deficit was estimated at 4.7 percent of GDP in 2005, and has remained stable over the past five years (up from 4.5 percent in 2000). At the same time, foreign reserves reached a record $2.3 billion at end-2005.

A. Financial Sector

71. **Costa Rica's financial sector is more developed than in other Central American countries and ranks second only to Panama; however, it is still fragmented and centered on banking intermediation.** Commercial banks are the most important financial institutions, accounting for more than 80 percent of financial sector assets, followed by savings and loan associations (Table 6).[23] Commercial banks are generally organized in financial groups that often include, in addition to an onshore bank, an offshore bank, a stock broker, an investment fund, an insurance commercialization firm, a pension fund, and a mortgage company. Since 1996, the growth of the banking sector has outstripped GDP growth. Gross assets of banks reached 66.7 percent of GDP in 2005 (up from 48.2 percent in 2000), which is high by Latin American standards. Investment funds have slowly regained market share since the mutual fund crisis in 2004 that slowed what had been rapid growth of both mutual funds and pension funds.[24] While banks have increasingly directed lending to the private sector, investment funds have concentrated almost exclusively in government debt securities for lack of a significant private debt market.

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[22] The principal author of this Chapter is Andy Jobst.

[23] Savings and loan associations are authorized by the *Sistema Financiero Nacional de Vivienda*.

[24] The growth of investment funds up until 2004 was due to reforms that clarified the legal and regulatory framework for mutual funds and created a privately-administered "second pillar" pension system.

Table 6. Costa Rica: Structure of the Financial System

	2000	2001	2002	2003	2004	2005
Number of financial institutions						
Banks	26	23	23	22	19	17
Of which						
Public/state-owned	3	3	3	3	3	3
Special banks under public law	2	2	2	2	2	2
Private	13	13	12	12	10	9
Savings cooperatives	26	26	26	26	23	28
Insurance companies[1]	1	1	1	1	1	1
Collective investment institutions	30	30	29	29	26	31
Financial holding corporations	21	21	22	26	24	22
Financial system indicators (in millions of U.S. dollars)						
Bank assets	7,691.9	8,163.6	8,971.8	9,819.8	11,641.6	13,036.8
Total deposits of banking system	2,109.0	2,437.4	2,777.8	3,126.8	3,626.9	4,167.0
Deposits (in percent of assets)	27.4	29.9	31.0	31.8	31.2	32.0
Private credit	3,693.0	4,322.7	4,799.8	5,271.1	5,739.9	6,784.2
Mutual funds AUM[2]	...	...	1,929.4	2,876.6	1,399.6	...
Pension funds AUM	...	...	858.0	1,210.0	1,075.5	...
Trading volume[3]	...	29,140.8	31,056.0	33,614.1	34,324.8	34,585.2
Volume of repo transactions	...	13,888.9	15,456.6	18,658.9	19,138.8	19,527.5
Total (in percent of GDP)						
Banks	48.2	49.8	53.2	55.5	62.9	66.7
Private credit	23.1	26.4	28.4	29.8	31.0	34.7
Mutual funds AUM	...	...	11.4	16.3	7.6	...
Pension funds AUM	...	...	5.1	6.8	5.8	...
Trading volume	...	177.9	184.1	189.9	185.4	176.8
Volume of repo transactions	...	84.8	91.6	105.4	103.4	99.8
Memorandum items:						
GDP (millions of U.S. dollars)	15,957	16,383	16,871	17,697	18,511	19,558
Exchange rate (colones in U.S. dollars)	318.0	341.7	378.7	418.5	458.6	497.7

Sources: Ministry of Finance, Central Bank, Financial Supervisory Agency (SUGFEF), and IMF staff calculations.

[1]Costa Rica has a state-run insurance sector. However, the U.S. Central America-Dominican Republic Free Trade Agreement (CAFTA-DR) is expected to bring about a substantial opening of the insurance sector in 2008.
[2]AUM denotes assets under management.
[3]This figure includes both primary and secondary exchange-based trading.

72. **Five public banks dominate the financial sector.** The three largest public banks—*Banco Nacional* (BN), *Banco de Costa Rica* (BCR), and *Banco Popular y de Desarrollo Comunal* (BP)—alone accounted for 49 percent of total banking assets in 2004. They are state-owned public banks and benefit from state guarantees of deposits, while the two remaining public banks, *Banco Hipotecario de la Vivienda* and *Banco Crédito Agrícola de*

Cartago (Bancrédito),[25] are special commercial banks incorporated under public sector law. BP receives indirect state subsidies via mandatory deposits raised in the form of a 1.5 percent deduction from gross wage income in Costa Rica. These "social charge" deposits earn low interest and have a minimum holding period of 18 months, which gives BP a large deposit base at low cost. Despite their mandate to engage in development activities, public banks generally allocate credit on market terms. Roughly 80 percent of public bank assets are private sector credits and 95 percent of their security investments are in government debt.

73. **The strong market position of public banks reflects the legacy of four decades of a state-controlled banking system, even though there have been substantial reforms over the past 10 years.** The banking sector was a state monopoly until the mid-1970s. Since the 1980s, the system has undergone major structural changes and has been deregulated in an effort to improve efficiency in the provision of financial services.[26] In 1996, a new bank law (*Ley Orgánica del Sistema Bancario Nacional*, LOSBN) and a new central bank law (*Ley Orgánica del Banco Central de Costa Rica*, LOBCCR) were enacted as independent initiatives to reorganize the supervision of financial institutions, pension funds, and the securities market as well as monetary policy. According to the LOBCCR, the principal objectives of monetary policy are to contain the growth of monetary aggregates to levels consistent with the central bank's targeted inflation-based crawling peg rate policy and to foster a stronger net international reserve position.

74. **LOSBN also revoked the exclusive rights of the public banks to hold savings and current account deposits[27] and allowed private banks to expand their range of services and investment instruments offered to the public.** Nonetheless, public banks still capture most of the local deposits and control roughly 70 percent of the banking system's domestic assets.

75. **Profound financial sector reforms have fostered more efficient financial intermediation.** The growth of credit to the private sector from 23.1 percent of GDP in 2000 to 34.7 percent in 2005 testifies to the increased accessibility of the private sector to financial services as a result of the financial reforms. Nonetheless, credit to the private sector and deposit volume in the banking system are among the lowest in Central America,[28] while the annual lending increase slowed from 44.1 percent in 1999 to 16.2 percent in 2004. In 2005, there were 17 commercial banks, including three public banks, two specialized banks and nine

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[25] Bancrédito, the fourth largest public bank, specializes in financing for micro and small and medium-sized enterprises, and has recently entered into a strategic alliance with BCR.

[26] Law No. 71 (June 21, 1948) restricted financial intermediation only to public banks. The *Banco Central de Costa Rica* (BCCR) controlled interest rates and credit supply, and conducted monetary policy only through direct instruments, such as reserve requirements.

[27] Article 59 of LOSBN No. 1644.

[28] Panama has the highest degree of banking sector penetration in Central America, with a deposit volume of almost 70 percent of GDP, followed by Honduras and Nicaragua with deposit volumes of roughly 50 percent of GDP.

private domestic banks,[29] 28 savings cooperatives, and 53 investment funds and financial holding institutions, which are largely foreign owned. An increase in minimum capital requirements and a policy of attracting foreign capital have stimulated the consolidation of financial groups since 1996.

76. **Despite the dominance of public banks, offshore banking has helped private banks gain a significant market share over the last 15 years.** Private banks are growing in importance and now hold more than 35 percent of total bank assets (up from 12 percent in 1990) and about one-third of all bank deposits (up from 7 percent in 1990) in the domestic banking system. The growth of private banks is driven mostly by offshore deposits (mainly from domestic depositors).

77. **Offshore banking in Costa Rica is unusually large,[30] having grown rapidly in the initial stages of private banking in the 1970s in response to excessive regulation in the form of high unremunerated reserve requirements, and as part of efforts by private banks to find a competitive edge against public banks.** Initial financial sector reforms in the middle of the 1980s, such as the Structural Adjustment Programs (*Programas de Ajuste Estructural*, PAE), were insufficient to reverse the trend towards arbitrage-based offshore banking. Since the 1990s, however, the relative importance of offshore banks has declined as regulatory distortions to the domestic financial system have been corrected, and in light of efforts by the national financial supervisory agency (*Superintendencia General de Entidades Financieras*, SUGEF)[31] to expand its supervisory role to foreign investors in Costa Rica. The decline followed a substantial reduction in reserve requirements (to 9 percent at end-2001), concerns about the negative connotations of offshore banking, and aggressive competition in the dollar funding market by mutual funds and public banks. However, offshore banking in Costa Rica remains significant and roughly matches domestic credit origination and deposit-taking by private banks. Today, offshore banks still account for more than 20 percent of total banking system assets.

B. Structure and Composition of Public Debt

78. **The public debt structure has moved toward more standardization, increased funding from the private sector and reduced external borrowing by the central bank.** In 2005, Costa Rica recorded a total public debt of $10,006 million, of which more than 70 percent was held domestically. Of the domestic debt, two-thirds was denominated in local currency, of which 80 percent was issued by the government and the rest by the central bank. The remaining one-third was mostly in U.S. dollars, of which 52 percent was central bank

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[29] All private banks must be incorporated locally, but there are no restrictions on foreign investment in domestic financial entities. Several locally domiciled banks are foreign owned.

[30] Unlike the more typical offshore systems, Costa Rican offshore banks are licensed in foreign jurisdictions but conduct most of their deposit-taking and lending activities domestically. As opposed to onshore banks, which are legally allowed to take dollar deposits and make dollar loans, offshore banks are mainly used for tax avoidance and regulatory arbitrage.

[31] With the adoption of the LOBCCR in 1996, SUGEF replaced the *Auditoría General de Entidades Financieras* (AGEF), marking a shift from an auditing perspective to prudential supervision.

debt and the rest government debt. Of the external debt, almost 94 percent has been issued by the government. The external government debt amounted to $2,367 million at end-2005 (12.1 percent of GDP), down from $2,287 million at end-2004, of which 80 percent (9.7 percent of GDP) was U.S. dollar-denominated and carried low rollover risk. The government's debt structure is weighted toward privately-held bonds, with domestic lenders holding roughly two-thirds, or $4,822 million. Total outstanding government debt at end-2005 was $7,189 million, roughly unchanged from 2004 (Tables 7 and 8). Due to recently implemented austerity measures, the consolidated fiscal deficit was projected to drop slightly from 4.3 percent of GDP in 2004 to 3 percent in 2005.

Table 7. Costa Rica: Local Government Debt
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005
Private creditors	3,482.0	4,301.6	4,525.7	4,461.2	4,870.2	4,820.0
Bank loans	0.0	0.0	39.3	32.0	25.9	23.4
Bonds	3,482.0	4,301.6	4,486.4	4,429.2	4,844.2	4,796.6
Supplier's credit	-	-	-	-	-	-
Others (private)	-	-	-	-	-	-
Public creditors						
Central Bank (BCCR)	506.9	0.1	0.1	0.1	0.1	0.0
Others (public sector)	97.9	73.1	50.1	30.9	15.1	1.9
Total	4,086.8	4,374.8	4,575.9	4,492.2	4,885.4	4,821.9
Decomposition by currency	4,086.8	4,374.8	4,575.9	4,492.2	4,885.4	4,821.9
Denominated in local currency	3,630.0	3,694.7	3,654.3	2,930.2	2,902.5	2,488.7
Denominated in foreign currency	456.9	680.1	921.5	1,562.0	1,982.9	2,333.1
Decomposition by maturity	4,086.8	4,374.8	4,575.9	4,492.2	4,885.4	4,818.8
Short-term (org. maturity)	825.7	920.1	1,216.3	834.2	1,423.3	1,886.2
Medium-term (org. maturity)	614.5	610.8	603.5	950.3	1,539.8	1,201.4
Long-term (org. maturity)	2,646.7	2,843.9	2,756.0	2,707.7	1,922.3	1,731.3
Decomposition by interest rate	4,084.8	4,374.8	4,575.9	4,492.2	4,885.4	4,821.9
Variable interest rate	1,871.6	1,916.4	1,991.6	1,317.0	1,100.8	989.9
Fixed interest rate	1,477.5	1,294.4	1,606.6	2,152.8	2,755.8	2,875.3
Inflation-linked	735.8	1,163.9	977.7	1,022.4	1,028.8	956.7
Decomposition by standardization	4,086.8	4,374.8	4,575.9	4,492.2	4,885.4	4,821.9
Negotiable	1,409.6	2,098.1	2,276.5	2,439.2	2,980.2	3,160.1
Nonnegotiable	2,677.2	2,276.7	2,299.4	2,053.0	1,905.1	1,661.8

Sources: Ministry of Finance and Central Bank.

Table 8. Costa Rica: External Government Debt
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005
Foreign creditors	1,565.7	1,721.5	1,951.2	2,181.6	2,401.2	2,367.4
Official creditors	748.9	659.6	631.1	609.2	578.2	556.0
Bilateral	216.2	176.6	158.8	142.2	126.1	112.9
Multilateral	532.7	483.0	472.3	467.0	452.1	443.2
Others						
Private creditors	816.8	1,061.9	1,320.1	1,572.4	1,823.0	1,811.4
Bonds	750.0	1,000.0	1,250.0	1,500.0	1,750.0	1,750.0
Supplier's credit	66.8	61.9	70.1	72.4	73.0	61.4
Others						
Domestic creditors	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total	1,565.7	1,721.5	1,951.2	2,181.6	2,401.2	2,367.4
Decomposition by maturity	1,565.7	1,721.5	1,951.2	2,181.6	2,401.2	2,361.8
Short-term (org. maturity)	99.3	98.9	273.1	99.9	118.5	79.5
Medium-term (org. maturity)	518.2	497.0	250.7	485.3	783.0	757.1
Long-term (org. maturity)	948.2	1,125.7	1,427.4	1,596.4	1,499.7	1,525.2

Sources: Ministry of Finance and Central Bank.

79. **As in many Central American countries, the central bank carries a significant quasi-fiscal deficit and is undercapitalized.** Central bank debt has increased consistently over the years and climbed by more than 20 percent to more than $2.7 billion in 2005 due to a large local issuance of medium-term bonds. At end-2005, the domestic component, $2.55 billion, comprised mainly short- and medium term debt (Table 9), while the external component, $169 million, has been issued at long maturities (Table 10). In 2005, the total outstanding stock of central bank debt amounted to 13.9 percent of GDP, up from 9.0 percent in 2000.

80. **The Ministry of Finance (Ministerio de Hacienda) is planning to recapitalize the central bank, whose debt amounts to approximately one third of domestic public debt.** As a first step toward a more long-term solution, the finance ministry assumed $500 million of central bank debt in 2004. A full recapitalization of the central bank through the issuance of finance ministry bonds (three, five, and seven years) is expected in 2007 in accordance with the new public debt restructuring regulation (Reglamento a la Ley de Reestructuración de la Deuda Pública No. 30803-H). However, both public and private sectors appear to agree that this is only feasible if the planned fiscal reform is approved in 2006

Table 9. Costa Rica: Local Central Bank Debt
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005
Private creditors	1,443.4	1,540.1	1,902.8	2,149.7	2,006.1	2,550.1
Certificates	457.2	1,069.0	1,106.8	1,205.7	1,071.9	1,149.0
Short-term (org. maturity)	128.6	160.7	145.6	92.8	97.1	340.1
Medium-term (org. maturity)	328.6	908.3	961.2	1,112.9	974.8	809.0
Bonds	986.2	471.2	796.0	944.0	934.2	1,401.0
Short-term (org. maturity)	964.4	450.8	777.6	671.2	446.8	461.0
Medium-term (org. maturity)	21.9	20.4	18.4	272.8	487.4	940.0
Bank loans	0.0	0.0	0.0	0.0	0.0	0.0
Others (public sector)	0.0	0.0	0.0	0.0	0.0	0.0
Total	1,443.4	1,540.1	1,902.8	2,149.7	2,006.1	2,550.1
Decomposition by currency	1,443.4	1,540.1	1,902.8	2,149.7	2,006.1	2,550.1
Denominated in local currency	1,064.7	581.7	891.8	1,036.7	1,031.3	1,741.1
Denominated in foreign currency	378.7	958.4	1,011.0	1,112.9	974.8	809.0
Decomposition by maturity	1,443.4	1,540.1	1,902.8	2,149.7	2,006.1	2,550.1
Short-term (org. maturity)	1,093.0	611.5	923.3	763.9	543.9	801.1
Medium-term (org. maturity)	350.4	928.6	979.6	1,385.7	1,462.2	1,749.0
Long-term (org. maturity)	0.0	0.0	0.0	0.0	0.0	0.0
Decomposition by interest rate	1,443.4	1,540.1	1,902.8	2,149.7	2,006.1	2,550.1
Variable interest rate	228.8	908.3	961.2	1,112.9	974.8	809.0
Fixed interest rate	1,214.6	631.9	941.6	1,036.7	1,031.3	1,741.1
Inflation-linked						
Decomposition by standardization	1,443.4	1,540.1	1,902.8	2,149.7	2,006.1	2,550.1
Negotiable	1,215.1	1,379.4	1,757.2	2,056.9	1,909.0	2,210.0
Nonnegotiable	228.3	160.7	145.6	92.8	97.1	340.1

Sources: Ministry of Finance and Central Bank.

Table 10. Costa Rica: External Central Bank Debt

(In millions of U.S. dollars)

	2003	2004	2005
Foreign creditors	522.9	234.4	168.5
Public Creditors			
Official Creditors	308.8	234.4	168.5
Bilateral	113.8	93.8	81.6
Multilateral	195.0	140.6	87.0
Private creditors	214.1	0.0	0.0
Bank loans	0.0	0.0	0.0
Bonds	214.1	0.0	0.0
Supplier's credit	0.0	0.0	0.0
Others	0.0	0.0	0.0
Domestic creditors	0.0	0.0	0.0
Total	522.9	234.4	168.5
Decomposition by maturity			
Short-term (org. maturity)	0.0	0.0	0.0
Medium-term (org. maturity)	0.0	0.0	0.0
Long-term (org. maturity)	522.9	234.3	168.5

Sources: Ministry of Finance and Central Bank.

81. **The large stock of public debt highlights the urgency of comprehensive fiscal reform to curb further increases of public debt and to improve payments capacity. Interest payments on the public debt have absorbed an average of 4 percent of GDP over the past four years despite a policy aimed at reducing the debt service by improving the maturity profile of public debt.** The planned fiscal reform seeks to broaden the tax base by applying value-added tax (VAT) to products and services that are currently exempt and by introducing universal income taxation. However, the reform process has suffered lengthy delays and was recently turned down by the constitutional court. Notwithstanding the broad political consensus for recapitalization of the central bank and restructuring of public debt, uncertainties remain about the prospects for fiscal reform.

C. Primary Issuance

82. **There is a need to develop a structured and integrated strategy for comprehensive debt management and for deepening the local debt market.** The primary market is fragmented due to an excessive frequency of issuance, nonstandardization,[32] and continuous issuance through a post-auction window. Both the finance ministry and the central

[32] All domestically issued, U.S. dollar-denominated debt is standardized, while 58.5 percent of all local-currency-denominated debt is standardized.

bank issue similar debt securities and compete in the same maturity spectrum. Despite efforts to coordinate their debt issuance through the joint auction of some short-term instruments, the process of reconciling the fiscal funding needs of the finance ministry with the liquidity needs of the central bank is weakly formalized and lacks an integrated debt management strategy.

83. **But the overlapping primary issuance of public debt by both the finance ministry and the central bank also reflects a deeper problem of decapitalization and losses of the central bank.** Generally, the administration of liquidity operations by a decapitalized central bank creates substantial problems of rollover risk (if debt is issued at short maturity) or competition with government debt (if central bank paper is issued at longer maturity). Because of its negative capital and ongoing deficits, the central bank is compelled either to extend the maturity profile of its debt beyond one year or roll over a large volume of short-term debt. At the moment, the central bank issues more than one-third of its debt at maturities of more than one year (Table 11), while the finance ministry also issues government debt at short-term maturities and recognizes annual losses of the central bank through the issuance of nonstandardized bonds.

84. **The finance ministry and the central bank issue most public debt securities through a joint auction process.** Since the adoption of LOSBN in 1996,[33] the finance ministry and the central bank have jointly sponsored a biweekly discriminatory price auction of short-term, zero-coupon certificates, denominated in local currency,[34] and medium-term, amortizing fixed-rate bonds, denominated in either local currency or U.S. dollars (Table 12).[35] This competitive auction is open to both exchange brokers *(puestos de bolsa)* as well as financial intermediaries. The national stock exchange, *Bolsa Nacional de Valores* (BNV), operates the electronic trading platform for public debt securities with a payment and settlement cycle of T+2. After auctions close, a joint auction committee[36] of officials from both institutions decides on the distribution of successful bids between the finance ministry and the central bank; however, this process is administered without clearly specified rules.[37]

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[33] The current mode of public debt issuance was adopted after the central bank augmented mandatory reserve requirements by open market operations (OMOs) as a direct monetary instrument. In 1992, two forms of OMOs were introduced: the money market *(mesas del dinero)* and the auctions, with the latter having become the dominating instrument of monetary policy. In 1996, the central bank gradually started to reduce and standardize both the required reserve and the liquidity reserve requirements according to the *Guidelines of Monetary Policy Regulations* of February 16, 1996 in order to reduce the cost of financial intermediation. Since February 1, 2002, the legal reserve requirement and liquidity reserve have been set at 5 percent of total assets irrespective of maturity or currency denomination.

[34] Investment interest for these debt securities is mostly centered on issues with six-month maturity.

[35] Although longer maturities are possible (Appendix Table 1.7), the maximum maturity of these instruments to date has been five years.

[36] The *junta de subastas* consists of one representative of the central bank and two representatives of the finance ministry.

[37] Investors do not know ex ante whether they will ultimately receive debt payments from the finance ministry and the central bank. The maximum annual amount of funding to the two entities is restricted to the prorated

(continued…)

Table 11. Costa Rica: Outstanding Government and Central Bank Debt Securities, 2005

(In millions of U.S. dollars)

Issuer/Security	December 2005	In percent
Government/Ministry of Finance	4,821.9	100.0
Floating rate, local currency (Títulos de Tasa Básica)	926.0	19.2
Zero-coupon, local currency (TP Cero Cupón Colones)	580.8	12.0
Zero-coupon, US dollars (TP Cero Cupón Dólares)	13.5	0.3
Floating rate US dollars (TP Interés Variable Dólares)	956.7	19.8
Indexed (Título de Propiedad Unidades de Desarrollo)	63.9	1.3
Fixed-rate, US dollars (TP Interés Fijo Dólares)	646.6	13.4
Fixed-rate, local currency (TUDEB/TUDEM,TP Interés Fijo Colones)	1,609.2	33.4
Subtotal bonded debt	4,796.6	99.5
Central bank debt (local currency)	0.0	0.0
Class 374 FODESAF debt	0.0	0.0
Class 355 Social Security Debt	1.9	0.0
Housing bank debt (BANHVI)	23.4	0.5
Subtotal other debt	25.3	0.5
Central Bank	2,550.1	100.0
Zero-coupon Monetary Stabilization Bonds (BEM)	461.0	18.1
Fixed-Rate Monetary Stabilization Bonds (BEM)	940.0	36.9
Certificates of deposit, US dollars	809.0	31.7
Short-term certificates (Inversiones de corto plazo)	340.1	13.3

Sources: Ministry of Finance, Central Bank, and IMF staff calculations.

monthly fiscal budget and must be repaid within a year. Despite the same sovereign risk of debt issued by either the finance ministry and the central bank, this funding restriction might explain why market participants discern a pricing difference of up to 70 basis points between comparable issues (interest, maturity, and volume).

Table 12. Costa Rica: Securities Issued by the Ministry of Finance and the Central Bank

Security Type	Maturity	Currency	Interest	Placement - Auction	Pricing	Standard	Reopening	Tradability
Government (Ministry of Finance)								
Treasury bills	≤ 30 days	Colones	Zero	Individually negotiated	Individually negotiated	No	No	No
Zero-coupon (TPCER)	3, 6, 9, 12 months	Colones	Zero	Competitive	Discriminatory	Yes	Yes	Yes
Zero-coupon, US dollars	3, 6, 9, 12 months	U.S. dollars	Zero	Competitive	Discriminatory	Yes	Yes	Yes
Indexed (TUDEB/TUDEM)	2, 3, 5, 10, 20 years	Colones	Fixed	Competitive	Discriminatory	Yes	Yes	Yes
Fixed-rate, US dollars	2, 3, 5, 10 years	U.S. dollar	Fixed	Noncompetitive	Discriminatory	Yes	Yes	Yes
Floating, US dollars	1, 10, 15 years	U.S. dollar	Variable	Competitive	Discriminatory	No	No	Yes
Floating, local currency	1, 10, 15 years	Colones	Variable	Competitive	Discriminatory	No	No	Yes
Inflation Indexed	variable	Colones	Inflation-indexed	Noncompetitive	Individually negotiated	No	No	No
Central Bank (BCCR)								
Short-term certificates *(Inversiones de corto plazo)*	7, 15, 30 days	Colones	Fixed	Individually negotiated	Individually negotiated	No	No	Yes
Zero-coupon Monetary Stabilization Bonds (BEM)	3, 6, 9, 12 months	Colones	Zero	Competitive	Discriminatory	Yes	Yes	Yes
Fixed-Rate Monetary Stabilization Bonds (BEM)	2, 3, 5 years	Colones	Fixed	Competitive	Discriminatory	Yes	Yes	Yes
Floating-Rate Monetary Stabilization Bonds (BEM)	Variable	U.S. dollar	Variable	Individually negotiated	Individually negotiated	No	No	Yes
Certificates of deposit, US dollars	5 and 10 years	U.S. dollar	Fixed	Competitive	Discriminatory	Yes	Yes	Yes

Sources: Ministry of Finance and Central Bank.

85. **Almost all public debt instruments issued by the finance ministry and the central bank are similar in substance (Appendix Table 1.7).** The finance ministry issues (1) *títulos de propiedad cero cupón* (TPCER) (short-term, zero-coupon debt denominated in local currency); (2) *títulos de propiedad interés fijo colones* (TUDEB/TUDEM)[38] (medium-term, fixed-rate, denominated in local currency); and (3) *títulos de propiedad interés fijo dólares* (TP$) (medium-term, fixed-rate, denominated in U.S. dollars). The central bank issues (1) *bonos de estabilización monetaria colones* (BEM) (short-term, zero-coupon debt, denominated in local currency); (2) *bonos de estabilización monetaria interés fijo colones* (BEM) (medium-term, fixed-rate debt, denominated in local currency);[39] and (3) *certificados de depósito a plazo en dólares* (CDP) (medium-term, fixed-rate debt, denominated in U.S. dollars). The central bank securities are reopenings of existing series and represent the only standardized public debt issues in Costa Rica besides dollar-denominated zero-coupon certificates (TPCER) issued by the Finance Ministry.

86. **Both the finance ministry and the central bank also seek funding outside the joint auction.** Other government-issued securities are (1) very short-term, local-currency-denominated treasury bills (*pagarés del tesoro*) issued to public authorities and financial institutions;[40] (2) variable interest rate, medium-term bonds denominated in both U.S. dollars and local currency (*títulos de propiedad, interés variable dólares* and *títulos de tasa básica, interés variable colones*); (3) inflation-indexed development bonds (*títulos de propiedad en unidades de desarrollo*, TUDES), which are offered to nonfinancial public sector entities; and (4) dollar-denominated *títulos propiedad cero cupón* (TPCER) (short-term, zero-coupon finance ministry debt). Only the last government debt security is offered via a competitive auction, whereas treasury bills, bonds with variable interest, and TUDES are individually negotiated. The central bank also offers two other types of debt securities: short-term certificates *(inversiones de corto plazo)*, which are denominated in local currency; and fixed rate *bonos de estabilización monetaria interés variable dólares* (BEM), denominated in local currency and issued at variable maturity terms.

87. **In addition to the competitive auction, the finance ministry operates a noncompetitive auction window and separate issuance arrangements with nonfinancial institution as alternative channels of government funding.** During the period between two competitive auctions, the finance ministry occasionally offers the same instrument noncompetitively to both private and public financial entities through an electronic window at a uniform price with a spread level of approximately 20 basis points lower than the secondary market rates.[41] This auction picks up an average of 30 percent of available public debt that has

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[38] The classifications TUDEB ("fiscal") and TUDEM ("macroeconomic stabilization") distinguish U.S. dollar-denominated Finance Ministry debt by purpose of issuance.

[39] The auction of BEMs establishes the discount rate *(tasa monetaria)* with which the central bank intervenes in the money markets. An alternative central bank rate is the *tasa basica*, which is the weighted average of the 180-day deposit interest rate of six public and private banks and previous BEM auctions.

[40] This new instrument was created by *Decreto Ejecutivo No. 32097-H* (November 2, 2004).

[41] This window was offered eight times in 2005.

not been accommodated in the competitive auction process.[42] Furthermore, the finance ministry routinely offers nonstandardized, inflation-indexed development bonds (TUDES) to nonfinancial public entities via the *Caja Única de la Seguridad Social*, which is a general fund in charge of administering the demand of state agencies and public sector entities for medium- and long-term government debt. Private pension funds, whose investments are mostly buy-and-hold, also frequently negotiate the purchase of nonstandardized, long-term, inflation-indexed bonds from the government. The spreads of these bilaterally negotiated, nontradable instruments are approximately 100 basis points lower than the secondary market rates. They are not subject to specific regulations, vary greatly in terms and conditions, and add to the stock of nonstandardized public debt ($2,002 million or 10.2 percent of GDP).

88. **The auction results of medium-term debt issued by the finance ministry and the central bank indicate that both issuers pay a substantial risk premium over other benchmark interest rates.** The central bank raises funds more cheaply at shorter maturities, while debt securities issued by the finance ministry at longer maturities attract a lower risk premium (Table 13). Both sovereign issuers also paid significant inflation-adjusted premia (230–450 basis points) over comparable U.S. government securities. In 2005, short-term BEMs (with a maturity term of 15 months) were issued at a mean spread of 240 basis points over the bank deposit rate at the time of the primary market auction, while *títulos de propiedad* of the finance ministry were auctioned at spreads of around 290 basis points.

89. **The liquidity premium for medium-term issues varies between 100 basis points (in the case of central bank debt) and 200 basis points (in the case of government debt) for public debt at a maturity term of five years.** A closer inspection of primary market auction results reveals a small dispersion of offered interest rates by successful bidders. However, this high degree of convergence to a uniform price is not due to efficient price discovery, but reflects price concentration at low allocation rates. Moreover, these findings do not indicate a scarcity of public debt, which might otherwise spawn lower spreads in response to large demand from institutional investors.[43]

90. **The ability of the central bank to administer monetary transmission continues to be plagued by structural deficiencies.** Comprehensive financial reforms in the 1990s strengthened monetary policy to support a sustainable inflation-based crawling peg rate policy. However, the central bank has been almost exclusively a seller of securities due to the funding requirements of its quasi-fiscal deficit. Moreover, the large deposit base of the three public banks, which comprise 75 percent of participation in the money markets, and the

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[42] A small allocation to competitive bidders at a high cutoff rate and a significant noncompetitive allocation in the window could be motivated by information extraction from the highest bidding (mostly public) banks at the lowest possible allocation. If the allocated amount consistently exceeds the originally planned issuance volume, larger public debt supply would lower future auction prices relative to requested demand unless over-allocation leads to reduced future issuance.

[43] Pension funds and insurance companies hold a significant share of their reserves in public debt due to regulatory requirements.

fragmentation of the money market into repos,[44] interbank OTC, and exchange-based trading of BEMs, makes it difficult for the central bank to transmit its monetary policy to the market.

Table 13. Costa Rica: Comparative Rates of Return of Public Debt Issues in 2005
(In percent)

Issuer	**Central Bank**		**Government**	
Security [Name]	BEM		Títulos de Propiedad	
Maturity (months)	15	60	20	60
(1) Cut-off price				
Last	15.5	17.5	16.0	17.0
Mean	15.4	17.2	16.0	17.0
(2) Bank deposit rate				
Mean	13.1	13.1	13.1	13.1
(3) International reference rate (U.S.)				
Mean	5.2	4.8	4.7	4.8
(1) - (2): Spread (over bank deposit rate)[1]				
Mean	2.4	4.4	2.9	3.9
(1) - (3): Spread (over international reference rate)[1]				
Mean	**2.3**	**4.5**	**3.4**	**4.3**

Source: IMF staff calculations.
[1] We also have taken account of the inflation rate differential between Costa Rica and the United States, which amounted to 7.85 percent on average in 2005.

D. Secondary Markets for Public Debt

91. **Following a merger of two stock exchanges in 1999, the BNV became the sole stock exchange in Costa Rica.** It is the largest exchange in Central America in terms of market capitalization, although small by international standards. Almost all capital market transactions are executed using the trading facilities of the stock exchange. According to Article 23 of the *Ley Reguladora del Mercado Valores* (LMV), No. 7732 (August 11, 1997)[45]

[44] In Costa Rica, the term repo actually denotes a *recompra* transaction, in which the underlying securities are deposited as collateral in a BNV-administered trust account created for this specific purpose. Because the transfer of funds is legally considered a loan and not a true sale of funds and securities, the reserve requirement applies to commercial banks but not broker/dealers. Hence, banks effect regulatory arbitrage by channeling their repo business to their broker/dealer subsidiaries in the stock exchange. The central bank is in the process of adopting the universal convention of treating repos as sales of funds and securities.

[45] The LMV replaced the *Comisión de Valores* by the *Superintendecia General de Valores* (SUGEVAL), which reformed the prudential supervision process and established the national securities exchange commission, the *Comisión de la Bolsa Nacional de Valores* (CBNV). The LMV also created the *Consejo Nacional de Supervision del Sistema Financiero* (CONASSIF) as the formal coordinator for the regulatory activities of SUGEF, SUGEVAL, and the *Superintendencia de Pensiones* (SUPEN).

all publicly offered securities (including repos) must be traded exclusively via registered brokers.[46]

92. **BNV operates a dedicated trading platform for public debt securities.** The LMV requires all publicly traded securities to be exchange-listed within the interbank electronic clearing and payment system, the *Sistema Interbancario de Negociación y Pagos Electrónicos* (SINPE).[47] The trading platform for the primary auction trades not only public securities every 14 days (according to the public auction schedule), but also short-term securities (e.g., certificates of deposit) issued by financial institutions on a daily basis. Settlement takes place in Box 1.

Box 1. Electronic Trading Platforms in Costa Rica

The BNV operates different electronic trading platforms for stock exchange transactions. Besides the trading platform (*subasta primaria*) for public debt securities and short-term securities issued by financial institutions, the BNV also operates a separate trading platform for stocks and standardized debt securities (with a settlement cycle of T+3 for stocks and T+1 for standardized debt securities, e.g., international bonds, mainly U.S. dollar-denominated Eurobonds issued domestically).

For money markets, the BNV administers two trading systems that have experienced significant increases in total traded value in recent years. Spot and forward transactions as well as repos are executed via the TEBEL system (with a settlement cycle of T+1). Overnight repos with the finance ministry and the central bank securities trade in the *Mercado de Liquidez* (which operates from 11.30 a.m. to 12.30 p.m. and settles in T). Moreover, the *Instituto Centroamericano de Finanzas y Mercado de Capitales* (ICAF), which in turn is owned by the BNV, operates the Interbank Money Market (*Mercado Interbancario de Dinero*, MIB). Participation is restricted to banks and the central bank, which trade without intermediation of a broker/dealer and subject to terms and conditions stipulated by the central bank for ICAF activities. Repos and outright loans with a maximum maturity of 30 days may be traded in this system. Settlement is gross, in real time, and takes place through the reserve accounts the banks maintain at the central bank.

Up until November 1998, the BNV also operated a foreign exchange trading platform (MONED), which was used for real-time gross settlement (RTGS) on a payment versus payment (DVP) basis before transactions were settled through the SINPE. The central bank regulates and controls the clearance and settlement system of foreign exchange trading.

93. **Secondary market trading is dominated by repo and outright transactions in public securities.** Secondary trading (without exchange-based primary issuance) at the BNV has increased steadily from $23.8 billion to $29.4 billion over the last five years (Table 14). In 2005, debt securities issued by the finance ministry and the central bank represented almost 87 percent of the total value traded in outright and repo transactions. Repo transactions (on

[46] Only bonds issued by entities under the supervision of SUGEF are also traded over the counter (Article 10 of LMV).

[47] SINPE was created in 1996 after the adoption of LOBCCR. Every financial institution in Costa Rica may access SINPE, which completes payments and securities clearance and settlement operations through reserve accounts. Currently, approximately 65 institutions participate in SINPE, including all private and public banks, several brokers, all nonbank financial entities, all mortgage companies, and the biggest savings and loans cooperatives, which represent 95 percent of the cooperative sector. Nonfinancial public entities connected to SINPE are the Ministry of Finance, CCSS, and the state-owned *Instituto Nacional de Seguros* (INS).

Table 14. Costa Rica: Secondary Trading of Domestic Securities in 2005
(In millions of U.S. dollars)

	2001	(In percent)	2002	(In percent)	2003	(In percent)	2004	(In percent)	2005	(In percent)
Repo	13,888.9	58.5	15,456.6	60.4	18,658.9	63.7	19,138.8	63.3	19,527.5	66.5
Outright	5,351.8	22.5	4,600.7	18.0	5,887.6	20.1	6,302.3	20.9	4,881.4	16.6
Equity	124.4	0.5	81.4	0.3	35.0	0.1	44.8	0.1	27.8	0.1
Others	4,387.0	18.5	5,470.6	21.4	4,733.2	16.1	4,730.9	15.7	4,919.3	16.8
Total	**23,752.1**	**100.0**	**25,609.3**	**100.0**	**29,314.7**	**100.0**	**30,216.8**	**100.0**	**29,356.0**	**100.0**

Sources: Ministry of Finance, Central Bank, Stock Exchange Superintendency (SUGEVAL), National Stock Exchange (BNV), and IMF staff calculations.

both private and public debt securities) constitute the largest money market[48] and amount to about 67 percent of the total trading volume. Given the large share of repo operations of maturities up to seven days in recent years, much of the secondary market trading seems to be liquidity-driven.

94. **Partly due to the small size of the country and concentrated ownership patterns, the market for private securities is undeveloped.** The lack of a long-term public debt yield curve makes it difficult to obtain long-term, capital market-based financing, allowing banks to dominate both medium and long-term lending and secondary market activity through their own brokerage houses. Long-term capital market finance for corporate investment is also largely absent, as local corporations seem to prefer the more limited information disclosure needed for private bank lending. There is only a handful of private debt securities, mainly issued by the financial sector, with limited trading. Corporate bonds and equities are almost absent in the secondary market and represent merely 0.2 and 0.1 percent of the total trading volume. Besides some conventional capital market-based debt finance, the secondary market activity involves money market transactions only.[49]

[48] The money markets of Costa Rica are composed of (1) the *recompra* (or repo) market; (2) the *Mercado de Liquidez*, an overnight recompra market, based on the *Bono de Estabilización Monetaria* (BEMs) as collateral, which is also operated by BNV; (3) the *Mercado Interbancario* (MIB), an informal OTC telephone and/or computer screen market banks use to adjust their liquidity after the *Mercado de Liquidez* has closed; and (4) the *Sistema de Inversiones de Corto Plazo* (ICP) operated by the central bank, where commercial banks can place deposits for 7, 15, and 30-day periods; and (5) the joint auction of short- and medium-term fixed-interest-rate or zero-coupon debt by the finance ministry and the central bank.

[49] The envisaged adoption of the old 1988 Basel Accord for capital requirements of credit risk (from January 1, 2007 onward) will imply a 10 percent risk-weighting on dollar-denominated public debt (up from 0 percent). SUGEF expects that this move might spur higher demand for alternative debt instruments, such as investment-grade corporate bonds.

95. **Fragmented and volatile primary issuance of public debt, a short-term sovereign yield curve, and a very liquid public banking sector hinder secondary market deepening.** Both the finance ministry and the central bank issue public debt securities in small amounts, at high frequency and short maturities within a joint auction process, which is dominated by public banks. Additionally, fluctuations of public debt supply in the primary market precludes sufficient market volume of the same issue type for secondary trading. Issuance through post-auction windows in the primary market creates nonstandardized issues, which exacerbate the problem. Moreover, the small volume of retail investment in capital markets restricts the lending width.

E. Investor Universe and Regulation of Investments in Public Debt

96. **Nonfinancial investors and banks are the most important investors in public debt.** Nonfinancial private and public investors hold 35.6 percent (or $1,786 million) and 24.7 percent (or $1,241 million), respectively, of locally issued, bonded public debt (Table 15), followed by banks and quasi-banks, which hold 24 percent (or $1,206 million). Banks capture about 80 to 85 percent of the primary market issuance,[50] which constitutes roughly 90 to 95 percent of their security investments. Private banks receive a far smaller allocation of public debt in the primary market than their share in the banking system. Other important institutional investors are pension funds, which hold 5.3 percent of the total amount of outstanding debt. Following a severe mutual funds crisis in 2004 (which also affected investment in pension funds),[51] investment funds in Costa Rica have been gradually regaining depositor confidence.[52]

F. Problems and Recommendations

Primary Issuance

97. **The functioning of the primary market for public debt suffers from the lack of a structured and integrated strategy for comprehensive debt management.** Joint debt issuance by the finance ministry and the central bank is inefficient and contravenes a clear separation of fiscal and monetary policy. Although the authorities justify the current auction system on the grounds of more efficient management, coordination, and greater

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[50] According to SUGEF, the competitive advantage stemming from state guarantees to public banks is a much more pressing political and economic issue than the pricing advantage such guarantees offer public banks in the primary market.

[51] The supervisory agency for pensions, SUPEN, was created by the Law for the Private Regime for Complementary Pensions (Ley No. 7523 of August 18, 1995). SUPEN authorizes and regulate private plans and systems for complementary pensions and individual savings.

[52] Between April and May 2004, mutual funds in Costa Rica lost $1.5 billion (or 50 percent) of their marked-to-market aggregate investments and $300 million (or 50 percent) of their scheduled investor deposits due to spread compression in fixed-income markets. The resultant loss of investor confidence made investors return to short-term bank savings, mostly certificates of deposits. The crisis has also been exacerbated by the indirect market access of institutional investors to the primary public debt market.

Table 15. Costa Rica: Investor Breakdown of Public Debt (2000–05)
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005
Domestic investors	4,523.2	4,209.1	4,652.0	4,690.9	4,861.0	5,019.4
Banks and quasi-banks	745.9	598.4	1,053.9	1,052.6	1,394.2	1,206.0
Insurance companies	270.3	323.7	296.4	261.0	327.6	445.3
Pension funds	225.1	266.0	238.7	223.2	267.7	263.7
Central Bank (BCCR)	617.6	114.3	102.0	92.3	84.2	77.6
Nonfinancial public sector	1,159.4	1,295.1	1,174.0	1,103.2	1,157.4	1,241.3
Nonfinancial private sector	1,505.0	1,611.6	1,787.0	1,958.6	1,629.9	1,785.5
Foreign investors	116.1	83.3	50.5	15.9	0.0	0.0
Total	4,639.3	4,292.4	4,702.5	4,706.8	4,861.0	5,019.4
Memorandum item:						
Exchange rate (colones in U.S. dollars)	318.0	341.7	378.7	418.5	458.6	497.7

Sources: Ministry of Finance, Central Bank, Stock Exchange Superintendency (SUGEVAL), National Stock Exchange (BNV), IMF staff calculations.

standardization of short-term public debt supply, the process of reconciling fiscal funding of the finance ministry with the monetary policy of the central bank is weakly formalized and fails to redress the decapitalization of the central bank as a major source of inefficiency. The funding of the central bank's long-term deficits requires the bank to extend the maturity of its debt issuance beyond one year in order to mitigate its rollover risks.

98. **Fragmented public debt issuance hinders efficient price discovery by market participants.** Besides opaque allocation rules between the finance ministry and the central bank, the high frequency of issuance, a wide variety of debt instruments, significant nonstandardization of public debt, and the continuous issuance through a post-auction window have fostered inefficient price formation in the primary market. Frequent auction failures and the substantial influence of public sector investors in determining the auction rate are two examples of a malfunctioning auction process. Moreover, otherwise identical central bank and government debt issues trade at different prices.

99. **Remedial measures would include recapitalization of the central bank, the cessation of joint auctions, and the extension of the maturity profile of government debt.** The timely and complete recapitalization of the central bank would allow the bank to conduct monetary policy operations using a stock of government debt. In the interim, the efficient execution of monetary policy and the effective funding of fiscal needs require an increasingly clear delineation of debt issuance by the central bank and the government at different maturities and possibly through distinct auction processes. The finance ministry needs to extend the government debt yield curve by issuing tradable, long-term debt securities in higher volumes in order to "populate" the yield curve, while slowly phasing out short-term debt. Although the profile of debt issued by the finance ministry has gravitated toward longer

maturities since 2003,[53] more efforts are required to develop a clear demarcation of maturity profiles of debt issued by the finance ministry and the central bank.

100. **There is a need to eliminate issuance of nonstandard debt and convert the existing stock of such debt into standard instruments to foster secondary market liquidity.** Almost half of all newly issued government debt is still nonstandardized. There is also a need to convert most of the existing stock of nonstandardized debt into negotiable obligations in order to improve secondary market trading and foster efficient price discovery.

101. **The dominance of public banks in the primary market and the price distortions of nonstandardized debt issuance outside the auction process call for further financial reform.**[54] In light of persistent structural distortions imposed by state-owned banks and suboptimal cross-financing between the finance ministry (which benefits from high auction prices offered by public bidders) and public banks (which receive state guarantees and transfer payments), the authorities should consider a fair-value-based charge for the state deposit guarantee. Moreover, the current issuance of TUDEBs to nonfinancial public entities at below-market spreads effectively amounts to a government subsidy of the social security system. This observation is particularly important considering that pension system liabilities already represent a contingent liability of about 13 percent of all assets in the domestic financial system.

Secondary Market

102. **Short-term public debt supply and investor uncertainty in the primary market inhibit secondary market development.** Piecemeal primary issuance at high frequency and short maturities thwarts profitable market-making of public debt securities. Variable debt supply due to unexpected changes from the originally-announced auction volumes and large allocations to public sector banks, which tend to hold public debt until maturity, limit the deepening of secondary market trading of public debt. Post-auction windows of residual public debt stocks in the primary market create nonstandardized issues, which exacerbate the problem. Moreover, secondary trading of public debt must by law take place at the stock exchange, which perpetuates the fragmentation of money markets and efficient information dissemination across the financial system.[55]

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[53] The finance ministry acknowledges the problem of a weakly developed sovereign yield curve and has set its sight on local-currency-denominated debt with maturities of three, five, and six years. Medium-term local-currency-denominated and long-term U.S. dollar-denominated finance ministry debt recently have received renewed investor interest.

[54] The viability of plans to promote further deregulation of the financial system, such as the reorganization of the public banking system, will hinge on the timely approval of the fiscal reform package.

[55] The recent move by the central bank to invite institutional investors (pension funds, mutual funds, etc.), in addition to banks and broker/dealers, to the biweekly auctions of BEMs represents an expedient measure to redress some of the negative effects of fragmented money markets on monetary policy.

103. **The authorities may want to consider issuance in local currency debt to foreign investors as another means to jump start the development of the local debt market.** Given the large fragmentation of domestic debt issuance and the presence of nonstandard and poorly traded debt, the local market lacks a reliable benchmark yield curve. While working gradually to move the domestic public debt structure toward more standardized and market-determined debt, the finance ministry might also consider borrowing in local currency from foreign investors as one way to establish a large and long maturity benchmark issue quickly that can in turn firmly anchor the yield curve and guide future issues targeted principally to domestic investors. The examples of Brazil, Colombia, and Mexico may be useful in this regard. Some of the essential requirements for external borrowing in local currency are already in place, such as a healthy level of NIRs in 2005 and an established local and foreign investor base.

III. The Public Debt Market in the Dominican Republic[56]

104. **The Dominican Republic is rebounding from the severe banking crisis of 2003** that led to recession, high public indebtedness, inflation, and currency depreciation. Following prudent fiscal and monetary policies and reforms since 2004, the economy has turned around and investor confidence has returned. Real growth has continued at a fast pace and underlying inflation remains low despite the adverse effect of the oil price shock. Real GDP grew by 9.3 percent in 2005 and end-year inflation stood at 7.4 percent, while the external current account recorded a deficit of 0.5 percent of GDP.

105. **The country's financial system is still underdeveloped.** Banks are the most important intermediaries. While total banking assets and deposits have recovered from the steep declines during the crisis, financial penetration has fallen by nearly one-third since then. The ratio of total assets to GDP was 37 percent in 2005 compared with 53 percent in 2003 (Table 16). Capital markets are largely underdeveloped. Pension fund assets account for only about 3 percent of GDP. There are seven insurance companies. Mutual funds are not in operation yet.

106. **Several initiatives have been undertaken in recent years to foster the development of a local capital market.** In 2000, the Securities Market Law created the securities regulator. In 2001, the Social Security Law created private pension funds based on individual accounts. Both the Securities Market Law and the Monetary and Financial Law of 2002 *(Ley Monetaria y Financiera No.183–02)* envision the creation of a market for asset-backed securities.

[56] The principal author of this Chapter is Iván Guerra.

Table 16. Dominican Republic: Structure of the Financial System

	2000	2001	2002	2003	2004	2005
Number of:						
Banks	16	13	15	14	14	13
Official	2	2	2	2	2	2
Domestic-majority owned	12	9	11	9	9	8
Branches of foreign banks	2	2	2	3	3	3
Pension funds			9	9	9	7
Financial system indicators (In millions of U.S. dollars)						
Bank assets	8,299	10,131	9,768	7,357	9,816	10,009
Private credit	4,507	5,619	5,410	4,003	4,395	4,393
Total deposits of banking system	5,756	7,361	6,955	5,685	7,909	8,144
Investment in goverment securities	1	89	70	38	92	117
Investment in central bank securities	13	2	102	541	1,021	912
Deposits (percent of assets)	72	76	74	80	84	81
Investment in goverment securities (percent of assets)	0	1	1	1	1	1
Investment in central bank securities (percent of assets)	0	0	1	8	11	9
Pension funds assets					354	880
(In percent of GDP)						
Bank assets	41.9	46.7	45.0	44.3	52.6	34.1
Total deposits of banking system	29.0	34.0	32.0	34.2	42.4	27.8
Investment in goverment securities	0.0	0.4	0.3	0.2	0.5	0.4
Investment in central bank securities	0.1	0.0	0.5	3.3	5.5	3.1
Pension funds assets					1.9	3.0
Memorandum items:						
GDP (in millions of U.S. dollars)	19,815	21,680	21,715	16,626	18,653	29,333
Exchange rate (RD peso per U.S. dollar)	16.5	17.0	20.8	37.1	30.4	34.7

Source: Superintendencia de Bancos.

107. The improved macroeconomic outlook and debt restructuring has left the government with room to establish itself as a conventional issuer of public debt. Public debt increased sharply during the 2003 financial crisis as a result of significant liquidity advances by the central bank during the crisis, a build-up of arrears, and new borrowings from both official and private creditors. Agreements were signed in October 2005 with the London Club and other commercial banks to reschedule principal falling due in 2005–06 and clear outstanding arrears. The Paris Club rescheduled pre-cutoff date obligations maturing in 2005. These developments have permitted the government to rebuild its access to external debt markets. Indeed, in March 2006, the government placed a successful sovereign bond issuance, its third since 2001 (Table 17), issuing 20-year bonds at 8.6 percent to buy back its debt to Union Fenosa, a Spanish gas and electricity company. However, government access to the domestic debt market has been very poor. The central bank is the most important domestic sovereign issuer, managing a debt stock of about 15 percent of GDP originally issued to absorb the liquidity injection during the crisis.

Table 17. Dominican Republic: Public External Debt
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005
Foreign creditors	3,685	4,177	4,459	5,987	6,380	5,790
Official creditors	2,987	3,018	3,231	3,676	4,123	3,985
Bilateral	1,744	1,677	1,789	1,983	2,133	2,271
Multilateral	1,243	1,341	1,443	1,692	1,991	1,714
Others						
Private creditors	698	1,159	1,227	2,312	2,257	1,805
Bank loans	657	630	705	803	781	318
Bonds	-	500	500	1,100	1,100	1,149
Supplier's credit	41	29	23	409	376	338
Total	3,685	4,177	4,459	5,987	6,380	5,790
In percent of GDP	19	19	21	36	34	20
Memorandum item:						
GDP (in millions of U.S. dollars)	19,815	21,680	21,715	16,626	18,653	29,333

Source: Central Bank "Informe de la Economía Dominicana."

A. Structure and Composition of Public Debt

108. **There have been important organizational weaknesses in the public debt management function in the Dominican Republic.** These include significant problems in budgetary management, cash forecasting, decentralized and loose control over expenditure of different ministries and public agencies, and eventual failures in making timely payment to creditors and suppliers. The Department of Public Credit serves as a back office, while the Treasury carries out operational functions. As part of a comprehensive fiscal reform supported by the International Monetary Fund, the authorities are implementing a reorganization of the ministries of finance and of economy and planning. Treasury and public debt management practices are being upgraded with technical assistance provided by the IMF. Further reforms entail establishment of a single treasury account, legislation aiming at unifying fiscal functions and public investments, rationalization of procurement policies, and programs to verify stock of arrears and monitoring and prevention of future arrears. These inherited problems have significantly limited access to domestic debt market and influenced the current structure of government debt.

109. **The reorganization and strengthening of the Ministry of Finance is already on its way.** As of January 2006, a new law has created the new Public Credit system. This system will be responsible for establishing the financing needs of the public sector and its debt ceilings, identifying the appropriate operational avenue, capturing the required resources, applying them for specific needs and efficiently servicing all debt payments originated from said operations. This new law aims towards a more centralized public debt management.

B. Primary Market for Sovereign Debt

110. **The domestic public debt market is still at an incipient stage characterized by few issues in domestic currency.** The main issuers are the government and the central bank. Of the two public issuers, the Central Bank is perceived as a more credible institution than the government, despite its long history of deficits. Thus, the central bank instruments enjoy high local retail and institutional demand.

111. **Poor budget, cash, and debt management practices have prevented the government from developing normal access to domestic bond markets.** As of December 2005, 73.8 percent of the government's domestic debt was in the form of loans from the banking system, while only 26.2 percent was in the form of government securities. The outstanding domestic government bonds amounted to RD$8.7 billion (US$249.3 million). These outstanding domestic bonds are not usual issues of bonds to investors, but rather direct placements (e.g., to suppliers in lieu of arrears or to recapitalize public banks) that take place over a period of time. Moreover, each such government issuance has been authorized by the Congress under a very specific law, as described below, which sets absolute issuance ceilings and very specific terms and restrictions. This issuance process has thus created uncertainties about the government as a borrower in the domestic capital markets, and caused significant problems of market access and cost differential relative to the central bank. The legal uncertainties surrounding the validity of some of the government bonds and resulting delays in repayment have further weakened the government's status as a domestic debt issuer.

112. **The Bond 104–99 was issued by the first Fernández administration to redress accumulated government obligations—to government contractors, for land expropriations, and for other purposes—that originated as far back as 1996** (see Box 2). The bond was first issued in November 1999 as a deeply discounted, six-year bond. As the bond approached maturity, many of the underlying claims of the original bondholders were challenged as fraudulent or overstated and certain validation requirements were imposed regarding the underlying claim. This resulted in significant confusion and a slowdown of the repayment process, as well as some complex legal issues arising from the transfer of bonds from original holders to current holders. An ensuing judicial injunction stopped all payments on the bonds, and bondholders are still being repaid on a case-by-case basis. While the government had the means to repay this bond and deposited appropriate amounts with the payment agent, this legal delay in payment has created the perception of a "technical default" that has added to the credibility problems of the government.

113. **The Bond 172–3 was issued under the Mejía administration and was directed toward rescheduling and consolidating government debt to the Banco de Reservas and Banco Agrícola.** A total of RD$4.7 billion was issued of an authorized RD$ 5.1 billion. The six-year issue paid a fixed interest indexed to the devaluation rate and was deeply discounted. It was dematerialized but hard to trade and held at the Banco de Reservas. All trades so far have been over-the-counter transactions and banks generally do not even accept this bond as collateral. Currently the issue has around 200 certified holders, so legal problems are not anticipated, but in light of the Bond 104–99 experience, it would be worth assessing all potential legal issues well before the bond matures.

114. **Bond 121-05 was issued in October 2005 to recapitalize the central bank and the Banco Reservas.** The separate 10-year issues amounted to RD$2.3 billion and RD$1.5 billion, respectively, at an inflation-adjusted real rate of 2 percent.

Box 2. The Repayment of Bond 104–99

Law 104-99 authorized an issuance of up to RD$5 billion as a way of paying past government obligations. The first bonds were issued on November 2, 1999. As of August 2005, only RD$3.6 billion had been issued, given problems in certifying the government debt.

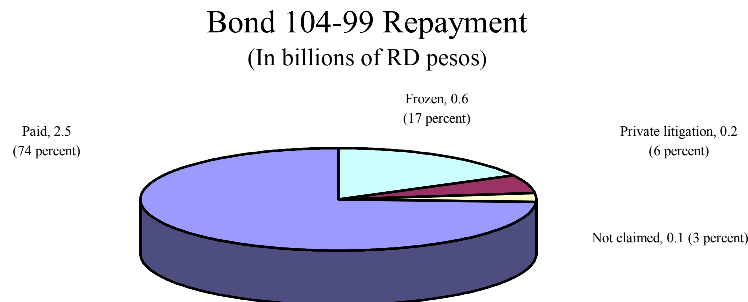
The incoming administration was prepared to honor the principal repayment obligation falling due on November 9, 2005. However, payment on certain series of the bonds was barred at the treasury by the order of a judge acting on allegations that some of the bonds had been used to pay for overvalued land expropriations and thus were invalid. The problem series amounted to RD$568 million. According to the judge, one of the original bond recipients had been paid RD$325 million in bonds for land worth only RD$33 million. In another case, the government paid RD$243 million in bonds when the land was only appraised at RD$38 million.

Compounding the legal problems, the treasury also faced private litigation on another bond series for an estimated RD$200 million. An additional RD$100 million had not been collected by the holders. These factors resulted in about RD$886 million of unpaid bonds. On the other hand, about 2,537 million pesos or 71.2 percent of the outstanding bonds, had actually been paid.

As of December 2005, the Public Ministry in charge of the investigation had already verified that RD$9.7 million worth of bonds were in the hands of third-party buyers who had bought the bonds "in good faith" in the secondary market. However, RD$568 million were still frozen and under investigation, highlighting a painstakingly slow payment process.

The government has argued that the episode should not be viewed as a credit event but as a legal impediment to its honoring the debt, since its full payment was already appropriated in the 2005 fiscal year budget. Currently this issue has completely been paid.

Bond 104-99 Repayment
(In billions of RD pesos)



Source: Secretaría de Estado de Finanzas.

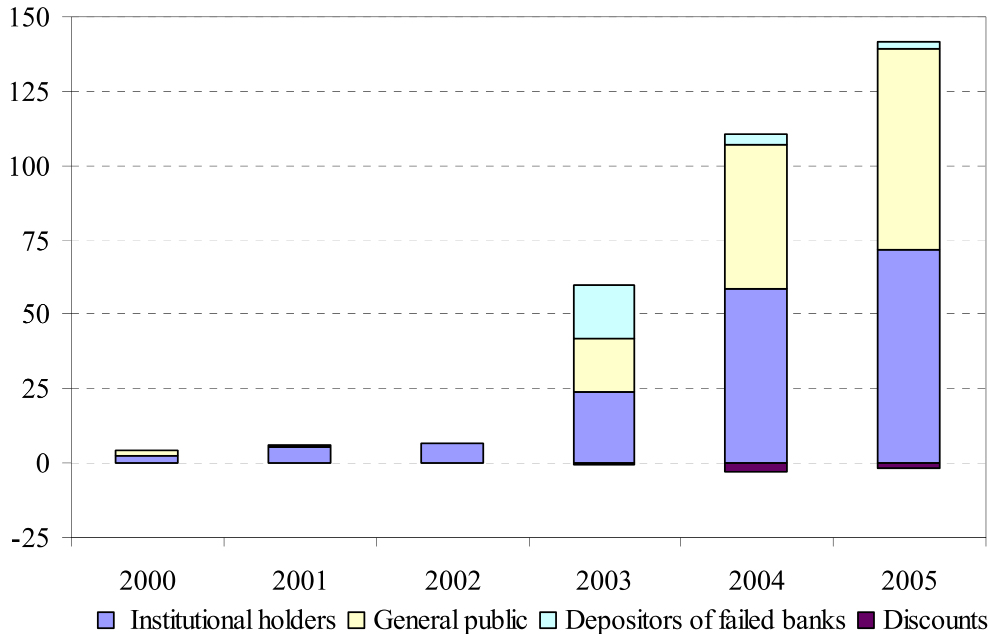
115. **Two more bond issues were authorized to be placed in 2006:** Bond 119–05 to repay supplier arrears, and Bond 120–05 to raise budget financing (originally intended to help repay amortizations under Bond 104–99). The latter two laws authorize for the first time the issuance of dematerialized bonds, but their placement has not taken place..

C. Central Bank Issues and the Quasi-Fiscal Deficit

116. **The central bank has a long history of operational deficits.** At the end of 2000, the monetary authority approved a plan to refocus the central bank functions to its core mission and reduce its debt. Outstanding Central Bank Participation Certificates mostly in the hands of the general public, were not to be rolled over and new issuance stopped. The goal was partially achieved in 2001 (Figure7), but in 2002, a restrictive monetary policy environment forced the central bank into issuing new Central Bank Special Participation Certificates, this time aimed primarily at institutional investors.

Figure 7. Central Bank Securities by Holder

(In billions of RD pesos)



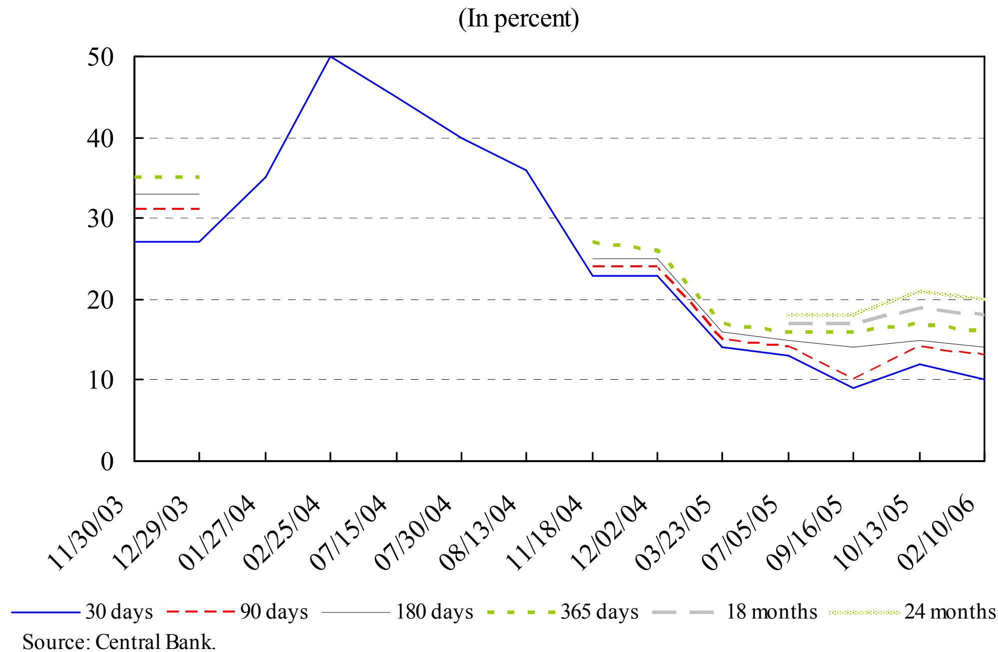
Source: Central Bank.

117. **The 2003 banking crisis wielded a further blow to the recapitalization plans**. The BCRD provided significant liquidity to banks in distress as lender of last resort and later served as deposit insurance agency to rescue depositors from the failed banks. To counter the expansion in the money supply, it offered deposits through three separate mechanisms, including direct window (38 percent), competitive auction (32 percent) and directly to depositors of failed banks (30 percent). The differences in the investor base in these windows and restrictions on tradability allows the central bank somewhat greater control over money supply and interest rates, but also segments the sovereign debt market. Interset rates jumped

from around 34 percent in August 2003 to 50 percent by February 2004. The high rates compounded the central bank debt and increased the quasi-fiscal deficit.

118. **Excess money supply was finally contained in October 2004 with a subsequent fall in inflation and interest rates.** Interest rates dropped from 60 percent in June 2004 to 25 percent by the end of the year. Concurrently, window rates dropped and maturities were again re-extended to up to one year (Figure 8).

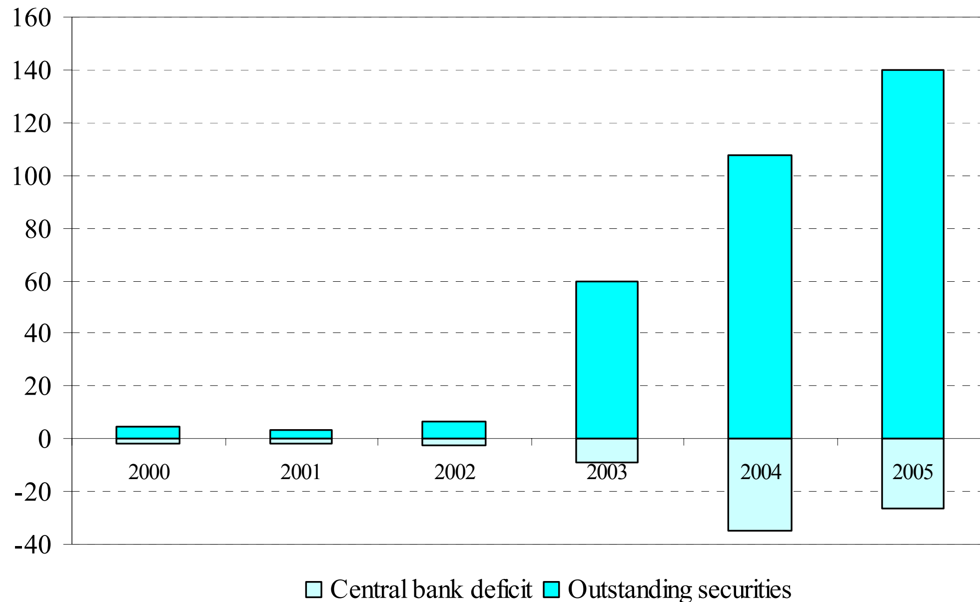
Figure 8. Central Bank Certificate Rates at the Direct Window



119. **The drop in interest rates has allowed for a continued increase in the issuance of certificates and a gradual reduction in the quasi-fiscal deficit.** In 2005, the central bank was able to reduce its deficit to RD$26 billion from RD$31.6 billion in 2004 (Appendix Figure 2.3). There has also been some progress in implementing a short-term strategy to strengthen the central bank's balance sheet. In this regard, three points need to be made: (1) the average maturity of the certificates was extended from three months in September 2004 to 13.5 by December 2005 as a result of the decision to place certificates with maturities of 1-1/2 and 2 years; (2) Congress has authorized the issuance of a RD$2.3 billion bond to recapitalize the central bank and the government has prepared an action plan that is envisaged to fully recapitalize the central bank in ten years. A recapitalization law is currently in Congress and (3) the central bank's Assets Recovery Commission has started selling the assets from the failed banks. Moreover, the 2007 budget already includes transfers to the central bank consistent with the recapitalization plan.

Figure 9. Central Bank Deficit and Outstanding Securities

(In billions of RD pesos)



Source: Central Bank.

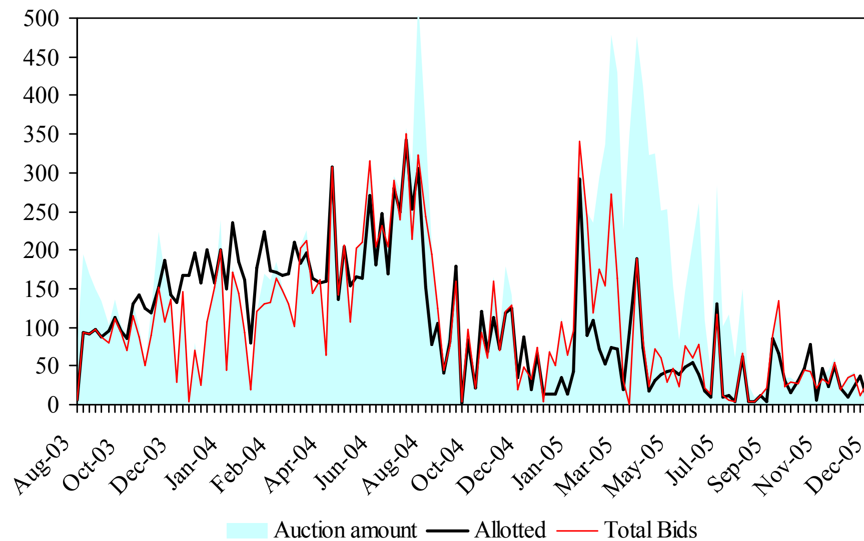
120. **Domestic public debt issuance is dominated by the Central Bank's short-term, zero-coupon Investment Certificates.** Current outstanding issues are about RD$140 billion (US$4.2 billion). Of these RD$ 30.9 are zero-coupon bonds issued in maturity denominations of 33, 91, 182, and 364 days, which allow for early redemption. These instruments also trade in the secondary market and are the most popular product with investors and are generally oversubscribed. Auctions run every Wednesday, with a an auction announcement indicating the amount to be issued on Tuesdays and settlement on Fridays. Participants are the general public and institutional investors. The pension funds are excluded due to the Social Security Law (see paragraph 26). Auctions are characterized by their frequency and the small amounts, with a typical median amount of US$30 million (Appendix Figure 2.4). The central bank uses a variety of instruments, as summarized in Appendix Table 2.3.).

121. **Fixed-rate notes of one and a half to two years were created in order to extend debt maturities.** They differ from other certificates in that there is no early redemption, they have longer terms, and they have biannual coupon payments. Four RD$5 billion issues were placed in 2005. The first two were completely subscribed while the other two were closed to the public as other issues were under rapid growth. In February 2006, in an effort to reduce the rollover risk, the central bank started offering certificates at the retail level, without an early redemption clause, at maturities of 1½ , 2, and 2 ½ years. The new certificates carry a 3 percentage point premium over the standard window certificate. More than RD$25 billion worth of these certificates had been placed through end-March 2000. Long-term certificates feature maturities of 1½, 3, and 5 years and have been authorized for up to RD$10 billion but not yet issued .

122. **Almost US$4 billion in retail certificates were issued through the central bank window as part of the banking system bailout to honor intervened banks' liabilities.** The bonds (Central Bank Investment Certificates) were issued directly to large depositors at maturities that generally varied between 30 days and one year. These securities paid above-average interest (around 28 percent, compared with an average 20 percent time deposit rate for commercial banks). They allow for early redemption, albeit at a penalty, but most holders opt for a rollover. In addition, the bonds featured fiscal incentives for holders, making their after-tax yield even more attractive to depositors. The securities originally could not be traded, until depositor benefits were clearly assessed, but they were automatically rolled over at current (decreasing) rates. As of January 2006, a longer-dated (*plazo fijo*) series extends the rollover maturities to between 1, 2, and 2½ years.

Figure 10. Dominican Republic Central Bank Certificates Auction

(In millions of U.S. dollars)



Source: Central Bank.

Table 18. Dominican Republic: Public Debt Securities issued

Security	Maturities Offered	Discount or Coupon Interest Rate	Placement 1/	Standardization / Reopenings (Y/N)	Secondary Market Tradability
Government/Ministry of Finance					
Bond 104-99	6 years	Fixed	DP	Y	Y
Bond 172-03	6 years	Exchange rate-indexed	DP	Y	N
Central Bank					
Certificados de Inversión	30, 90, 180, 365 days, 1½ and 2 years	Fixed	DP		
Certificados Cero Cupón	35,91,182,364 days	Zero-coupon	AC/AN	Y/N	Y
Certificados a Plazo Fijo	1½ and 2 years	Fixed	DP		
Fixed Income Notes	1½ and 2years	Fixed	AC	Y/N	N
Long Term Certificates	1½, 3 and 5 years	Deposit rate-indexed	AC		N

Source: Central Bank.
1/ Competitive (AC), Non-competitive (AN), Direct placement (DP).

D. Investors in Public Debt

123. **The banking system is a sizable government creditor, with a loan portfolio typically of 3 to 4 percent of GDP**. However, it has little appetite for government bonds, with positions of less than 0.5 percent of GDP. However, the banking system constitutes the main institutional investor in central bank certificates. Banks usually hold the certificates to maturity (since there is no repo market and no early redemption), rolling them over or reselling them to the central bank for liquidity purposes at a small penalty. Intermediation margins are handsome, as deposit rates are currently around 13 percent, while the central bank's short-term securities yield over 15 percent (Table 19). As of 2005, around 10 percent of the banking system's assets under management were invested in central bank certificates (Table 16). This amounted to around 24 percent of all of the central bank's debt holders (Table 20). The savings and loan associations are another sizable holder of central bank debt (around 20 percent in 2005), but unlike their commercial bank counterparts, their portfolio is only composed of securities and they do no hold any loans.

Table 19. Dominican Republic Interest Rates
(As of March 2006)

Term in Days	Deposit	Central Bank Auction	Spread
30	11.6	13.0	1.4
90	12.0	13.9	1.9
180	11.1	14.7	3.6
365	12.9	17.0	4.1

Source: Central Bank.

124. **Institutional investors find participation in the sovereign securities market highly profitable**, given the tight monetary policy that is seen as necessary to defend the currency (rates still hover between 13 and 17 percent).

Table 20. Investor Breakdown of Central Bank Securities
(In millions of RD pesos)

	2002	2003	2004	2005
Domestic investors	6,905	59,523	107,771	140,204
Banking system	2,010	16,535	31,100	32,831
Savings and loans	3,465	5,122	23,054	25,062
Other financial institutions	316	1,111	2,226	11,779
Non financial private sector	1,088	1,386	2,154	2,161
Retail investors	26	35,370	49,237	68,372
Foreign investors				
Total	6,905	59,523	107,771	140,204
Currency decomposition				
Denominated in local currency	6,905	57,440	107,034	140,178
Denominated in foreign currency	-	2,083	737	26

Source: Central Bank.

125. **Unlike most of Central America, pension funds in the Dominican Republic have no investments in public debt**. Over 90 percent of fast-growing assets under management of these funds is invested in short-term commercial bank certificates of deposit. Only 3 percent of assets is invested in corporate activity. The privately-managed pension fund industry is overseen by the National Social Security Council, which represents the government and different sections of the financial and real sectors and oversees the Pension Superintendency under an “administrative tutelage.” The national council thus essentially overrides the authority of the regulator. The regulations of this body currently do not allow the seven pension funds to invest in government or central bank securities. Market sources attribute this highly unusual regulation to the influence of other financial sector participants represented at

the council, and their desire to preserve higher interest rates and profits on investment in public securities.

126. **There are other regulations preventing adequate diversification of pension funds and limiting the maturity of the public debt market.** Pension funds' average portfolio duration is only 85 days, despite the long-term nature of their liabilities. The current legal framework does not promote portfolio diversification. Performance regulation that forces funds to perform within a band of 2 percentage points around the pension funds' average return encourages funds to hold very similar portfolios.

127. **The pension regulator is requesting new instruments from the private sector,** namely mortgage notes. These long-term instruments are already allowed in the current legislation, and would provide a better matching for the assets and liabilities of financial institutions. At the same time, the regulator is also promoting securitization transactions under the newly approved law. However, the banking sector appears to be averse to parting its mortgage portfolio in the current environment.

128. **Insurance companies are allowed to participate in central bank placements.** They are lightly regulated, as the Insurance Commission principally monitors solvency. Other common monitoring indicators have not been implemented. Little data are unavailable on the insurance sector.

129. **The Securities Market Law of 2000 allows for dematerialized representation of securities**, even though there has not yet been any issues of dematerialized securities. Currently traded securities (Bond 104.99, investment certificates) are represented by individual physical titles.

130. **The Dominican Stock Exchange is implementing a central security depository (CSD) for custody of public securities.** This initiative, CEVALDOM, is authorized but not yet operational and is perceived by some observers as insufficiently independent and undercapitalized. CEVALDOM's main objectives are to provide greater physical and legal security, guarantee investor rights, and carry out all liquidation through payment-delivery systems, reducing the credit risk of market participants. The main objections to CEVALDOM are its lack of independence from the stock exchange, with which it shares physical space, that it is undercapitalized (a current paid-in capital of only $200,000), and that its technological platform is also shared with the stock exchange and has little activity. CEVALDOM is addressing theses issues by implementing several structural and organizational improvements and discussing an association with an international partner (IBERclear), with a potential capital injection of up to $1 million.

131. **In the meantime, a public sector bank, Banco de Reservas,** has been used as a de facto custodian in some of the government bond issues (e.g., Bond 172–03). It has accepted becoming a part of CEVALDOM. At the same time, the Securities Market Law (Article 71-C) clearly appears to prohibit a banking institution from taking a majority ownership in a CSD. Thus, in effect, CEVALDOM–the intended central depository and custodian—is not yet functional while the sole de facto custodian—Banco de Reservas—lacks the legal basis for

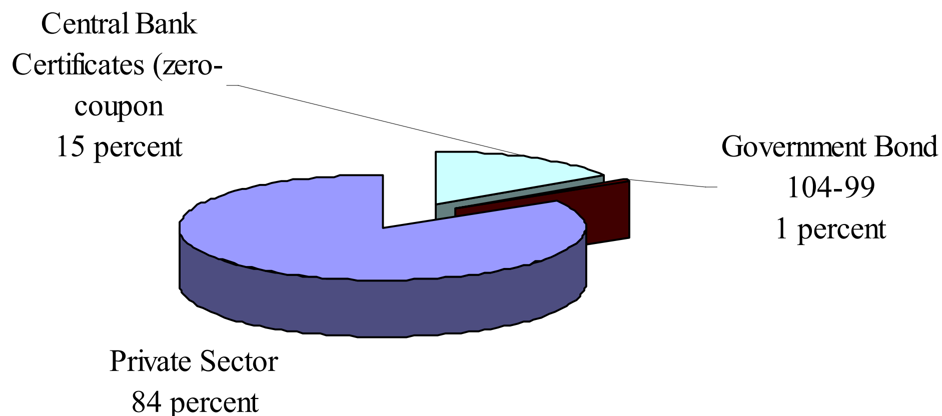
developing into a formal custodian. Given this, CSD limbo, the government remains unable to issue dematerialized securities even if it wanted to.

132. **There is currently no centralized system for compensation and liquidity.** At present, CEVALDOM and Banco de Reserva are two providers of depository services, with both maintaining their separate payment and settlement rules.

Secondary Market

133. **There are few government issues trading in the secondary market and they do so at deep discounts.** Central bank certificates of deposit comprise the bulk of public debt securities traded in the secondary markets. Little trading occurs in government securities, as brokers are excluded from the primary market. There is a preference for nontransparent transactions outside the stock exchange. This market is very thin and limited by the absence of an electronic book-entry system for securities. Currently, all trading of certificates is physical and requires a contract transferring the ownership of the central bank security. Nevertheless, arrangements for the use of outstanding government bonds (mainly Bond 104-99) as tax payments have stimulated informal bond exchanges. Only in May 2005 was this bond registered in the stock exchange, which means that all trading has to be carried out or at least registered in the stock exchange. Thus, an incipient secondary market has developed with 1 percent of trading (Figure 11).

Figure 11. Dominican Republic: Secondary Market Trading, 2005
(In percent)



Source: Stock Exchange.

134. **Universe of listed companies is very limited.** With respect to real sector companies, pervasive dual bookkeeping undermines the listing of more companies. There are currently only five listed companies. The financial sector also has few listed bonds as issuance of bonds by banks is also subject to reserve requirements ordinarily applicable to retail deposits. Banks are proposing an exclusion for bonds over five years. In the absence of adequate secondary

trading volume, there are high costs associated with connecting buyers and sellers of issues with little structure, and brokerage fees hover around 1 to 3 percent. The Securities Commission has approved a new private debt issue as of March 2006. This issue, a five- to eight-year bond, is aimed at pension funds and insurance companies and has great potential for the secondary market due to its longer term. Issue date, however, is not anticipated for another six months.

E. Problems and Recommendations

135. **Central Bank needs to be recapitalized and government is taking steps to do so.** The government has already launched a 10-year recapitalization plan, with Fund support. To increase the likelihood of its completion, it has submitted to congress a Framework Recapitalization Law to provide legal support to the fiscal transfers and needed debt issuances.

136. **It is imperative that the Ministry of Finance regain market confidence and start issuing longer-term securities on a regular basis.** The government must be able to tap domestic market on a regular basis as a long-term strategic priority. Given the many basic problems in cash flow planning, budgeting, and effective expenditure control, along with the problematic debt issuance history to date, this is clearly a long-term goal. However, toward this end, the Ministry of Finance needs to develop capacity to:

- adequately budget, monitor and plan public sector cash flows.
- acquire capacity for timely payment of expenditure and servicing of debt. Prompt payment of all debt obligations must be sought by both the executive and the legislature.
- exercise effective control over all spending departments and agencies of the administration.
- issue long-term debt through a more general authorization for debt placement. The current process of approval of individual debt issues is cumbersome and may unduly restrict debt management operations that must respond to market realities.
- develop the organizational and technical capacity of the debt management unit.

137. **Several aspects of basic market infrastructure need to be addressed urgently.** In particular, the payments system needs to be modernized (the World Bank is working a project to have a centralized electronic system in place by 2008); an electronic book entry and recording system needs to be established so that securities can be dematerialized; a securities settlement system needs to be established; and an adequate securities depository, settlement and custodian agency needs to be put into operation. The Central Bank has already taken important steps for a reform of the payments system. A special department has been created for a complete reform within a 2-year time horizon.

138. **The government needs to encourage the resolution of a common custodian.** A small market such as Dominican Republic does not allow for two competing custodians. This is particularly the case if a public sector bank cannot by law act as a custodian. Given this legal obstacle, the private custodian should solve operational problems as soon as possible.

139. **There is a need to clearly demarcate short- and long-term debt management issuance between the government and the central bank** by focusing the latter on short-term issues. In the medium term, the goal should be to eliminate central bank issuance of its own paper once it is adequately capitalized to conduct open market operations through a stock of government securities.

140. **In the interim, the central bank needs to increase the size and decrease the frequency of issuance, with the auctions serving as the principal vehicle for primary issuance.** While the current use of open window issuance to retail investors may allow additional degrees of control over interest rates, in the long term, the central bank is likely to pay a price for issuance of small quantities of nontradable debt through a higher liquidity premium. The central bank thus needs to concentrate all issuance through the auction mechanism. To permit retail investors, it could allow noncompetitive bids in the auction, eliminating the distinction between institutional and noninstitutional investors which would facilitate greater secondary market liquidity.

141. **Current restrictions on pension fund investment in public debt are very harmful and should be removed.** The participation of pension funds in the public debt market is vitally important to the government's ability to source long-term funding domestically. The authorities should consider removing the current restrictions on pension fund investment in public securities. The current restriction—zero investment in government securities—makes little economic sense and could be relaxed to allow these funds to diversify risk.

142. **The authorities are well aware of these issues and have requested IMF's technical assistance in implementing required reforms.** Since 2004, the Ministry of Finance has committed itself to promptly honor its domestic and external debt obligations. No arrears have occurred on domestic or sovereign bonds as well as obligations to banks. The Ministry of Finance is currently undergoing an organizational and functional restructuring a process and has expressed an interest in IMF's technical assistance. Dominican Republic is a member of the Regional Standards Technical Committee and of the LAC Debt group, under whose programs the Ministry is also currently modifying its debt issuance process, with a more omnibus Congressional authorization, standardized issues at medium and longer terms, and using the auction mechanism.

IV. The Public Debt Market In El Salvador[57]

A. Financial Sector Structure

143. **El Salvador has one of the most diversified financial sectors in the region. Lead intermediaries include banks followed by pension funds.** The banking sector in El Salvador is among the largest in Central America relative to GDP. Foreign banks are granted national treatment and can offer the same services as domestic banks. As of 2005, five out of the sixteen banks were foreign banks, and only two banks were publicly owned. Financial depth is high, with bank assets amounting to 63 percent of GDP (Table 21). Credit to the private sector has remained steady during the last five years at around 42 percent, somewhat higher than in the Euro area.

144. **In addition to banks, institutional investors especially private pension funds also play an important role.** The congressional Decree 927 of 1996, allowing the creation of the Pension Savings System, facilitated the formation of privately managed pension funds. Currently there are two private pension funds, *Confia* and *Crecer*, whose aggregate assets exceed 15 percent of GDP. Further, there exist eight *administradores de cartera,* collective investment institutions, typically administered by an exchange broker, whose assets reached 4.0 percent of GDP in 2005. The insurance sector is more fragmented and limited in size, with 17 insurance firms with aggregate assets amounting to 2.1 percent of GDP.

145. **The main investment vehicles traded in the domestic financial market are public securities.** They are issued both by the central government to finance the fiscal deficit (*Letes* and *Eurobonds*), and by the central bank for liquidity management purposes (*Cenelis*). Secondary market trading consists primarily of repo transactions. Specifically, repo transactions in public securities accounted for over three quarters of total trading volume in 2005 (equivalent to 30.8 percent of GDP). The second and third largest category of trading consists of international transactions and outright transactions in public securities, each accounting for 4.1 percent and 2.4 percent of GDP, respectively. On the other hand, equity trading and trading of private securities—including bank and nonbank investment certificates—accounted for a mere half a percentage point of GDP.

[57] The principal author of this paper is Laura Valderrama.

Table 21. El Salvador: Structure of the Financial System

	2000	2001	2002	2003	2004	2005
Number of:						
Banks						16
Official						2
Domestic-majority owned						9
Foreign-majority owned						3
Branches of foreign banks						2
Insurance companies (mixed)						17
Collective investment institutions						8
Pension Funds						2
Financial holding corporations						9
Securities dealers						7
Mortgage companies and regional social housing corporations						10
Financial System Assets						
(In billions of U.S. dollars)						
Banks' assets				10.1	10.6	10.7
Of which						
Large banks					8.6	8.9
Foreign-majority owned						
Domestic-majority owned					9.9	10.3
Foreign branches					0.4	0.5
Total deposits of banking system					6.5	6.6
Deposits (relative to assets)					60.9	61.7
Private credit	5.6	5.5	5.9	6.3	6.6	7.0
Insurance sector's assets				0.3	0.3	0.4
Collective investment institutions' assets						0.7
Pension Funds' assets						2.6
Trading Volume of:				7.8	9.1	7.5
Repos Private				0.7	0.7	0.3
Repos Public				5.3	5.6	5.2
Secondary Private				0.0	0.1	0.1
Secondary Public				0.3	0.5	0.4
Stocks				0.0	0.5	0.1
International operations				1.0	0.9	0.7
(As a percent of GDP)						
Banks' assets				67.8	67.1	63.1
Private credit	42.8	39.9	41.4	42.3	42.0	41.4
Insurance companies' assets				2.1	2.1	2.1
Collective investment institutions' assets						4.0
Pension Funds' assets						15.3
Trading Volume				51.9	57.9	40.1
Repos Private				4.4	4.3	1.8
Repos Public				35.5	35.4	30.8
Secondary Private				0.2	0.6	0.6
Secondary Public				2.0	2.9	2.4
Stocks				0.1	3.2	0.5
International operations				6.5	5.4	4.1
GDP (in billions of U.S. dollars)	13.1	13.8	14.3	14.9	15.8	17.0

Sources: Banco Central de Reserva de El Salvador, Bolsa de Valores de El Salvador, and IMF estimates.

B. Structure and Composition of Public Debt

146. **El Salvador has one of the lowest and more stable level of public debt in Central America.** Formal dollarization was introduced on January 1, 2001, anchoring the policy framework and helping reduce interest rates and ease inflation.[58] Dollarization has been accompanied by the Monetary Integration Law, precluding the central bank from supplying credit to financial institutions, and providing for the transfer of central bank's liabilities to the government. Central government debt stood at US$6,456 million in December 2005, an estimated 38 percent of GDP, about the same as in the preceding two years (Table 22). One-third of the central government debt was issued in domestic capital markets, mostly in the form of long term securities (accounting for over 96 percent of overall domestic debt). The remaining two-thirds of government debt was raised in international markets, with eurobonds accounting for 40 percent of external debt, and syndicated loans for the remaining 60 percent. The share of the latter has gradually declined from 83.8 percent in 2001.

Table 22. El Salvador: Central Government and Government-Debt
(In millions of U.S. dollars)

	2001	2002	2003	2004	September 2005[1]	December 2005[1]
Securities	1,309	2,533	2,970	3,380	3,677	3,777
Short term	661	0	90	205	80	180
Long term	647	2,533	2,880	3,175	3,597	3,597
Bank loans	2,937	2,508	2,627	2,632	2,621	2640
Short term	0	0	0	0	0	0
Long term	2,937	2,508	2,627	2,632	2,621	2,640
Guaranteed Debt [2]	56	116	82	48	41	39
Short term	15	13	0	3	2	0
Long term	41	103	82	45	39	39
Total						
In millions of U.S. dollars	4,302	5,158	5,679	6,060	6,339	6,456
In percent of GDP	31.15	36.04	38.01	38.35	38.79	38.03

Source: Banco Central de Reserva de El Salvador.
[1] Preliminary figures.
[2] They include bank loans awarded to nonfinancial public firms and to the town hall of San Salvador.

147. **Total public external debt, including central bank liabilities, reached US$4,941 million in September 2005.** Most of external debt was issued by the central government, i.e. US$4,320 million, with the rest of the nonfinancial public sector and the central bank accounting for merely US$466 million and US$155 million, respectively

[58] Consumer prices declined significantly to 1.4 percent in 2001 from 4.3 percent in 2000, following the introduction of dollarization.

(Table 23). Multilateral institutions held 51.4 percent of the total, with financial institutions and bilateral organizations holding 34.6 percent and 14.0 percent, respectively.

Table 23 El Salvador: Outstanding of External Debt
(In millions of U.S. dollars)

	2001	2002	2003	2004	September 2005[1]
I. By Debtor					
Public Sector	3,028	3,892	4,455	4,580	4,786
Central Government	2,633	3,457	3,937	4,141	4,320
Rest of Public Sector	395	435	517	439	466
Central Bank	120	95	263	198	155
II. By Creditor					
Bilateral Organisms	660	709	761	746	691
Multilateral Organisms	2,164	2,317	2,574	2,455	2,541
Financial Institutions	324	962	1,382	1,577	1,710
Total	3,148	3,987	4,717	4,778	4,941

Source: Banco Central de Reserva de El Salvador.
[1] Preliminary figures.

148. **Thanks to prudent fiscal policies and a sustainable debt level, El Salvador has maintained an uninterrupted access to international markets.** During 1999–2005 total issuance amounted to US$2.8 billion all at fixed rates, and El Salvador has succeeded in developing a longer term yield curve in international capital markets. El Salvador entered the eurobond market in August 1999 with a 7-year eurobond for US$150 million with a 10.0 percent coupon. The more recent placements included a 30-year US$286 million eurobond in September 2004 at 8.0 percent, and a 30-year US$375 million eurobond in June 2005 at the same rate. El Salvador is one of the region's most stable credits, rated BB+ by S&P since 1999, and reaching investment grade under Moody's. Improved growth prospects, expected benefits from CAFTA, and a solid fiscal performance underlie this positive market outlook.

C. Legal and Institutional Structure of Public Debt Management

149. **The responsibilities for public debt management are shared between the Ministry of Finance (MOF) and the Central Bank (BCR).** The decisions on quantity, timing, and structure of domestic and external debt issuance are made by the Treasury at the MOF, subject to prior congressional endorsement of debt ceilings as part of the fiscal budget approval. In addition, an ample ceiling is established by Congress to cover short term financing. The back office operations are handled by the Directorate of Investment and Public Credit at the MOF. The BCR acts as a fiscal agent for the MOF. In this role, the BCR executes international transfers on behalf of the MOF, and acts as a custodian and administrator of the securities issued or guaranteed by the MOF. Moreover, the BCR assists the MOF in facilitating international placement, including the selection of the foreign issuance

administrator and the preparation of road shows. Finally, it assists the MOF with the organization of domestic auctions (it conducted issuance of its behalf until June 2005) of government bonds and T-bills.

D. Primary Issuance of Public Debt

Domestic Market

150. **Both the BCR and the MOF issue public securities through competitive auctions.** Even though the BCR concentrates on the short end of the yield curve in order to conduct liquidity management operations, and the MOF on the longer term, there is (an actual and) potential overlap in the issuance of the two. Although most of government domestic issuance has been in the form of 12-month treasury bills, issuance of 5-year bonds was initiated in 2005, and issuance of 7, 10 and 12 year maturities is being considered for 2006. The BCR on the other hand, issues paper from 7 days up to 3 years, thus potentially creating competition between the two sovereign issuers. The pricing benchmark typically utilized by the MOF, namely Libor plus a spread, tends to offer more competitive rates than the ones offered by the BCR.

151. **Until June 2005, the placement of government paper was intermediated by the BCR, which allotted securities to invited investors through a rate of return mechanism using its window facility.** In June 2005 the government initiated the issuance of standardized bonds in the domestic market through an open auction. The reference rate used for the pricing of short term government securities is Libor plus a spread. However, the existing pent-up demand for government securities partly due to excess liquidity in the banking sector has led to some issues being placed at a rate lower than Libor. Securities are allotted via a discriminatory price mechanism in order to enhance liquidity in the secondary market. The most popular maturity is 180 days. The main features of government securities are exhibited in Table 24.

Table 24. El Salvador: Domestic Securities Issued by the MOF

Security	Maturity	Interest Rate	Placement
LETEs (Treasury Bills):			
Series A, B, C, D	90, 180, 270, 360	Discount	Competitive auction
Government bonds	3, 5, 7, 10, 12 year	Fixed	Competitive auction

Source: Ministerio de Hacienda de El Salvador.

152. **In 2005, the joint debt ceiling for domestic and international bond issuance was set at US$541 million with US$27 million being raised in the domestic market.** The limit for T-bill issuance during 2005 was set at US$900 million, with a mere US$178.6 million having been placed in the same period (see Table 25). Specifically, the MOF placed nine tranches of the series B, C, and D of LETEs, with individual tranches ranging between US$10 million and US$25 million. In addition, the government placed two tranches (of

Table 25. El Salvador: Central Government Securities
(In millions of U.S. dollars)

Security	Outstanding in December 2005[1]	Issuance in 2005
LETEs	166	179
Government bonds	1,981	27
Total	2,147	205

Source: BCR and MOF de El Salvador.
[1] Preliminary figures.

US$15 million and US$11,8 million respectively) of the series SV05 of 5-year bonds in July and August, with a 5.75 percent coupon, and average yields of 5.34 percent and 5.15 percent respectively. Both auctions were fully covered, they were even widely oversubscribed, signaling excess demand at the current yields. The two issues were auctioned at favorable conditions. The average yields, namely 5.34 and 5.15 percent, compare favorably with the underlying US 5-year Treasury benchmark, 4.062 and 4.073 percent respectively, and with the 30-year eurobond placed in June 2005 at a yield of 7.84 percent. The conditions of the latter placement are comparable to the 29-year eurobond issued in August of 2005 by another BB sovereign credit in the region, i.e. the Republic of Panama, for US$250 million at a yield of 7.16 percent. Separately, the initial plan of the government for 2006 is the issuance of an overall amount of US$600 million, out of which US$150 million are expected to be placed in the domestic market in the form of 7, 10, and 12 year maturity bonds.

153. **After the implementation of dollarization in January 2001, monetary operations of the BCR are primarily constrained to liquidity management transactions.** The details of the securities issued by the BCR are listed in Table 26.

Table 26. El Salvador: Securities Issued by the BCR

Security	Maturity	Interest Rate	Placement
CENELIs *(Certificados negociables de liquidez)*	7, 28, 91, 182, 364	Discount	Competitive, Uniform price
NOTASBC	1-year	Discount	Competitive, Uniform price
BONOBC	3-year	Fixed	Competitive, Uniform price

Source: Banco Central de Reserva de El Salvador.

154. **The instrument used to manage liquidity is the CENELI, a nonstandardized instrument placed through a competitive auction in the stock exchange.** The last issuance

of 1-year NOTASBC tapping international investors (to cover past debts with foreign banks) was placed in July 2004 for an amount of US$14.5 million at a 4.01 percent rate. Likewise, the last issuance of BONOBC was the 3-year series BONEBC0706 placed in July 2003 for an amount of US$35.5 million at a 4.95 percent rate. The issuance of three-year paper was aimed at replacing maturing paper and reduce liquidity risk pending the full transfer of nonmonetary liabilities to the government. The current outstanding of US$14.5 million (see Table 27) and US$143.5 million of NOTASBC and BONOBC respectively, matures in June and July 2006. Separately, the current outstanding of US$138.7 million of Cenelibor corresponds to a nonmarketable instrument transferred to the Banco Multinacional de Inversiones to cover a bad debt portfolio. During 2005, the BCR issued US$157.4 million of CENELIs. Most of the issuance was in the form of 1.-year instruments, except for a US$2.0 million 182-day placement. This contrasts with 2004, when the BCR issued US$715.9 million of CENELIs mainly in the form of 28-day instruments, (59.3 percent) and 1-year securities (26.6 percent).

Table 27. El Salvador: Central Bank Securities, 2005

Security	Outstanding as of December 2005		Issuance in 2005	
	In millions of U.S. dollars	In percent	In millions of U.S. dollars	In percent
CENELIs	156.1	34.5	157.4	91.6
CENELIBOR	138.7	30.6	-	-
BONOBC	143.5	31.7	-	-
NOTASBC	14.5	3.2	14.5	8.4
Total	452.8	100.0	171.9	100.0

Source: Banco Central de Reserva de El Salvador.

155. **The BCR places its securities through uniform price auctions, whereby allotment is at the cutoff price for all successful bidders.** By contrast, the MOF employs discriminatory price auctions (Table 28). The auction pricing literature suggests that uniform price auctions may increase revenue to the issuer compared to discriminatory practices. However, they can also be more vulnerable to market collusion, particularly in thin markets.

Table 28. El Salvador: Auction Mechanism

Issuer	Security	Placement	Day	Frequency	Participants	Allotment	Type
BCR	CENELI	Cero coupon	Monday	Weekly	Brokers	Uniform rate	Nonstandardized
MOF	LETEs	Cero coupon	Tuesday	Bi-monthly	Brokers, approved dealers	Discriminatory price	Standardized
MOF	Bonds	Fixed rate coupon	Tuesday	Monthly	Brokers, approved dealers	Discriminatory price	Standardized

Sources: Ministerio de Hacienda and Banco Central de Reserva de El Salvador.

156. **The MOF encourages broad participation to improve competition, by opening the auction not only to exchange brokers but also to direct investors approved by the MOF, including domestic and foreign banks.** By contrast, the BCR auctions have been traditionally only open to brokers, who intermediate for other investors. There are currently fifteen brokers, with only four with more than US$1 million in capital. The largest (Valores Cuscatlan) had total assets of US$5. 8 million. The relatively low capitalization of exchange brokers may create some concerns about market risk. However, more recently BCR has encouraged broader participation including public and private investors such as commercial banks and pension funds.

157. **Table 29 shows the uniform rates paid for the 28, 91, 182, and 364-day maturity CENELIs at the date of their last placement (note that only 182 and 364-day maturity paper was issued during 2005) against current deposit bank rates for similar maturities.** The benchmark yield used to determine the cut-off yield of BCR auctions is an average of six-month deposit rates. This contrast with the benchmark used by the MOF based on Libor plus a spread. Separately, deposit rates have remained sticky in 2005, pointing out at excess liquidity in the banking sector.

Table 29. El Salvador: Comparative Rates of Return of CENELI by Maturity

	Maturity			
	28	91	182	364
Last placement before Oct 2005	27-Sep-04	27-Sep-04	18-Apr-05	19-Sep-05
CENELI	2.74	3.05	3.25	4.20
Bank Deposit Rate	2.90	3.01	3.45	3.77
Spread	-0.16	0.04	-0.20	0.43

Source: Banco Central de El Salvador.

158. **A comparison between the rates of return on BCR's CENELIs and those on similar maturity government T-bills, suggests no major discrepancy between these two papers.** For example, the six month LETE10020 issued in October 2005 at an average rate of return of 4.14 percent by the central government is comparable with to the one year CENELI issued in September 2005, with the uniform rate of 4.20 percent.

159. **El Salvador has successfully refinanced most of its domestic debt since 2001 with the issuance of eurobonds, creating a yield curve in international markets over the 7 to 30-year maturity segment.** In June 2005, it issued a 30-year bond for US$375 million at 8 percent fixed coupon and average yield of 7.84 percent. The expected sovereign issuance in international capital markets expected in 2006 is of the order of US$450 million. The principal investors in government and BCR securities are banks and institutional investors, including pension funds and *administradores de cartera* (collective investment entities).

160. **Several prudential requirements affect the banks' investment in public debt of El Salvador and in regional/foreign governments.** As of December 2005, liquidity requirements on domestic banks were 26 percent of deposits, including a temporary special liquidity requirement of 6 percent which is expected to decline to 3 percent by 2007. The

liquidity reserve is solely for the protection of depositors in the absence of a Lombard Facility by the BCR. The liquidity reserve is required to be constituted by the following tranches: 25 percent in current deposits at the BCR or at a foreign bank; 25 percent in current deposits or securities issued by the BCR; and 50 percent in securities issued by the BCR. In addition, banks are subject to two limits on funds invested abroad: an individual investment limit of 10 percent of capital, and an aggregate limit of 75 percent on all foreign securities rated below AA. Moreover, the risk-based capital adequacy requirements impose a weight of 100 percent on paper rated between BB+ and B-, and 150 percent on paper under B- or nonrated paper.

161. **Pension funds constitute the main domestic institutional investors in El Salvador.** As of December 2005, there were two private pension funds in El Salvador, namely Confia and Crecer. A third pension fund—Profuturo—was under liquidation. Their nominal portfolio amounted to US$2,447 million in June 2005, 82.7 percent of which was invested in domestic public debt securities. Pension funds are subject to investment caps on government bonds of 20 to 50 percent of the fund's assets depending on the features of the underlying security, and of 20 percent to 30 percent on holdings of BCR securities.

162. **In addition to banks and pension funds, the *administradoras de cartera*, are the third main financial investor in El Salvador.** These are private entities, typically administered by an exchange broker. There are currently thirty three operational portfolios with an overall investment portfolio of US$657 million in March 2005. Of this, 43.7 percent of assets invested in short term instruments (including 15.3 percent in instruments with maturity under 30 days), 31.9 percent in medium term securities, and the remaining 21.4 percent in long term securities. By type of instrument, 27.7 percent were invested in investment certificates, 24.7 percent in long term deposits, 21.4 percent in domestic government bonds, and the remaining 12.3 percent in foreign government bonds.

163. **Securities markets are governed by the Securities Market Law of 1994.** Currently, there is a new draft of the Securities Law which is awaiting approval by Congress, in addition to a preliminary draft still under scrutiny by the Superintendence of Securities. This draft will facilitate the registry process of the issuance of domestic and international securities, which is judged to be currently too cumbersome by market participants (specifically private banks and pension funds). In addition, a Law of Securitization that will boost the liquidity of otherwise illiquid assets is currently in discussion in Parliament. Furthermore, a Law of Investment Funds is being elaborated. aiming at converting the current *administradores de carteras* in mutual funds, including the mark to market requirement for the valuation of securities.

E. Secondary Market of Public Debt

164. The Bolsa de Valores de El Salvador (BVES) is a private entity created in April 1992, regulated by the Superintendence of Securities, and operating under the Securities Market Law of April 2004.

165. **Secondary trading is concentrated in public debt instruments, which accounted for 93.2 percent of all transactions recorded in 2005 (Table 30).** Repurchase agreements accounted for the large majority of trading in fixed income securities (91.8 percent). During

Table 30. El Salvador: Secondary Trading of Fixed Income Domestic Securities

	2002		2003		2004		2005[1]	
	In millions of U.S. dollars	In percent	In millions of U.S. dollars	In percent	In millions of U.S. dollars	In percent	In millions of U.S. dollars	In percent
REPO	5,958	91.8	5,955	94.8	6,286	91.9	5,548	91.8
Private securities	692	10.7	650	10.4	686	10.0	322	5.3
Public securities	5,266	81.1	5,305	84.5	5,601	81.9	5,226	86.5
OUTRIGHT	535	8.2	326	5.2	556	8.1	493	8.2
Private securities	38	0.6	30	0.5	90	1.3	86	1.4
Public securities	497	7.7	296	4.7	466	6.8	407	6.7
TOTAL	6,492	100.0	6,280	100.0	6,842	100.0	6,041	100.0

Source: Bolsa de Valores de El Salvador.
[1] Preliminary figures.

September 2005, 86.9 percent of the repo transactions were for a maturity under 7 days, 11.7 percent between 8 and 15 days, the rest were for under 45 days.

166. **To examine if the rate of return of public securities depends on whether they have been issued by the BCR or the MOF one could compare their associated outright yields in the secondary market.** Unfortunately the BCR securities are nonstandardized instruments they that do not trade in outright transactions. However they serve as underlying securities for repos. Table 31 summarizes the market information of the same maturity repos transacted in February 27, 2006 on public securities. The average rate of return of three-day repos on BCR securities (namely 4.08 percent), does not depart significantly from the average rate on government securities (i.e., 4.31 percent), especially considering the differences in size and variation across transactions using the same security.

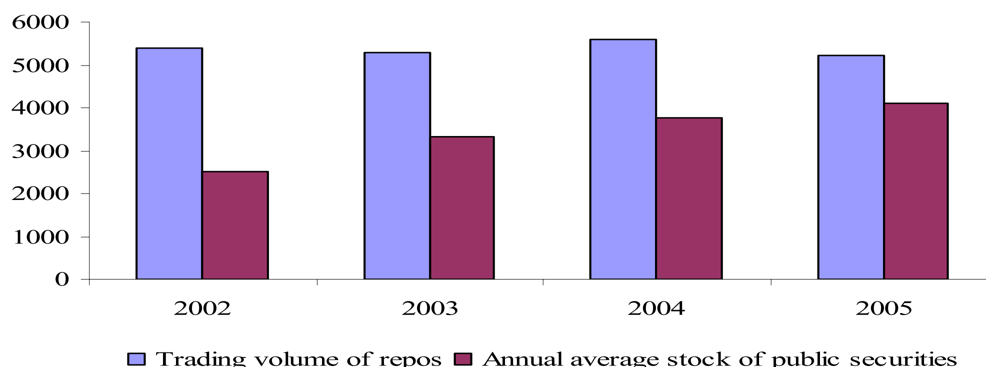
167. **Concerning the liquidity of public debt securities, an examination of Figure 12 indicates that although the average stock of public securities has increased gradually over time, the trading volume of public securities in the secondary market has remained rather steady.** The annual average stock of public securities includes all securities issued by the MOF and the BCR in domestic and international markets. Trading volume includes the transactions executed in the stock exchange over public securities (both repos and outright purchases).

Table 31. El Salvador: Repo Transactions on February 27, 2006
(In thousands of U.S. dollars)

Underlying Security	Issuer	Maturity	Amount	Rate of Return (in percent)		
				Minimum	Maximum	Average
CENELI	BCR	3 days	228	4.08	4.08	4.08
EUROCR2009	MOF	3 days	755	4.28	4.58	4.35
EUROCR2011	MOF	3 days	428	4.28	4.58	4.37
EUROSV2006	MOF	3 days	350	4.28	4.28	4.28
EUROSV2032	MOF	3 days	1,073	4.28	4.29	4.28
EUROSV2035	MOF	3 days	14	4.28	4.28	4.28

Source: Bolsa de Valores de El Salvador.

Figure 12. El Salvador: Liquidity of Public Securities in Stock Exchange
(In millions of U.S. dollars)



Sources: Banco Central de Reserva de El Salvador, Bolsa de Valores de El Salvador, and IMF estimates.

168. **In the secondary market, the annualized cost of a total round trip of an outright transaction is of the order of 0.75 percent of the market price of bonds, with the following breakdown: 0.25 percent charged by the stock exchange, and 0.125 percent charged by the exchange broker.** These fees are applied to both the buyer and the seller of the security. For a repurchase agreement, these charges are reduced to 0.07625 percent for the stock exchange and the exchange broker respectively, resulting in a round trip cost of 0.305 percent on an annualized basis.

F. Market Infrastructure: Clearing, Settlement and Payment

169. **CEDEVAL (Central de Depósito de Valores S.A.) is the centralized securities depository mandated for all securities traded in the *Bolsa de Valores* of El Salvador.** This centralized depository offers safekeeping, transfers, clearing and settlement of securities through a book-entry system. CENEVAL has also conducted global operations through the Bank of New York, State Street and Clearstream Banking utilities. Following the implementation of Decree No. 742 in September 2002, permitting a *sistema de anotaciones en*

cuenta (electronic registry of transactions), dematerialization of securities has advanced rapidly from 32.4 percent of total securities in 2001 (US$550 million out of US$1,695), to 71 percent in 2005, amounting to a volume of US$3,113 million of dematerialized securities. The remaining 30 percent corresponds to *certificados de traspaso*[59] held by pension funds and to bank equity which is required to be kept in physical form by the Law of Banks.

170. **Since 2002, the Superintendence of Securities (Superval) has undertaken a review of changes needed in the legal framework, using international principles of securities regulation as the benchmark.** After the drafting of the 2003 Securities Market Law, Superval requested support from the Inter American Regional Committee and IOSCO on adapting this Law to comply with IOSCO international principles, which resulted in IOSCO accepting Superval in its Assisted Assessment Pilot Program. As part of this initiative, Superval has also signed mutual agreements with Costa Rica and Panama to facilitate the cross border settlement and payment system.

171. **The electronic settlement cycle is standardized to t+0 for repurchase agreements, t+2 for treasury bills, and t+3 for government bonds.** Securities transactions are settled on a delivery-versus-payment system in both primary and secondary markets. A gross settlement systems is operated by the BCR drawing on the deposit accounts held by private banks at the BCR. Also the set up of a clearing house of checks was approved in February 2004, and modified in November 2004, to facilitate electronic migration. Currently, CENEVAL is advancing to integrate clearing and settlement cycles for cash and securities processing, creating a straight through processing system to advance in real-time processing of information.

G. Problems and Recommendations

172. **Public debt is issued in the domestic market at regular issues with a pre-announced annual timetable.** However debt issuance is rather *fragmented*. In 2005, the government placed nine tranches of three series of LETEs (T-bills) for an aggregate amount of US$178 million. Public debt issuance is implemented in tranches. The volume of individual tranches varied between US$10 and US$25 million. Also, two tranches of a 5-year bond were placed during the same period for an amount of US$15 and US$11.8 million respectively. The plan for 2006 is to gradually extend public debt maturities by issuing a total of US$150 million of 7, 10 and 12 year maturity bonds in the local market in monthly placements. This could result in possibly 36 separate issuances of a security with an average issuance volume of little over US$4 million. Even if the annual issuance of 7, 10 and 12-year bonds were consolidated, each individual bond would have too small overall volume to ensure adequately liquid secondary market trading. Fragmentation of issuance, though allowing the government to lower its financing costs, may hinder the development of a yield curve, especially in the 3 to 10 maturity segment (the government has already generated a yield curve in the 10 to 30 year segment in international markets).

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[59] The *certificados de traspaso* are claims held by the ISSS on the central government following the reform of the pension system.

173. **The auction technique used by the MOF is discriminatory price auctions, whereas the placement method used by the BCR is the uniform rate mechanism.** A priori, the design of central bank and government issues should be homogeneous in markets in which both are players,[60] with the choice between the two auction methods depending on the prevailing market conditions. For instance, discriminatory price auctions may be desirable in thin markets owing to its information gathering role; a caveat may be however, that the substantial uncertainty embedded in prices may add up to the risk perceived by market participants of bidding out of the market. More importantly, short term instruments including LETEs and CENELIs are allocated via rates of return, which may inhibit secondary market liquidity. This contrast with the placement of long term bonds which are allocated via prices thus fostering secondary market trading.

174. **The short term instruments issued by the BCR for liquidity management purposes, i.e. CENELIs, are nonstandardized securities allotted in small issues (an average of US$4.4 million per week were placed in January–September 2005) to exchange brokers.** By contrast, the 12-month securities NOTASBC are standardized instruments issued by tranches and aimed at replacing maturing debt. The standardization of CENELIs and the increase in issues' volume would enhance market competition and forward liquidity in secondary trading.

175. The current auction mechanism used by the BCR, restricts the allotment of CENELIs to exchange brokers. Encouraging broader participation in auctions by opening primary auctions to banks and institutional investors would result in enhanced market competition.

176. **The government should fully assume the BCR's accumulated losses which are currently estimated at around US$700 million.** The transfer of the quasi-fiscal deficit would allow the BCR to decrease its rollover risk. It would also mitigate the existing competition between the two sovereign issuers for the same investors.

177. **There is close coordination between the BCR and the MOF. The BCR acts as a fiscal agent for the MOF, serving as a custodian and administrator of the securities issued by the Ministry and executing international transfers.** Also the BCR coordinates with the government on the securities issue date. However there may be scope for further coordination in the maturity of instruments as both entities issue 12-month paper. In addition, the BCR issued 3-year bonds in 2003 for US$35.5 million to replace maturing debt. Ultimately, the intended transfer of the quasi-fiscal deficit from the BCR to the MOF would allow centralization of issuance at the MOF allowing larger volumes of fungible securities per issue seeking at developing the domestic yield curve.

178. **There are currently three legislative projects concerning further development and proper regulation of financial markets.** First, a Securitization law is under consideration to allow for the design and issuance of securitized instruments. Second, an

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[60] The homogenous design of instruments and issues is supported by the regional standards for regional harmonization of the public debt markets of the Central America Isthmus and the Dominican Republic (Resolution CMCA/CMH-RE-02/11/03).

Investment Funds Law that should facilitate the conversion of the current *administradores de cartera* into mutual funds. Third, a reform of the existing Securities Market Law that will simplify the procedure (and mitigate the discretion of the Securities Superintendence) to register domestic and foreign securities in the stock exchange. Simplified mechanisms for the registry of foreign securities such as self-registration, are not currently permitted. Also, there appears to be duplicity of procedures as securities' registration necessitates the approval of both the stock exchange and the Securities Superintendence. Streamlined registration requirements would enhance market efficiency while facilitating trading of regional securities.

179. **Private pension funds are subject to investment limits as a measure to avert undue risk. Specifically they have to comply with a 10 percent investment ceiling in foreign securities, and with a 5 percent threshold in equity.** Separately, the existing regulation requires private pensions funds (which are the most active players in the stock exchange), to seek authorization by the Securities Superintendency in order to participate in international placements. Pension funds are also restricted from operating through the stock exchange for secondary trading. This provision precludes their participation in the active OTC market where commercial banks execute most of their trading. Advancing efforts to ensure equity treatment of investors in gaining market access may contribute to foster trading in public debt thus increasing market liquidity. Also, establishing a procedure for reporting of OTC transactions to the BCR for subsequent dissemination to the market in aggregate form would advance transparency and price discovery, further contributing to market development.. market.

180. **The current plan to consolidate the three existing Superintendencies overseeing the Financial System, the Securities Market, and the Pension Funds respectively, may contribute to reduce transaction costs and mitigate systemic risk.** Also, the current efforts to modernize the payments system by advancing in the implementation of a real-time gross settlement (RTGS) system for high-value payments, and in the design of an automated clearing house, will foster competition in the interbank market. Moreover, by lessening bank exposure to domestic interbank settlement risk (the payment leg of debt securities and cash flows would be settled in real time), an RTGS system will further enhance interbank market liquidity. Finally, extending the existing agreements with Costa Rica and Panama to other countries in the region so as to facilitate the cross-listing of securities and to harmonize the settlement and payments system, will accelerate regional financial integration.

V. The Public Debt Market in Guatemala[61]

A. Financial Sector

181. **The financial system in Guatemala is dominated by the banking sector.** There is one public bank, which is a mortgage bank (CHN), and 25 private banks, including one foreign bank (Citibank) (Table 32). Financial depth is modest, with bank assets accounting for 36.3 percent of GDP. Although dollarization of the banking system increased to 13 percent of total deposits following the adoption of enabling regulation in 2001, financial dollarization is significantly lower in Guatemala than in its peer countries. Bank credit to the private sector rose gradually to 19.8 percent of GDP in 2005 from 17.7 percent in 2000, but is still low.

182. **The nonfinancial sector is still underdeveloped.** There are 18 insurance companies, whose aggregate assets stand at a miniscule 1.3 percent of GDP. There are 35 investment funds with an insignificant aggregate investment amount of $88 million as of July 2005. While 22 private companies have listed their stock and 25 have issued corporate bonds in the Guatemalan stock exchange, market capitalization of private securities stood at a mere 0.2 percent of GDP in 2005.

183. **Capital markets are dominated by public debt securities.** Market capitalization of private securities is also miniscule, at around 0.2 percent of GDP. This stands in stark comparison to outstanding stock of public debt of around 20 percent of GDP. Total trading volume in the stock exchange has risen rapidly in recent years, peaking at 58.5 percent of GDP in 2004. The bulk of securities exchange trading is in public securities, and the lion's share thereof is in repo transactions. In 2004, the volume of repo transactions, at Q107,598 million ($13,884 million), was dominated by quetzal-denominated securities accounting for 96 percent of total transactions. During the fiscal period from 2003–04, outright transactions reached Q716 million ($92 million), with 98 percent on public debt securities.

[61] The principal author of this paper is Laura Valderrama.

Table 32. Guatemala: Structure of the Financial System

	2000	2001	2002	2003	2004	2005
Number of:						
Banks	32	31	31	26	25	26
Public						1
Domestic-majority owned	29	28	28	23	23	24
Foreign-majority owned	2	2	2	2	1	1
Branches of foreign banks						
Insurance companies	18	18	18	18	18	18
Collective investment institutions						35
Financial holding corporations	20	20	20	18	19	16
Companies with listed stocks						22
Financial System Indicators (In millions of U.S. dollars)						
Banks' assets	6,444	7,103	7,959	8,236	9,795	11,653
Total deposits of banking system	4,237	4,899	5,668	6,088	7,362	8,830
Deposits (relative to assets)	66	69	71	74	75	76
Private credit	3,436	3,785	4,165	4,408	5,132	6,344
Insurance sector's assets	228	253	291	309	349	410
Trading volume	5,821	7,615	8,643	9,888	16,079	
Of which: repos.					13,884	
Market cap private securities				57	82	73
(In percent of GDP)						
Banks	33.3	34.5	34.1	33.5	35.0	36.3
Private credit	17.7	18.4	17.8	17.9	18.3	19.8
Insurance companies	1.2	1.2	1.2	1.3	1.2	1.3
Trading volume	30.1	37.0	37.0	40.4	58.5	
Of which: repos					50.5	
Market cap private securities				0.2	0.3	0.2
GDP (in millions of U.S. dollars)	19,288	20,987	23,317	24,895	27,312	32,119
Quetzales per U.S. dollar	7.76337	7.85574	7.81728	7.93719	7.94807	7.62929
GDP (in millions of Quetzales)	149,743	164,870	182,275	197,599	217,075	244,427

Sources: Central Bank of Guatemala; Ministry of Finance of Guatemala; National Stock Exchange; and IMF estimates.

B. Structure and Composition of Public Debt

184. **Outstanding government debt in Guatemala was $5,928 million as of September 2005** (Table 32). This is approximately equivalent to 19.9 percent of GDP, in line with the trend during the past four years. All the maturing repayments have been fulfilled since 1993, sustaining the credibility of the government in financial markets.[62] Furthermore, the government has never fallen into arrears on any commercial bank debt, given its limited exposure to bank credit in the 1980s and 1990s.

Table 33. Guatemala: Outstanding Public Debt[1]

	2000	2001	2002	2003	2004	September 2005
Central government						
In millions of U.S. dollars	3,657	3,994	4,085	4,769	5,499	5,928
In percent of GDP	18.9	19.4	17.5	19.5	20.0	19.9
Central bank (open market bills)						
In millions of U.S. dollars		1,376	1,429	1,518	2,046	2,253[2]
In percent of GDP		6.7	6.1	6.2	7.4	7.6

Source: Ministry of Finance and Central Bank of Guatemala.

[1] Excludes the central bank and decentralized entities.

[2] US$ 2,237 in December 2005.

185. **External debt accounts for about two-thirds of public debt,** with the total amount outstanding at $3,749 million as of September (Table 34). Multilateral and concessional credits accounted for 67 percent of external debt. For instance, loans from the Inter-American Development Bank (IDB), which accounted for 63 percent of multilateral debt in June 2004, offer extensive grace periods of up to 10 years, accruing interest of the order of 1 or 2 percent. Foreign governments and bilateral organisms held 12.3 percent of external debt, and only 3.5 percent of external debt is in the form of bank credit. Finally, 29.5 percent of external debt is in the form of long-term bonds held by private investors. Having successfully issued three 10-year eurobonds in 1997 ($150 million), 2001 ($325 million), and 2003 ($300 million), Guatemala managed to extend the external yield curve to 30 years in October 2004, with a $330 million issue. This issue was very successful, with a substantial oversubscription of $2,445 million.

[62] In 1993, the government was compelled to refinance its public sector external debt with some bilateral and multilateral agencies through the Paris Club.

Table 34. Guatemala: Outstanding External Debt by Creditor[1]
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	September 2005
Multilateral agencies	1,584	1,671	1,895	1,961	2,091	2,052
Foreign government and bilateral entities	618	556	537	530	514	462
Long-term bonds held by investors	150	475	475	775	1,105	1,105
Short-term bonds held by investors	0	0	0	0	0	0
Bank credit	189	132	131	131	131	131
Trade credit	0	0	0	0	0	0
Other	0	0	0	0	0	0
Total external debt	2,541	2,834	3,039	3,397	3,842	3,749

Source: Ministry of Finance of Guatemala.

[1]Excludes the central bank and decentralized entities.

186. **In September 2005, domestic public debt outstanding reached Q16,779 million ($2,179 million), accounting for over on-third of overall public debt** (Table 35). Guatemala's public sector domestic debt consists primarily of government bonds. Principal investors include nonfinancial private creditors (54.3 percent of the total), followed by other public sector entities, mainly the Guatemalan Social Security Institute,[63] accounting for 23.6 percent, and deposit banks. Of the Q12,841 million outstanding domestic debt in 2004, 54 percent was dollar-denominated debt with a weighted-average interest rate of 7.7 percent, and average maturity of 6.7 years. The remaining 46 percent was in quetzals denominated at a weighted-average interest rate of 12.3 percent and average maturity of 5.4 years.

Table 35. Guatemala: Outstanding Domestic Debt by Creditor[1]
(In millions of quetzales, unless otherwise stated)

	2000	2001	2002	2003	2004	September 2005
Other government levels	2,581	2,561	2,770	3,578	3,827	3,964
Deposit banks	2,478	2,446	1,487	1,722	2,767	3,685
Nonfinancial private sector	3,571	4,275	3,911	5,736	6,247	9,130
Total (in millions of quetzales)	8,630	9,282	8,169	11,037	12,841	16,779
Total (in millions of U.S. dollars)	1,116	1,160	1,046	1,373	1,657	2,179

Source: Ministry of Finance of Guatemala.

[1]Excludes decentralized entities.

[63] As a case in point, the institute held 29.2 percent of overall domestic public debt as of June 2004.

187. **As a result of the incomplete transfer of its losses to the government, the Bank of Guatemala (Banguat) is an important domestic debt issuer.** Banguat has not issued any external debt since the 1992 law. By contrast, it has actively conducted open market operations and has accumulated sizable losses in the process that have not yet been fully transferred to the government. A 2000 law regarding Banguat requires the government to assume the losses suffered through open market operations with a two-year deferral. There had been significant delays in the transfer of losses up to 2002, and while the more recent losses have been transferred relatively quickly, transfers typically occur in the form of deep discount bonds carrying terms well below market rates. For example, the central government in 2005 issued a Q963.7 million bond with a 3.87 percent coupon to cover the losses incurred in 2003.[64] Losses incurred in 2005 were expected to amount to Q593.8 million (about 0.3 percent of GDP). Banguat issues long-term debt primarily to finance its own losses. Its outstanding domestic debt reached Q16,977 million in December 2005. Lacking a stock of government debt instruments, Banguat's liquidity management operations are also conducted through issuance of its own debt.

C. Legal and Institutional Structure of Public Debt Management

188. **The legislation regulating the issuance, negotiation, and placement of public debt is governed by the Guatemalan constitution, with Article 171 granting power to Congress to approve government indebtedness.** It also prohibits Banguat from financing the government. Furthermore, section V of the Congressional Decree 101–97, the organizational budget law, holds further provisions on public debt management granting consent to the Ministry of Finance to issue public debt on behalf of the republic. The annual decree entitled the "General Budget Law for the Fiscal Year" authorizes the maximum limit of public debt issuance during the year and the year-end stock of debt for each fiscal year. The law sets an overall limit on government debt and by and large does not restrict debt management by specifying additional binding limits on the types of instruments (domestic versus external issuance, domestic versus foreign-currency-denominated debt, or bonds versus syndicated loans). However, the organizational budget law does not permit the rollover of treasury bills; therefore this instrument is rarely used by the government to finance the fiscal deficit. The General Budget Law for Fiscal Year 2006, approved on December 27, 2005, with a budget of Q37,703 million, also defines public debt placement until 2007 as well as multiannual budgeting projections until 2008.

189. **Given the substantial domestic issuance needs of Banguat, the government and the bank need to closely coordinate domestic debt issuance.** Since 2002, the finance ministry and Banguat have held weekly meetings to coordinate monetary and fiscal policy. Also, they agree on the calendar of public debt issuance, as well as on the features of the securities that will be auctioned during the week, including their face value and maturity. This weekly meeting also serves to facilitate an exchange of information concerning reserves, the

[64] This rate is well below the prevailing market rate. In 2005, the longest maturity instrument issued by the government was a 10-year bond placed at an average 9.6 percent rate of return.

liquidity of the banking system, price levels and trends, and the extent of open market operations needed to achieve price stability.

190. **A technical committee of Banguat and the government coordinates joint debt issuance.** The weekly technical committee is presided over by the vice minister of finance and the vice president of Banguat and includes the directors of the treasury and the sovereign accounting, public budget, economic and fiscal studies, and public credit agencies. This committee acts as the front office for both Banguat and the government. The bank performs the function of back office, drawing on the regulatory mandate requiring the government to establish an account at Banguat to guarantee debt service and to make all payments for interest, principal, and commissions related to debt service. The Department of Public Debt Placement and Negotiation (within the Directorate of Public Credit at the finance ministry), performs the middle office role for the finance ministry for the purposes of public debt management. Separately, Banguat's Monetary Stabilization Operations Department-formerly the Open Market Operations Department—is now configured with a front, middle, and back office to allow for separation of functions in the conduct of monetary operations within the newly established inflation-targeting framework.

D. Primary Issuance of Public Debt

Primary Issuance by the Ministry of Finance

191. **For its 2005 bond issuance, the Ministry of Finance defined the following objectives: coordination between fiscal and monetary policy; scaling down of issuance costs; satisfaction of financing needs in a timely fashion; decreasing currency mismatches; debt maturity expansion; and, minimization of volatile instruments within the debt portfolio.** These objectives were by and large met, given the abundant liquidity prevailing in the domestic market during the first semester of 2005. Excess liquidity has allowed the government to issue in local currency, at fixed rates, and for long maturities. This strategy enabled the government over 2005 to increase the maturity of domestic debt by more than a year to an average of 8.5 years while lowering the estimated weighted average cost of debt service by 1.5 percentage points.

192. **Ministry of Finance issuance is predominantly of medium- to long-term bonds (Table 36).** The finance ministry is very active in issuing 3 to 10-year bonds. By contrast, 12-month t-bills are barely used. Short-term instruments are required by law to be retired before the end of the fiscal year, thus preventing rollover (the last issuance was placed in 2003). The 2005 budget law approved an overall issuance of Q3,585 million to finance the fiscal deficit, and an additional Q1,695 million to refinance maturing debt. The overall issuance of Q5,280 million of government paper (*certificados representativos de Bonos del Tesoro*), accounting for 2.3 percent of GDP, had the following structure:

- A bond with the face value of Q964 million issued to Banguat to cover the 2003 quasi-fiscal deficit losses.
- Q741 million, Q1,094 million and Q2,481 million was issued in three bonds of 5, 7, and 10-year maturities at respective average rates of 7.9, 8.7, and 9.8 percent.

Table 36. Guatemala: Instruments Issued by Ministry of Finance

Security	Currency	Maturity	Interest	Placement Methods	Purpose
Certificado representativo de Bonos del Tesoro	U.S. dollars or quetzals	3,5,7, or 10 years	Floating or fixed	Competitive auction, window placement, nonstandardized	Government financing
Certificado representativo de Bonos del Tesoro	Quetzals	29.6 years	Fixed	Direct placement to central bank, nonstandardized	Transfer of central bank quasi-fiscal deficit to government

Source: Ministry of Finance.

Table 37. Guatemala: Government Financing by Instrument
(In millions of quetzales)

	2000	2001	2002	2003	2004	September 2005[1]
Long-term bonds						
Issuance	7,551	8,732	1,858	4,890	3,526	5,280
Amortization	6,728	8,080	2,971	2,022	1,722	1,342
Total	823	652	-1,113	2,868	1,804	3,938
Short-term bonds	0	0	0	0	0	0
Long-term bank credit						
Placement	1,591	4,062	2,547	3,786	4,881	770
Amortization	874	1,559	1,216	1,357	1,660	1,070
Total	717	2,503	1,331	2,429	3,221	-300
Short-term bank credit	1,155	0	0	0	0	0
Other liabilities	0	0	0	0	0	0
Change in liquidity	16	-64	1,552	-731	-2,945	-2,199
Total	2,710	3,090	1,770	4,566	2,080	1,439

Source: Ministry of Finance of Guatemala.

1/ Appendix Table 4.6 shows the issuance and amortization pattern of government securities from 2000–05.

2/ In December 2005 the figures for Long-term bonds were: Issuance 5,280 and Amortization 1,695.

193. **Government bonds (*certificados representativos de bonos del tesoro* or *certibonos*) are not standardized instruments.** Although these bonds are offered through auction, the government does not specify a common interest rate for them, but rather offers bonds at different rates to investors with the lowest interest bids. There is a plan to standardize these instruments in 2006 to comply with the harmonization program initiated by the Central American Monetary Council.[65]

Primary Issuance by Banguat

194. **Banguat is currently working toward adopting an inflation-targeting framework** that aims to reduce inflation from 8.8 percent in June 2005 (of which 3 percentage points are estimated to be imported inflation) to an estimated target band between 4 and 6 percent by 2007. Monetary policy has been gradually tightened throughout the year to contain second-round inflationary effects of oil prices. Specifically, the prime rate increased from 2.55 percent in January 2005 to 4.25 percent in December of that year following a sequence of seven consecutive increments.

195. **In January 2005, Banguat's Executive Committee chose the seven-day deposit rate (which is determined once a month) as the principal signaling rate to set the yield curve, manage liquidity, and pin down inflationary expectations.** Financial transactions on seven-day deposits are executed in the Electronic Money Transfer Market and in the Stock Exchange. These instruments are auctioned electronically and transactions are settled through the accounts held by commercial banks at the Bank of Guatemala. Separately, the bank issues nonstandardized certificates of deposit at various maturities (Table 38).

Table 38. Guatemala: Instruments Issued by the Bank of Guatemala

Security	Currency	Maturity	Interest	Placement	Purpose
Certificates of deposits	Quetzales	91, 181, and 364 days; 2, 4, 6, and 8 years	Fixed	Competitive auction, nonstandardized	Liquidity management, quasi-fiscal deficit financing

Source: Bank of Guatemala.

196. **Following the inflation-targeting policy framework, the issuance pattern of Banguat instruments changed significantly in 2005.** Whereas most certificates of deposit outstanding in 2004 were short-term instruments (24 percent were for 91 days, 18.2 percent for 182 days, and 18.9 percent for 354 days), most of them outstanding on November 9, 2005 were long-term instruments (19.4 percent were four-year certificates of deposit and

[65] This program, approved by the Central America Monetary Council's resolution CMCA/CMH-RE-02/11/03, proposes adoption of a set of standards to govern the harmonization of regional public markets in the Central America isthmus and the Dominican Republic, with a view to gradually developing the regional public debt market.

16.1 percent were two-year). The breakdown of outstanding certificates of deposit by auction mechanism and maturity is shown in Table 39.

Table 39. Guatemala: Outstanding of Certificates of Deposit by Placement Method and Instrument
(In millions of quetzales)

	December 2004	December 2005
Method of issuance		
Auction	7,885	8,787
29-182 days	1,774	888
183-364 days	2,197	1,507
>365 days	3,914	6,392
Placement through Electronic Money Transfer Market/Stock Exchange	3,250	2,561
7-14 days	270	2,561
21-28 days	470	0
29-182 days	2,510	0
Window	4,720	5,629
Public entities	4,675	5,583
Retail investors	46	46
Total	15,855	16,977

Source: Central Bank of Guatemala.

197. **Private banks held 58.6 percent of certificates of deposit as of November 2005.** The second main investor in Banguat deposits is the Guatemalan Social Security Institute, with 23.2 percent of the total (Table 40).

Table 40. Guatemala: Outstanding Certificates of Deposit by Investor

	December 2004		December 2005	
	In Millions of Quetzales	In Percent	In Millions of Quetzales	In Percent
Banking sector	10,429	65.8	10,529	62.0
Private nonbanking	752	4.7	870	5.2
Public entities	2,924	18.4	3,654	21.5
	1,751	11.0	1,924	11.3
Total	15,856	100.0	16,977	100.0

Source: Central Bank of Guatemala.

198. **Currently, Banguat's certificates of deposit are nonstandardized instruments that are allotted to investors through an interest rate auction.** This procedure circumvents Article 171 of the Guatemalan constitution that requires congressional approval for the issuance of public debt (which would be the case if "deposits" were to be renamed as

"securities"). Because Banguat has issued these nonstandard securities for some time and they have become market standard, the finance ministry also continues to use the same nonstandard format for its own securities. However, as of November 2005, a legal amendment was being devised to allow Banguat to issue standardized securities by 2006. At that time the finance ministry will simultaneously start the issuance of standardized bonds.

199. **The Ministry of Finance issues public debt very frequently through three separate mechanisms.** The ministry conducts two competitive auctions on Tuesdays and Thursdays, with Banguat acting as the fiscal agent for both. A monthly calendar of maturities is preannounced each month. The first auction is open to all financial institutions and public entities. The ministry forwards the registry of eligible investors, the auction call, and the guidelines for individual bids to Banguat. Investors advance their bids on the auction day directly to Banguat, which in turn reports the bids to the finance ministry, preserving the anonymity of investors. The ministry proceeds with the allotments of securities to investors (with prior notification by Banguat) by early afternoon on the same day. Investors confirm their bids to Banguat and forward their approval for the debit of their reserve account at the central bank, or in other cases, proceed to execute electronic payment. Banguat receives the settlement, prints the materialized securities, or alternatively the dematerialized registry,[66] and credits the account of the finance ministry accordingly.

200. **The second weekly auction conducted by the Ministry of Finance is restricted to exchange brokers (*puestos*) and uses the infrastructure provided by the stock exchange.** With the prior notification of the finance ministry, Banguat announces the auction terms to the stock exchange, which in turn informs the exchange brokers. Brokers submit the consolidated bids from their clients via the stock exchange and Banguat to the finance ministry. In the afternoon, the ministry proceeds with the allotment of securities, and settlement occurs on a T+2 basis.

201. **Besides the two competitive auctions described above, the Ministry of Finance also runs a noncompetitive auction through the window of Banguat at the average rate of return resulting from the competitive auction.** Placement through the window mechanism targets retail investors and public institutions such as the Guatemalan Social Security Institute. There is a maximum limit on individual bids of Q10,000.

202. **The Guatemalan money market enjoys a deep and liquid cash yield curve, particularly in the short maturity segment.** Banguat manages liquidity in the financial system through two mechanisms. First, it conducts transactions in the Electronic Money Transfer Market and in the Stock Exchange with seven-day deposits. Second, it runs a competitive auction of certificates of deposit through exchange brokers. The frequency of the auction has declined from five to three times a week since January 31, 2005. On Mondays, 91-day and 364-day certificates of deposit are auctioned; on Wednesdays, 182-day and two-year certificates of deposit; and on Fridays, certificates of deposit of four, six, and eight years.

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[66] The materialization of government securities is contingent on investors' preferences. By contrast, central bank paper is materialized in compliance with Banguat's internal regulation.

Banguat sets quotas for all maturities, with the exception of the seven-day prime rate and the four- and six-year certificates of deposit, with the aim of smoothing interest rate volatility.

203. **Altogether, there are nearly 200 auctions of public securities annually and 10 issues of different maturities by the two issuers.** Average issuance per auction is typically paltry—the equivalent of $11 million in 2005. Even if public securities were tradable, such frequent small issuances would severely deter development of a secondary market.

204. **The presence of institutional investors is limited, owing to the absence of specific legislation regulating investment funds.** Of the 35 investment funds legally constituted under the 1996 securities market law, only 10 are operational. Further, they invest through participation certificates, and their transactions are intermediated by exchange brokers. There are no private pension funds, and as of November 2005 there was no definite timetable for the creation of private pension funds.

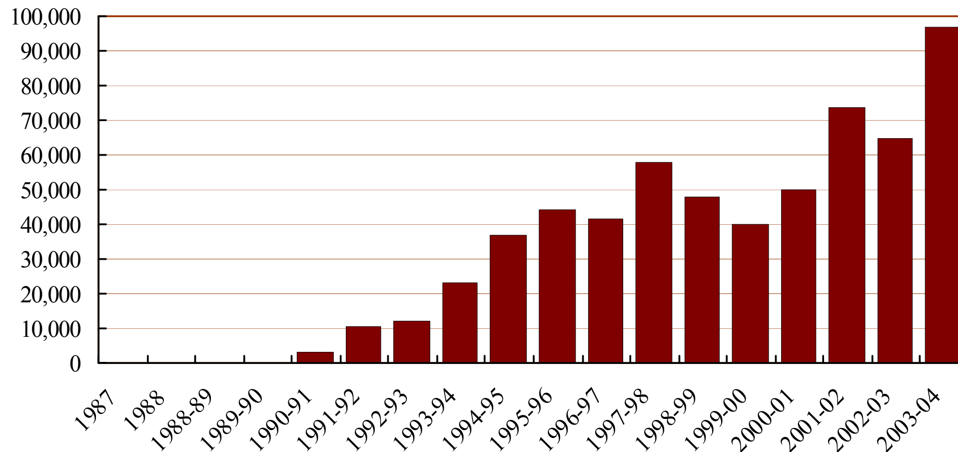
205. **Banks are subject to a cash reserve requirement of 14.6 percent of total deposits, and as of November 2005 were remunerated at 0.6 percent.** Banks are allowed to invest in paper issued by the finance ministry and the central bank without investment restrictions. By contrast, investment in securities issued by domestic financial institutions or private entities is subject to a 15 percent investment limit on the bank's capital. Investment in private securities, with a minimum credit rating over A-3 or BBB- for short- and long-term securities, respectively, is also subject to prior authorization of the Monetary Council. Moreover, investment in private securities is subject to a risk-weighted capital-adequacy ratio. Since August 2005, banks have been allowed to invest in U.S. government bonds and t-bills under resolution JM-124-2005, subject to the 15 percent investment limit.

E. Secondary Market of Public Debt

206. **There are two, partly competing, exchanges in Guatemala, namely the National Stock Exchange *(Bolsa de Valores Nacional)* and the *Corporación Bursatil.*** The National Stock Exchange was established in 1987 with prior authorization of the finance ministry. Currently there are 20 operational brokers, of which 17 are backed by financial conglomerates. The second stock exchange (*Corporación Bursatil*) also trades in public securities, though it mainly taps corporate issuers and commodities trading. The National Stock Exchange charges a fee of Q10,000 monthly, while the *Corporación Bursatil* charges Q7,000. Moreover, none of these exchanges charges a commission to brokers for operations transacted in the stock exchange. By contrast, exchange brokers charge brokerage fees to investors of an order ranging between 0.1 percent and 1 percent in annualized terms.

207. **The bulk of trading is in repo transactions in sovereign securities.** In 2003–04, the National Stock Exchange registered the highest trading volume ever, with the total of more than Q96 billion ($12.4 billion) representing an increase of 50 percent over the previous period (Figure 13). However, repo transactions accounted for 99 percent of the total. The volume of repo transactions, at Q88,037 million ($11,360 million), was dominated by quetzal-denominated securities standing for 96 percent of total transactions. Outright transactions only amount to Q716 million ($92 million), with 98 percent in public debt securities (including

Figure 13. Guatemala: Trading Volume in the Stock Exchange
(In millions of quetzales)



Banguat's certificates of deposit and government *certibonos*), 60 percent of which were denominated in U.S. dollars. Most repo transactions are for very short maturity periods (80 percent for less than seven days), with rates of return varying between 1 and 2.5 percent for one- to three-day maturity repos, and between 1 and 3.5 percent for four-to seven-day maturity repos.

F. Market Infrastructure: Clearing, Settlement, and Payment

208. **The National Stock Exchange provides optional custody and settlement services.** These services are provided to exchange brokers as well as to other authorized institutional investors and corporations through the Securities Depository (Caja de Valores). Although the Securities Depository is currently run by the board of directors of the National Stock Exchange and acts as a department of the exchange, there is an initiative for it to become an independent private entity. The Securities Depository uses an Oracle-based electronic system that provides its participants with remote information on a real-time basis and enables settlement through the central securities depository. The participants can choose between delivery versus payment, or free of payment delivery electronic settlement. Whereas repo transactions are settled on a T+0 basis, outright transactions in Banguat and government securities are settled on a T+2 basis. The Securities Depository has opened accounts with all major banks to facilitate payment. Banguat does not accept direct payment from exchange brokers. Instead it is the stock exchange that collects payment from brokers and settles with Banguat. For operations transacted over the counter, Banguat acts as the central depository of securities. This is particularly relevant for the seven-day transactions executed in the interbank market. However, Banguat does not solicit submission of information on individual interbank trades, which could help the process of price discovery if disseminated back to the market in aggregate form.

G. Problems in the Public Debt Market

209. **Sovereign debt issuance is highly fragmented in Guatemala.** In 2005, the finance ministry placed government securities for an amount of Q4,316 million (excluding the direct placement at Banguat for Q964 million). Taking into account that the overall placement of government paper was finalized by June 2005, and that two weekly auctions are run (an auction open to financial intermediaries and a bid intermediated by brokers), the average placement per auction amounts to a volume of Q30 million ($4 million). Similarly, the overall amount of certificates of deposit issued by Banguat in 2005, namely Q16,977 million, was placed in three weekly auctions of three short maturities throughout the year, and four long maturities after June, amounting to an average issue size of Q70 million. The continuous trickle of issuance by the government and Banguat prevents adequate secondary market trading and creates a perception that the issuers are seeking the lowest rates. In the long run, the loss of liquidity in the secondary market may imply a higher cost for the authorities than savings garnered through aggressive skimming of quotes.

210. **Issuance of nonstandard securities further prevents trading and liquidity**. The instruments issued by both the finance ministry and Banguat are nonstandardized, in two respects. First, securities are allocated to successful bidders through rates of return instead of prices. Second, they are not allocated in standard lots or dematerialized form in all cases. Investors' preferences are often biased towards materialized securities owing to the absence of a central depository. Moreover, full dematerialization of central bank paper is prevented by Banguat internal regulation. These practices originate in the regulatory impediment preventing Banguat from issuing standardized securities without prior congressional approval, which does not apply to the issuance of nonstandardized deposit certificates. With Banguat acting as a fiscal agent for the treasury, the latter follows the same issuance strategy as the former. The two issuers are conscious of the necessity to standardize public securities, particularly under the current arrangements to implement an inflation-targeting framework by 2007. There is a plan to standardize all public securities in 2006 following the endorsement of the Central American Monetary Council.

211. **The two sovereign issuers compete in some market segments.** The Ministry of Finance coordinates with Banguat on the issuance of public instruments through weekly meetings. Further, to avoid undue market competition, Banguat concentrates on short-term issuance, with the treasury issuing at longer maturities. However, following the completion of the placement of long-term securities by the finance ministry, the central bank opened the issuance of four- and six-year instruments to finance the quasi-fiscal deficit. While Guatemala has not yet experienced a significant problem in divergent rates between the two issuers, issuance of overlapping maturities creates just such a potential problem. More importantly, aggregate sovereign issuance gets divided between two issuers, preventing the domestic issues from reaching an adequately large benchmark size, and creating an additional liquidity premium or cost for the issuers.

212. **More fundamentally, the central bank needs to be adequately capitalized to eliminate the need for the central bank to issue its own debt and to allow it to conduct monetary policy operations through government securities**. The estimated quasi-fiscal deficit incurred by Banguat for monetary operations, exchange rate interventions, and credit

policy transactions performed in 1982–2002 was of the order of Q16,000 million (or $2,100 million). Whereas this deficit is expected to be covered by a special bond issuance by the treasury, the losses suffered by Banguat after 2002 are being financed by the Ministry of Finance through issuance of interest-bearing bonds, in accordance with the 2002 Banguat law. Already in 2005, the ministry granted a 29.6-year bond at a 3.87 percent interest rate to cover the losses incurred in 2003. However, the two-year gap in the financing of the quasi- fiscal deficit by the ministry compels Banguat to tap investors for financing purposes, which may hinder the efficacy of liquidity management operations. The below-market interest rate and the illiquidity of the instrument also complicate Banguat's operations.

213. **Several gaps in enabling legislation and regulation need to be addressed**. The current legislation in Guatemala does not yet provide for establishment of a securities commission. This lack of adequate oversight has constrained the creation of a central depository of securities, which would require the presence of a regulatory body to guarantee the compliance of market transactions with intended prudential norms. The authorities are contemplating the creation of such a central depository subject to the enactment of adequate legislation. Further, legislation and regulation are needed to regulate collective investment and to allow for the creation of pension funds. Though the current securities market law contemplates the creation of mutual funds, their size is restricted by the absence of enabling legislation (their accumulated portfolio in July 2005 amounted to Q672 million, or 0.3 percent of GDP). Concerning the banking sector regulatory framework, the requirement of prior approval by the Superintendency of Banks for investment in foreign sovereign securities, excluding U.S. instruments, may hinder the development of a regional market.

214. **There are also several problems in market trading**. First, the absence of a procedure for reporting individual interbank operations to Banguat that can be subsequently aggregated and disseminated to the market may constrain the development of a liquid interbank market. Second, although their capital in all cases exceeds the minimum mandatory capital, brokers may be undercapitalized. Of the 21 brokers, only 14 have capital exceeding Q1 million ($130,000), with 17 brokers forming part of larger financial conglomerates, and only two of the remaining four being significant traders. The undercapitalization may create risks, particularly for investors in the investment portfolio. Also, the existence of two competing stock exchanges, the *Bolsa de Valores Nacional* and the *Corporación Bursátil,* (with the caveat that most of public debt trading is performed in the former) may further fragment the already-small secondary trading—despite the lack of trading commissions—on an outright basis.

H. Recommendations

215. The following recommendations aim to advance development of the domestic public debt market and improve liquidity in secondary trading.

216. **Promote the standardization of domestic securities by drawing up a plan to restructure the outstanding nonstandard instruments in compliance with the regional**

standards set up by the Central American Monetary Council.[67] Furthermore, public securities should be issued in tranches of sufficient volume to guarantee the liquidity of these issues in the secondary market.[68] The current high degree of fragmentation hampers market liquidity and prevents the creation of a meaningful benchmark issue that would span the yield curve.

217. **Firm up in the recapitalization of the central bank to cover losses incurred by the monetary, exchange, and credit policy operations over 1981–2002.** These losses should be assumed by the government, following the 2002 Banguat law, with treasury bonds or other financial instruments accruing market interest rates that should be negotiable in the secondary domestic market. In the meantime, central bank issues aimed at financing the quasi-fiscal deficit should be separated from monetary policy issues, in that the former should have longer maturities, coordinating with the government to avert undue competition.

218. **Allow financial institutions—including banks and institutional investors—to participate in central bank auctions on a direct basis.** Broad participation is expected to foster competition.

219. **Allot securities through a price auction (instead of the current interest rate auction) to enhance liquidity in the secondary marke**t. The choice between discriminatory and uniform price auction might depend on the vulnerability of investors to market collusion. A priori, while discriminatory price auctions may improve competition in thin markets, uniform price auctions might increase government revenue.

220. **Promote legal reforms to provide for establishment of a market securities commission.** The presence of such a commission could also facilitate the establishment of a central securities depository, which in turn would facilitate an electronic auction system and the phasing out of materialized securities. Moreover, the enactment of specific legislation regulating the securities portfolio of institutional investors would facilitate the creation of pension funds and the growth of investment funds, thus ensuring a stable demand for long-term securities. Finally, Banguat should consider facilitating the clearing and settlement of multilateral cross-border payments in the region to enhance financial integration.

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[67] The authorities are planning to standardize public securities issues in 2006 to order to facilitate the inflation-targeting framework expected to be implemented by 2007.

[68] In its resolution of 2003, the council recommends that domestic debt issuances be implemented in tranches with a minimum magnitude of $200 million for central bank issues, $100 million for short-term government issues, and $300 million for long-term government issues.

VI. THE PUBLIC DEBT MARKET IN HONDURAS[69]

A. Financial Sector

221. **The financial system of Honduras is composed primarily of private commercial banks, but there is a significant public sector presence**. Most of the 16 banks are privately owned, with the exception of two public banks (Table 41). The banking system includes nine domestic banks and seven foreign banks accounting for 31 percent of total bank capital. There is limited offshore banking in Honduras. Most domestic banks are family-run and provide credit primarily to affiliated businesses and individuals. A well-functioning interbank market of reserve funds ensures sufficient overnight-bank liquidity. Almost all of the banks have open lines of credit with each other. Despite the high level of liquidity in the banking sector, the absence of collateral in inter-bank transactions increases the systemic vulnerability from bank failures. In general, credit to the private sector has gradually risen in recent years, from 43.7 percent of GDP in 2001 to 52.6 percent in 2005. In addition, there are 10 insurance companies whose aggregate assets are less than 4 percent of assets held by banks. Other financial institutions include six collective investment institutions,[70] nine financial holding corporations, and the nascent securities markets in Tegucigalpa and San Pedro Sula.[71]

222. **In the 1990s, the Honduran government began to rapidly deregulate the financial sector.** The initiative included gradual liberalization of interest rates, creation of stock exchanges, and several banking sector reforms to encourage efficiency and interbank competition**.** The collapse of several financial institutions in the late 1990s and early 2000s,[72] however, led to the adoption of more stringent capital adequacy rules and banking supervision, clarification of the role of the central bank, and greater oversight of offshore banking operations. Many of the bank insolvencies from 1999 to 2002 were caused by mismanagement and internal fraud,[73] which prompted the Congress in September 2004 to adopt four financial sector reform laws to improve the functioning of the banking system, insurance sector, and central bank.[74] Nonetheless, the banking sector is still fragile and in need of further consolidation.

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[69] The principal author of this Chapter is Andy Jobst.

[70] This number includes savings and loan (S&L) associations, which are much smaller than commercial banks. Several S&Ls are owned by commercial banks.

[71] Finance companies in Honduras form part of a significant informal, nonregulated financial market that includes a wide variety of agents, institutions, and arrangements that extend far beyond finance companies and money lenders.

[72] Bancorp collapsed in 1999 and Banhcreser in 2001. In 2002, the National Banking and Insurance Commission (CNBS) announced the forced liquidation of Banco Capital, while another bank, Banco Sogerin, was placed under the supervision of the National Deposit Insurance Fund. After some delay to prevent wider damage to the banking system, the sale of Banco Sogerin was finally announced in July 2003.

[73] Before the adoption of the financial system law, financial institutions were subject to the general corporate governance regulations contained in the commercial code, which dates to 1950 and has undergone minimal revisions over time.

[74] The four laws reformed the National Deposit Insurance Fund, the Central Bank, the National Banking and Insurance Commission, and the general financial supervision system. A fifth law, passed in December 2004, established new and stronger penalties for financial crimes, including bank fraud.

Table 41. Honduras: Structure of the Financial System

	2001	2002	2003	2004	2005
Financial institutions					
Number of:					
Banks	21	19	16	16	16
Domestic-majority owned	19	17	10	9	9
Of which: public banks	2	2	2	2	2
Foreign-majority owned	2	2	6	7	7
Insurance companies	12	12	11	11	10
Collective investment institutions	5	5	5	5	6
Financial holding corporations	8	8	9	9	9
Financial system indicators (in millions of U.S. dollars)					
Bank assets	4,203.8	4,438.8	5,036.4	5,690.0	6,707.4
Total deposits of banking system	2,796.2	2,978.2	3,208.0	3,657.1	4,284.9
Deposits (in percent of assets)	66.5	67.1	63.7	64.3	63.9
Private credit	2,429.0	2,404.9	2,590.9	2,868.0	3,404.9
Insurance sector assets	228.0	259.5	265.8	253.4	271.7
Total (in percent of GDP)					
Banks	65.7	67.5	72.5	77.8	82.4
Private credit	43.7	45.3	46.2	50.0	52.6
Insurance companies	1.0	1.0	0.9	0.9	0.8
Memorandum items:					
GDP (in millions of U.S. dollars)	6,400.0	6,579.5	6,945.8	7,312.0	8,143.0
Exchange rate (lempiras per U.S. dollar)	15.9	16.9	17.7	18.6	18.9

Sources: Ministry of Finance, Central Bank, Banking and Insurance Commission, and IMF staff calculations.

B. Structure and Composition of Public Debt

223. **Despite increased local borrowing in recent years, the lion's share of total public debt remains external (Table 42).** As of the end of 2005, the stock of the central government's outstanding domestic debt (denominated in national currency) was $368.7 million (see Table 43), while its outstanding external debt was $4,453 million (of which 95 percent was bonded debt). External debt is long term and almost entirely concessional, with 75 percent of it owed to multilateral organizations.

Table 42. Honduras: External Government Debt
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005
Foreign creditors	4,147.80	4,167.10	4,410.30	4,817.90	5,208.70	4,452.59
Official creditors	4,124.30	4,164.60	4,408.70	4,815.40	5,206.00	4,448.89
Bilateral	1,417.10	1,372.80	1,504.30	1,707.90	1,772.20	1,103.54
Multilateral	2,707.20	2,791.80	2,904.40	3,107.50	3,433.80	3,345.35
Private creditors	23.50	2.50	1.60	2.50	2.70	3.70
Domestic creditors	-	-	-	-	-	-
Total	4,147.80	4,167.10	4,410.30	4,817.90	5,208.70	4,452.59

Sources: Ministry of Finance, Central Bank, and IMF staff calculations.

Table 43. Honduras: Local Government Debt
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005
Private creditors	249.16	261.34	309.38	460.73	471.42	367.51
Bank loans (long-term)	35.54	35.00	33.00	31.00	29.00	27.00
Bonds	211.04	224.07	274.44	428.08	441.04	339.36
Short-term (org. maturity)						
Medium-term (org. maturity)			50.23	236.51	291.83	219.09
Long-term (org. maturity)	211.04	224.07	224.21	191.57	149.21	120.27
Supplier's credit	-	-	-	-	-	-
Others (private)	-	-	-	-	-	-
Public creditors						
Central bank	-	-	-	-	-	-
Others (public sector)	2.59	2.27	1.94	1.65	1.38	1.15
Total	251.76	263.60	311.32	462.39	472.79	368.67
Decomposition by currency	249.16	261.34	309.38	460.73	471.42	367.51
Denominated in local currency	193.33	214.82	273.45	434.39	451.96	354.31
Denominated in foreign currency	55.83	46.51	35.93	26.34	19.46	13.21
Decomposition by maturity						
Short-term (org. maturity)	-	-	-	-	-	-
Medium-term (org. maturity)	-	-	50.23	236.51	291.83	219.09
Long-term (org. maturity)	249.16	261.34	259.15	224.22	179.58	148.42
Decomposition by interest rate						
Variable interest rate	150.44	156.53	166.46	255.43	224.10	158.59
Fixed interest rate	98.72	104.81	142.92	205.30	247.32	208.93

Sources: Ministry of Finance, Central Bank, and IMF staff calculations.

224. **In January 2006, Honduras reached an agreement with principal official creditors for a significant debt reduction.** The International Monetary Fund (IMF) has agreed to forgiveness of the equivalent of 84 percent of outstanding external debt at end-2005 under the Multilateral Debt Relief Initiative (MDRI), while the World Bank has approved relief of 80 percent of outstanding debt owed to the International Development Association (IDA) by July 1, 2006. Further external debt relief by the Inter-American Development Bank under the HIPC initiative is currently under discussion. Overall these debt relief initiatives are expected to result in a total reduction of external debt by more than 70 percent through the end of 2006.

225. **Central Bank is the more important sovereign debt issuer in the local market.** The central bank carries locally-issued debt of $882.2 million (Table 44). While the public sector is primarily financed by external debt, the issuance of domestic debt by the central bank (*Banco Central de Honduras*—BCH) serves exclusively to manage domestic liquidity through open market operations in short-term, zero-coupon Absorption Certificates, which are denominated in either local currency (CAM) or U.S. dollars (CADD).

Table 44. Honduras: Local Central Bank Debt
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005
Private creditors						
Certificates	120.05	223.87	322.86	368.80	576.20	882.18
Short-term (org. maturity)	120.05	223.87	322.86	368.80	576.20	882.18
Bonds	-	-	-	-	-	-
Bank loans	-	-	-	-	-	-
Others (public sector)						
Total	120.05	223.87	322.86	368.80	576.20	882.18
Decomposition by maturity						
Short-term (org. maturity)	120.05	223.87	322.86	368.80	576.20	882.18
Medium-term (org. maturity)	-	-	-	-	-	-
Long-term (org. maturity)	-	-	-	-	-	-
Decomposition by interest rate						
Variable interest rate	-	-	-	-	-	-
Fixed interest rate	120.05	223.87	322.86	368.80	576.20	882.18

Sources: Ministry of Finance, Central Bank, Banking and Insurance Commission, and IMF staff calculations.

226. **Currently only 19 percent of outstanding government debt is standardized.** Nonstandardized, low-interest or no-interest bonds were issued between 1997 and 2003 to settle concessional debt for land reform and housing subsidies. During the same period the government also issued several deeply discounted bonds to the central bank to cover the persistent central bank deficit.

227. **The Ministry of Finance recognizes central bank debt on an annual basis through the issuance of nonstandardized, long-term bonds (*bonos de reconocimiento)* at zero or below market interest to the BCH.** Before granting independence to the central bank in 1997, the government absorbed the bank' accumulated losses up to 1996.[75] Continued losses, however, forced the central bank to issue more debt to finance its own operations. In order to finally redress the problem of central bank decapitalization, the finance ministry started recognizing central bank losses with a one-year delay in accordance with Article 5 of the Central Bank Law. In 2003, the finance ministry issued a 50-year bond with a notional value of $250 million, and a 25-year bond with a notional value of $926 million in the subsequent year.[76] These transfer payments reduced outstanding central bank losses by 1.3 to 1.5 percentage points of GDP each year, respectively.

228. **The current recognition of central bank losses with deep discounted bonds does not eliminate future losses and calls for a timely and complete recapitalization of BCH.** For example, using a 12 percent discount rate,[77] the market value of the 50-year bond would be less than 2 percent of the face value. Although the government has lowered the maturity of these long-term government bonds issued to the central bank since 2003, this strategy of partial recapitalization with extremely discounted bonds is cumbersome, and does little to restore sufficient margin for the unconstrained execution of monetary policy.

229. **The stock of Central Bank domestic debt has grown steadily in the last five years from $120 million to almost $900 million.** Most of this debt has been issued short term and is held by private creditors (Table 44).

230. **The finance ministry lacks the financial capacity to recapitalize BCH, whose deficit climbed from around 2 percent of GDP in 2000 to more than 14 percent in 2005 (Table 45).** The finance ministry recognizes the need to reorganize the transfer payments to the central bank; however, the recapitalization can only be implemented after settlement of external payment obligations. Moreover, the savings from HPIC debt relief must be used for poverty reduction and are not available for fiscal reorganization.

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[75] The BCH is now prohibited from financing the central government by virtue of law enacted in 1997.

[76] The two bonds also include grace periods of 25 and 10 years without interest payment, respectively. The latter issue was split into 90 percent of zero-coupon bonds and 10 percent of coupon bonds at market interest.

[77] The secondary market yield for government debt of longer maturities in 2005 was between 12.1 and 12.4 percent.

Table 45. Honduras Quasi-Fiscal Debt
(In millions of U.S. dollars)

	2001	2002	2003	2004	2005
Total central government (local)	261.34	309.38	460.73	471.42	368.69
Of which:					
Financial Stabilization II	5.65	4.79	4.06	3.38	2.86
Financial Stabilization III	33.61	29.51	26.12	22.97	20.76
Financial System Strengthening Law			75.85	54.96	49.96
Government Bonds 2001		18.52	26.62	23.77	20.92
Government Bonds 2002		44.98	44.98	36.33	12.65
Government Bonds 2003			105.92	112.72	71.95
Government Bonds 2004				84.51	84.51
Total central bank quasi-fiscal debt	223.87	322.86	368.80	576.20	882.18
Total	485.21	632.24	829.54	1,047.62	1,250.87
Total central government	4.08	4.70	6.63	6.45	4.53
Total central bank	3.72	5.36	6.12	9.56	14.64
Grand total	8.05	10.49	13.77	17.39	20.76
Total central government	4.89	18.38	48.92	2.32	-21.79
Total central bank	86.49	44.22	14.23	56.23	53.10
Grand total	31.42	30.30	31.21	26.29	19.40
Memorandum items					
Net international reserves (in billions of U.S. dollars)		1.20	1.13	1.62	1.98
Exchange rate (lempiras per U.S. dollar)	15.92	16.92	17.75	18.63	18.90
GDP (in billions of U.S. dollars)	6.40	6.58	6.95	7.31	8.14

Sources: Ministry of Finance, Central Bank, and IMF staff calculations.

C. Primary Issuance

231. **At the beginning of each year, Congress authorizes the total annual issuance volume of public debt.** However, this decision does not set the overall debt ceiling or maturity profile of debt within an integrated debt management strategy or desired level of indebtedness. Congress frequently authorizes new debt issuance at a later stage if the need for more funding arises during the year.

232. **Public debt issuance in Honduras is mostly limited to short-term, negotiable certificates issued by both the BCH and the Ministry of Finance.** While the government desires to issue medium- and long-term debt, at the moment, it issues debt only to the extent of amortizations (i.e., no net increase in debt stock), and such issuance currently is short term. In addition, long-term government bonds are issued annually to cover the losses of the central bank (Table 46), but outside the normal auction process.

233. **Domestic government debt issuance is rare and considered a last resort to raising external finance.** In contrast, issuance by the central bank for monetary policy purposes is frequent and more significant in volume than the debt issuance by the finance ministry.

234. **The BCH made efforts to modernize its monetary operations beginning in 2004 with the adoption of the new Central Bank Law.** The central bank relies mainly on open market operations as the appropriate instrument to control monetary aggregates in terms of liquidity and net international assets.[78] Key elements of the new monetary policy are the market-based primary auctions of negotiable central bank securities and an interest rate corridor for an overnight (collateralized) loan facility to commercial banks, with the interbank reserve loan rate (i.e. deposit facility) as the floor (at 4 percentage points below the monetary policy rate (*tasa de política monetaria* or TPM)) and a new Lombard facility (*facilidad permanente de crédito*) as the ceiling (at 4 percentage points below the TPM). The monetary policy rate is allowed to fluctuate within a band and sets the maximum rate permitted in the weekly auction of seven-day CAMs.[79]

235. **A rather large number of competing sovereign securities are issued in Honduras.** The BCH conducts auctions for both central bank and finance ministry issues. The central bank issues two types of standardized, short-term public debt instruments, through a discriminatory price auction. The central bank issues zero-coupon discount Absorption Certificates in domestic currency (CAM),[80] with maturities of either 7 days (only for financial institutions) or 21, 28, 91, 182, and 364 days (for all eligible investors),[81] and U.S.-dollar denominated Absorption Certificates (CADD), with maturities of 98, 182, and 364 days (Table 46). The Ministry of Finance Debt Management Office (*Crédito Público* or

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[78] Open market operations in Honduras respond mainly to the need to sterilize substantial foreign currency inflows (mainly from remittances), a policy measure that the IMF has recommended in the PRGF program.

[79] The BCH uses the seven-day local currency auctions to signal changes in the policy stance. The seven-day CAM interest rate is also the short-term operational target, while repos and reverse repos serve as means to manage systemic liquidity. In addition to the three auctions, the central bank also uses three types of Lombard facilities to conduct monetary policy: (1) the two-six-day repo market for short-term credit to temporarily illiquid banks; (2) a longer-term 180-day credit facility for more serious cases of illiquidity; and (3) a lender-of-last-resort credit facility that would be used to stave off a banking crisis. BCH also has improved its infrastructure by making securities negotiable, adapting its organization, and improving its technical capacity.

[80] In order to signify the restriction of seven-day CAMs to financial institutions only, these instruments carry the designation CAM/IF.

[81] In 2005, the central bank initiated biweekly auctions of 98-, 182-, and 364-day debt to provide investment and trading instruments for the short-term secondary markets.

Table 46. Honduras: Securities Issued by the Ministry of Finance and the Central Bank

Security Type	Maturity (In days)	Discount or Coupon Interest Rate	Placement-Auction	Pricing	Standardization	Reopening
Government/Ministry of Finance						
Government Notes	28	Zero				
Government Notes	91	Zero				
Government Notes	182	Zero	Competitive and noncompetitive	Discriminatory	Yes	Yes
Government Notes	364	Zero				
Government Notes	1096	12.5 (fixed)				
Central Bank						
CAM/IF	7	Zero				
CAM	21	Zero				
CAM	28	Zero	Competitive *(but possibility of issuance to public sector entities at average auction price)*	Discriminatory	Yes	No
CAM	182	Zero				
CAM	364	Zero				
CADD	91	Zero				
CADD	182	Zero	Competitive *(but possibility of issuance to public sector entities at average auction price)*	Discriminatory	Yes	No
CADD	364	Zero				

Sources: Ministry of Finance and Central Bank.

CP) uses the same auction platform to issue standardized, short-term government notes (*valores gubernamentales en moneda nacional* or VG), with maturities of 98, 182, and 364 days every two weeks and to issue three-year government bonds a few times a year.[82]

236. **The auctions of public debt follow a preannounced calendar.** Prior to adoption of Government Securities Trading Rulebook (RNVG), auctions of central bank debt securities (in local currency and U.S. dollars) were scheduled alternately on a weekly basis.[83] After RNVG came into effect in July 2005, the central bank switched to weekly and bi-weekly CAM auctions, while CADD auctions continued to be take place once every two weeks. The auction of seven-day CAMs is held every Tuesday afternoon and may be attended only by financial institutions. The central bank uses this auction to absorb excess liquidity in the banking system. The bi-weekly auction of CAMs with a maturity of three months or longer is held on Tuesday mornings and may be attended by representatives all public and private financial institutions that buy directly and by intermediaries that represent the investing public. Until their recent suspension,[84] weekly auctions for CADDs were scheduled every Wednesday and were meant to provide an investment outlet for dollar deposits. Although Honduran banks may invest their sizable dollar deposits abroad, dollar rates in the United States were below the cost of their dollar deposits.

237. **Government debt is always auctioned on the same day and in parallel with the auction of either CAMs or CADDs of the central bank with the same security characteristics.**[85] Only the auctions of VGs are reopening of existing series. All auctions are competitive, but public auctions of VGs also allow noncompetitive bids[86] by public sector entities and government agencies, which receive an allocation at the average rate of successful competitive bids.

238. **RNVG and Resolution No. 154–4/2005 establish the auction procedure.** Bids for public debt securities are accepted until 11 a.m. on auction day (except CAM/IFs, for which a deadline of 10:30 a.m. applies) and are submitted to the BCH's Debt Management Department. The auction closes at 11 a.m. after all the bid envelopes are opened. The central

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[82] The central bank discontinued auctioning both CAMs and VGs at 28-day-maturities after May 31, 2005. *Crédito Público* and the finance ministry have plans to issue public debt at longer maturities (five years). In the absence of an established and liquid domestic yield curve in the medium and long term, the finance ministry is forced to contemplate more external borrowing despite high external debt. *Crédito Público* views domestic bond issuance as an inefficient financing mechanism, given the current capital market development in Honduras.

[83] RNGV standardized BCH-issued debt and was adopted to stimulate exchange-based secondary market activity.

[84] According to the Ministry of Finance, auctions of CADDs will again be held every Wednesday once they are re-introduced.

[85] *Crédito Público* decides on the allocation of successful bids in the parallel auctions of CAMs/CADDs and VGs. Over the past six months, 90 to 95 percent of the bids were taken by the BCH after *Crédito Público* decided that there was no need for new fiscal funding. Only two combined auctions of VGs and CADDs are planned in 2006. At present, however, the auction of CADDs has been suspended.

[86] On average, these blind offers represent 4 to 5 percent of the auction volume.

bank only registers bids if they comply with RNVG, the minimum bid requirement,[87] and the preannounce indicative interest rate for each type of security tendered.[88] The highest acceptable interest rate (cut-off rate) is set by the board of directors of the central bank and is meant to signal the market as to the central bank's interest rate targets. In auctions of VGs, this decision is taken by the CP of the Ministry of Finance. Noncompetitive bids receive the average rate of successful bids (Article 28 of Resolution No. 154–4/2005). The auction is declared void *(subasta desierta)* if only one valid bid is received. BCH acts as custodian of the auction process, while the Central American Stock Exchange (*Bolsa Centroamericano de Valores*—BCV) usually administers the settlement and clearing on the same day of the auction.

239. **Participants in the primary auction are mainly banks and exchange brokers.** Any natural and legal person, resident or nonresident, is eligible to participate in the primary market. According to RNVG,[89] private financial institutions and the Honduran Bank for Production and Housing (BANHPROVI), a public second-tier bank, participate directly and commission-free in all auctions.[90] All other investors (mutual funds, private and public pension funds, state-owned banks, and individual investors) may submit bids via authorized intermediaries (brokers) of public debt on a commission basis. Recently, public entities have been allowed to also submit bids directly.

240. **As of February 2006, brokerage firms were able to implicitly control market access of public sector and nonfinancial bidders to the primary public debt market.** Honduras has 11 brokerage firms, nine of which are active participants in the auction process of public debt. More than two-thirds of all registered brokerage firms are subsidiaries of large banking groups. Since brokerage firms are largely owned by banks, which can access the primary market themselves, the legal restrictions on primary market participation by nonfinancial investors and public entities (other than BANHPROVI) profits banks. Brokers charge semiannual commissions in the range of 0.07 to 0.25 percent to their clients (both in primary and secondary market).

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[87] The minimum bid amount is L100,000 ($5,291) for competitive bids and L500,000 (US$26,455) for noncompetitive bids (Article 16 of Resolution No. 154–4/2005 of the BCH Directorate).

[88] Moreover, CAMs are subject to an interest rate limit of the monetary policy rate plus 2 percent. Although the central bank and the finance ministry make their decision about the characteristics of issued debt securities separately in joint auctions, they usually agree on the same indicative interest rate.

[89] RNVG represented an important departure from the previous regime of public debt issuance. Prior to RNVG all primary market participants were required to submit bids through brokerage firms, which charged a semi-annual commission. From July 2005, RNVG eliminated the commission for trading BCH-issued paper, and banks were entitled to directly participate in the primary market, while all other bidders were still required to place bids via registered brokers.

[90] BANHPROVI has assets totaling over $500 million and manages over a dozen trust funds for housing and production. In contrast to "first-tier" banks, which typically operate the full spectrum of risk management, second-tier banks are prohibited from using public deposits for (illiquid) lending to the private sector. In case of a so-called "narrow" bank, all deposit liabilities are invested in approved and highly-liquid money market instruments and no other credit business is allowed. "Core" banks can engage in lending to the private sector, provided such loans are funded from their second-tier capital.

241. **Conscious of the commission fees public entities pay to brokerage firms, the BCH on March 2, 2006 the BHC revised the existing provisions regulating primary market access (Article 13 of RNVG) and allowed public sector institutions to directly participate in primary auction of public debt.**[91] This policy change is likely to result in substantially lower revenues for brokers and ends indirect primary market control by commercial banks. Nonetheless, brokers retain the right to charge fees if they serve as intermediaries

242. **Primary issuance is dominated by local currency-denominated, short-term certificates issued by the BCH.** CAMs represent 95 percent of the primary market issuance of $2,864 million (2005), with the rest of the issuance volume being attributable to CADD (3 percent) and government bonds (2 percent). Banks and investment funds (mostly public, such as large government pension funds) are dominant investors in VGs, while only banks (by virtue of regulatory restrictions or organizational nature) invest in CAMs and CADDs. In 2005, most CAMs were issued at maturities of 7 days (29.4 percent) and 364-days (33.7 percent). The average auction volume of all CAMs was $80.1 million (Table 47). Sporadic auction of VGs in 2005 resulted in large variations in issuance volumes of government debt—as much as $7.9 million and as little as $54,295. New issuance volume for 2006 was expected to exceed $2.5 billion.

[91] This move comes as a blow to the national stock exchange and custodian of public debt auctions, which suffered a decline due to the elimination of intermediation fees.

Table 47. Honduras: Auctions of Domestic Public Debt Issues (2005)

Issuer	Central Bank (BCH)						Government (MF)				
Security [Name]	*CAM*						*VGBEC*				
Maturity (in days)	*7*	*28*	*91*	*182*	*364*	*all*	*28*	*91*	*182*	*364*	*all*
No. of auctions	36	20	37	36	36	165	4	11	17	1	33
Indicative amount											
Total (per maturity)	**1,253.0**	**3.5**	**483.4**	**601.2**	**614.9**	**2,955.9**	**0.8**	**105.6**	**256.3**	**0.3**	**363.1**
Share of total indicative annual (In percent)	42.4	0.1	16.4	20.3	20.8	100.0	0.2	29.1	70.6	0.1	100.0
Average amount (per auction)	34.8	0.2	13.1	16.7	17.1	81.8	0.2	9.6	15.1	0.3	25.2
Bid volume (per auction)											
Total (per maturity)	**839.3**	**178.2**	**408.3**	**547.9**	**1,048.9**	**3,022.6**	**3.3**	**16.7**	**28.3**	**7.9**	**56.3**
Share of total bids (In percent)	27.8	5.9	13.5	18.1	34.7	100.0	5.9	29.7	50.3	14.1	100.0
Average amount (per auction)	23.3	8.9	11.0	15.2	29.1	87.6	0.8	1.5	1.7	7.9	12.0
Offered volume (allocation)											
Total (per maturity)	**815.0**	**148.8**	**362.7**	**512.7**	**935.5**	**2,774.8**	**3.3**	**16.5**	**28.1**	**7.9**	**55.8**
Share of total issuance (In percent)	29.4	5.4	13.1	18.5	33.7	100.0	5.9	29.5	50.3	14.2	100.0
Average amount (per auction)	22.6	7.4	9.8	14.2	26.0	80.1	0.8	1.5	1.7	7.9	11.9
Cut-off rate (in percent)											
mean	7.07	8.54	11.33	11.82	12.27		8.59	11.31	11.84	12.31	
median	7.00	8.50	11.19	11.75	12.31		8.53	11.18	11.81	12.31	
Cut-off price											
mean	99.86	99.35	97.06	94.36	88.97		99.34	97.11	94.35	88.93	
median	99.86	99.34	97.10	94.39	88.93		99.34	97.08	94.36	88.93	

Sources: Ministry of Finance, Central Bank, and IMF staff calculations.

243. **Despite structural differences in the execution of the auction process for CAMs and VGs, both types of public debt are priced the same.** Auctions for CAMs are more competitive than VG auctions and attract more private and smaller bids. Issuance volumes for CAMs are much larger. Successful bids for CAMs also tend to be roughly twice as large as unsuccessful bids, which, at high aggregate allocation rates, suggests less price sensitivity of larger bidders. CAM auctions also show more efficient price formation and greater market consensus on a single price, given the small difference of mean/median bid prices between successful and unsuccessful bids. Notwithstanding these structural differences, the refinancing costs of both the central bank and the finance ministry are about the same. Spreads of VGs concur with those of CAMs for almost all maturity terms.

244. **There are several problems associated with the primary auction process.** Although the auction process is transparent, it results in frequent auction failures and deviations from the announced auction volumes. There are also some problems with the timing of the auction process. Moreover, BCH is exposed to high roll-over risk from the large-scale issuance of very-short term CAMs.

245. **Concurrent issuance by both the government and central bank has led to an excessive frequency of small issuances at short maturities, inefficient price formation, and auction failures.** The average auction volume offered ranges from $7.4 to $26 million for CAMs and from $800,000 to just shy of $8 million for VGs, with average indicative amounts between $200,000 and $34.8 million for CAMs and $200,000 and $15.1 million for VGs (Table 47). Moreover, undersubscribed auctions are frequent, and first-time auctions of VGs are routinely declared void. Bids for VGs are never rejected, yet occasional rationing takes place. In 2005, only about 70 percent of all announced auctions (and only at the most popular maturity terms of three months and longer) solicited sufficient demand to be declared valid. On average, demand falls consistently short of the indicative issuance amounts of both central bank and government debt and varies widely by maturity term. Only 28-day and 364-day CAMs (or 20.9 percent of offered CAMs) as well as 28-day VGs (or 0.2 percent of offered VGs) attracted sufficient investor demand for market clearing. At the same time, bidders can almost be certain to receive a full allocation (at a probability of 90 percent or more) across all maturities of CAM and VG issues, indicating that low demand for the announced volume coincides with little price competition. This problem is also compounded by the lack of a binding commitment on the part of the Ministry of Finance and the BCH to the indicative offered volume. In case of some incomplete auctions, the available issue amount is altered after the auction. Such ex-post changes in auction parameters reduce the perceived transparency of the process.

246. **The primary market auctions are conducted without complete ex ante coordination of fiscal funding with liquidity operations by BCH.** In 2005, the government perceived no immediate fiscal funding need and yielded its allocation of bids to the central bank about half of the time. More generally, the simultaneous issuance of identical debt securities may not be ideal for each issuer.

247. **There is also a problem of delayed disclosure of auction results**. The results of the Tuesday morning auction of CAMs with a maturity of three weeks or longer are not published before the afternoon auction of seven-day CAMs. Hence, bidders lack essential information about their success rate for CAMs at longer maturities before entering the afternoon auction of CAMs. While the central bank believes that there is an effective cash yield curve for 7, 28,

98, 182, and 364-day maturities, some banks believe that only central bank debt with a maturity of one year is efficiently priced.

248. **Auctions of debt securities with maturities of one month or more entails reveal a substantial maturity premium, which may reflect a convergence of market views on yields.** While the Ministry of Finance attempts to avert auction failure by sounding the market about current yields prior to the auction, the absence of liquid trading prevents adequate convergence on market clearing rates. Between 1 and 12 months, yield premia rise by nearly 380 basis points which might be explained by investor uncertainty in the absence of a liquid yield curve. The recent cancellation of a government bond issue for the national energy company (*Empresa Nacional de Energía Eléctrica)* (Box 3) underscores this problem.

Box 3. Government Bond Issue for the *Empresa Nacional de Energía Eléctrica*

The weaknesses in institutional infrastructure and transparency for public debt issuance were revealed recently in a failed attempt by the *Banco Nacional de Honduras* (BCH) to raise $100 million from capital markets for the national electrical energy company, *Empresa Nacional de Energía Eléctrica* (ENEE).

In January 2006, the government authorized the central bank to conduct a competitive public auction for $100 million of five-year government bonds to help pay off short-term debts of ENEE, which has long-standing payment problems. These government-backed bonds were offered at an indicative interest rate of 5.5 percent to domestic and foreign investors. However, the record issuance volume and inadequate information about payment provisions, lead managers, and the submission process for bids worried potential investors. Public statements prior to the auction concerning the liquidity problems of the company and the need for government support also adversely affected investor sentiment. After having received only bids with interest rates (9 to 12 percent) that far exceeded the announced (indicative) interest rate of 5.5 percent for what was essentially a risk-free transaction on the auction day of January 18, 2006, the central bank decided to cancel the auction.

In response to the limited demand for the issue, the central bank announced a new public auction for $50 million, half the originally issuance volume, of BCP (with auction number SPBCP-2005 02-01/2006) at the same indicative coupon rate of 5.5 percent, with an emission date of January 25, 2006 and a maturity date of January 25, 2011. Again, the auction was undersubscribed, and the central bank received bid prices at significant discounts, with yields ranging from 8.5 to 11 percent. The final auction results were as follows: cut-off rate: 9.5 percent; average interest rate of successful bids: 9.49 percent; bid volume: $47.0 million; and allocation volume: $32.0 million.

249. **The large liquidity operations by the decapitalized central bank carry potentially high rollover risk.** Open market operations have resulted in a stock of short-term central bank securities (seven-day CAMs) of only about $47 million (as of April 2006), which is less than 6 percent of the monetary base and about 2 percent of net international reserves. However, last year, BCH issued more than $815 million of seven-day CAMs (or more than 92 percent of total domestic central bank debt) at an average weekly auction volume of $22.6 million (or almost half of the current stock of seven-day CAMs). All of central bank issuance is short term, and the sleep yield curve may partly explain the preference for large issuance at very short term maturities. Although the central bank has sufficient discretion in choosing desired maturities up to one year (Table 47), when reserves decline, the overall refinancing needs of the decapitalized central bank (Table 44) may imply large rollover risks.

D. Secondary Market for Public Debt

250. **Secondary market trading is largely limited to short-term debt securities, virtually all of which is public debt.** The BCV administers the secondary market for exchange-traded securities in Honduras. Public debt constitutes 99.8 percent of secondary market trading, which dwarfs the secondary trading in financial sector bonds (Table 48). Commercial paper and long-term corporate debt issued by financial institutions are insignificant in size and trading, and are limited to Certificates of deposit (*certificados de depósitos a plazo* or CDP). An exchange-based repo market is virtually nonexistent.[92] Capital market-based corporate finance does not have a large following among the mainly family-owned businesses, who are reluctant to comply with public disclosure requirements for corporate bond listing.[93]

251. **Central bank-issued certificates are most frequently traded.** In 2005, the total trading volume of public debt and other securities at the BCV was $2,038 million (Table 48). CAMs were the most heavily traded (94.2 percent or $1.92 billion),[94] followed by CADDs (3.14 percent or $63.89 million), some medium-term government bonds (2.48 percent or $50.59 million) and CDPs (0.2 percent or $4.36 million). Traded government bonds had maturities of between 657 and 1,096 days and traded at an average yield of 12.31 percent, whereas debt certificates issued by the central bank recorded maturities of between 98 and 364 days (the dollar denominated CADDs) and 82 and 180 days (CAMs), at average yields of 3.15 and 9.57 percent, respectively. Secondary trading volume in 2005 suggests that the outstanding stock of these BCH-issued, open-market-operation securities ($867.2 million of CAMs and $13.2 million of CADDs) is turned over at least twice annually.

[92] Also note that the interbank market is considered more efficient and secure than the secondary market for repos, which might explain their insignificance. Banks have abandoned the repo market, mainly because of the administrative cost of handling and immobilizing collateral securities.

[93] For the first time since its creation in 1994, the BCV has five registered family-owned businesses that issue corporate bonds. Moreover, persistently high interest rates have made capital-market-based finance expensive.

[94] The money market is comprised of only two main instruments, CAMs and the interbank reserve deposits, with CAMs being by far the most important investment vehicle. In the absence of alternative investment vehicles, commercial banks hold large amounts of CAMs. This concerns officials from the National Banking and Insurance Commission, who worry about the effect of this concentration of risk (albeit sovereign risk) in the event of a national disaster.

Table 48. Honduras: Secondary Trading of Fixed Income Domestic Securities

(In millions of U.S. dollars)

	2002		2003		2004		2005			
	Trading volume		Trading volume		Trading volume		Average outstanding	Trading volume		
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Amount	Percent	Percent of stock
Repo	3.1	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Outright	1,231.4	99.7	1,415.2	100.0	1,262.9	100.0	781.2	2,038.6	100.0	260.9
Private securities	7.8	0.6	4.3	0.3	4.5	0.4	2.8	4.4	0.2	154.1
Public securities	1,223.6	99.1	1,410.9	99.7	1,258.4	99.6	778.4	2,034.2	99.8	261.3
Govt. bonds	71.0	5.7	43.2	3.1	52.9	4.2	72.1	50.6	2.5	70.1
CAM	864.2	70.0	1,091.9	77.2	1,051.0	83.2	697.3	1,919.7	94.2	275.3
CADD	288.5	23.4	275.8	19.5	154.4	12.2	9.0	63.9	3.1	709.2
Equity	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Others	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total	1,234.8	100.0	1,415.2	100.0	1,262.9	100.0	781.2	2,038.6	100.0	260.9

Sources: National Stock Exchange (BCV), and IMF staff calculations.

252. **The absence of significant volumes of medium-term government-issued debt and very small trading therein has prevented the development of a sovereign term structure beyond one year.** Notwithstanding the extension of the maturity term of CAMs and VGs in 2005 up to one year, almost all public debt securities are still short term. Currently, the absence of new issues of medium- and long-term government debt is due to the current stand-by agreement with the IMF, which requires total domestic debt issuance to be equal to zero.

253. **Systemic constraints have limited secondary market development.** Private interbank trading of public debt (to circumvent listing and registration fees) and the expedience of a "buy-and-hold" investment strategy for short-term debt have foiled broad secondary market development. Moreover, retail investors prefer certificates of deposit with local banks, which participate in the primary and secondary public debt markets. Although the secondary market is still incipient and lacks liquidity, the recent introduction of three-year, fixed-rate government debt and greater investor sophistication indicate an ongoing progress of market deepening.[95]

E. Investor Universe and Regulation of Investments in Public Debt

254. The largest investors in public debt markets are the public pension funds of the social security system (Table 49) and commercial banks. However, voluntary investment guidelines and mismanagement have produced chronic deficits in the social security system. Although good progress has been made in reforming the main public pension system (IHSS), some special public pension systems still face actuarial deficits, owing mainly to high administrative costs and low return on investments.[96] The National Banking and Insurance Commission (*Comisión Nacional de Bancos y Seguros*–CNBS), estimates the actuarial deficit of the special public pension funds at L6.7 billion ($354.5 million) or about 4.4 percent of GDP in 2005. At present, IHSS reports reserve holdings in the amount of L5.4 billion ($291 million), of which 90 percent are invested in public debt consistent with the above investment regulations. Commercial banks are the second most important investor group, with $114 million. Insurance companies are not significant investors in public debt.

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[95] The Ministry of Finance recognizes the need for the creation of an active local debt market. Initiatives from the World Bank have led to the creation of a working group of representatives from both the public and private sector (supervisors, banks, and brokers, but without BCH representation). The aim is to make recommendations for development of a secondary market of fixed-income securities. Local authorities are also exploring with counterparts in El Salvador, Guatemala, and Panama the possibility of forming a regional exchange.

[96] The IHSS, which is the largest system, covers workers employed in the private sector, while the special pension systems are for teachers, the armed forces, public sector workers, and university workers. The deficits are remarkable in light of the fact that the contribution rate to the IHSS is small (1 and 2 percent of gross income by workers and employers, respectively), whereas special pension funds receive relatively high contributions (7 and 11percent, respectively). The authorities have taken several steps to strengthen these pension funds, including issuing guidelines on eligible investments of pension reserves, requiring the publication of their portfolios; and establishing criminal liability for the mismanagement of pension reserves. CNBS is working on a strategic plan aimed at reforming the special pension regimes.

Table 49. Honduras: Investor Breakdown of Public Debt
(Local Market)
(In millions of U.S. dollars)

	2001	2002	2003	2004	2005
Domestic investors	284.26	295.96	507.44	399.56	357.76
Banks and quasi-banks	58.02	63.55	163.77	136.57	114.00
Insurance companies	12.15	7.87	7.56	3.36	1.96
Central bank	58.37	54.30	129.36	63.42	48.52
Nonfinancial public sector	103.43	119.26	158.24	150.60	140.86
Nonfinancial private sector	52.30	50.98	48.52	45.62	52.42
Foreign investors	0.00	0.00	0.00	0.00	0.00
Total	284.26	295.96	507.44	399.56	357.76
Decomposition by currency					
Denominated in local currency	284.26	295.96	507.44	399.56	357.76
Denominated in foreign currency	0.00	0.00	0.00	0.00	0.00

Sources: Ministry of Finance, Central Bank, Banking and Insurance Commission, and IMF staff calculations.

F. Problems and Recommendations

255. **Despite significant improvements to the organization of public debt issuance,[97] a formal strategy for managing the aggregate public debt does not exist.** The auctioning of central bank and government debt securities is conducted without a formal process to coordinate and reconcile fiscal funding needs with the liquidity operations of the central bank. Moreover, the concurrent issuance of the same types of public debt securities by both the government and central bank is not reasonable in a small capital market. Additionally, the implementation of modern debt management practices (back/middle/front offices) and more transparent issuance policies would help mitigate investor uncertainty in the primary market for public debt without hampering efforts to recapitalize the central bank under market conditions.

256. **The recapitalization of BCH is essential if the dominance of short-term central bank-issued public debt is to be reduced and if efforts to implement a sustainable government debt program are to move forward.** Currently, the government implicitly finances the implementation of monetary policy via the issuance of nonnegotiable, long-term debt to a decapitalized central bank, which frequently issues short-term certificates to implement monetary policy. The significant reduction in debt burden following debt relief in 2005–06, along with a stock of net international reserves at 24.3 percent of GDP at the end of

[97] Some of the regulatory and legislative improvements include the adoption of standardized central bank-issued debt securities; the reorganization of *Crédito Público*; and the reform of primary market access to nonfinancial public entities in March 2006.

2005, offers a benign environment for the timely recapitalization of the central bank. In this way, the issuance of tradable government debt at maturities beyond one year could accommodate some demand for public debt as the supply of short-term debt by BCH is gradually reduced.

257. **The primary of public debt is fragmented due to issuance by both the central bank and the government, excessive frequency of issuance, and continuous issuance of government debt through a central bank window**. The scheduling of frequent CAM auctions appears isolated from broader considerations of meeting investment demand in the primary market. Although auctioned government and central bank debt with maturities of one year or less share the same terms and security characteristics, their primary and secondary market prices differ (Table 45). Notwithstanding the merits of market clearing by noncompetitive bidders, the current allocation pattern to noncuantitative bidders and occasional changes in the amount of available securities at each auction might explain a part of the high incidence of cancelled auctions due to distorted bidder incentives. Since Congress does not determine the overall debt ceiling at the beginning of the year, there is also some uncertainty among investors concerning the overall debt trajectory. Debt issuance needs to be consolidated in a few large benchmark government issues. However, such consolidation would require an adequate recapitalization of the central bank, and issuance first of long-term, market-rate debt to the central bank.

258. The absence of standardized, long- and medium-term government debt and the frequent issuance of short-term paper by the decapitalized central bank have hampered secondary market development. Further development of a liquid secondary market hinges on reducing the frequency of issuance of short-term debt, increasing issuance volume, and extending the maturity profile (yield curve) of standardized public debt in order to encourage trading. A more competitive secondary market for public debt would also help realign interest rates in primary and secondary markets.[98]

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[98] There is a notable price difference of about 40 to 80 basis points between the primary and secondary markets for public debt that has been resilient to obvious arbitrage opportunities due to infrequent trading.

VII. The Public Debt Market in Nicaragua[99]

A. Financial Sector

259. **The financial sector in Nicaragua is dominated by the banking system.** There are seven private banks, five of which form part of larger regional financial groups. A draft securities market law, that has been awaiting congressional approval for over five years, is expected to be approved by mid-2006. While this bill provides for the creation of institutional investors, including mutual funds and pension funds, they were not yet operational as of November 2005. A separate pension fund law was passed in 2000 permitting creation of funded private pension plans, and three pension funds were approved in 2003–04. However, lack of action on the transfer of contributions has prevented privately—funded pension plans from becoming operational. Financial intermediation has gradually expanded since the 1999 banking crisis, with total assets of the banking system increasing from 47.5 percent of GDP in 2000 to 53.4 percent in 2005 (Table 50). Likewise, private credit has gradually recovered following the severe contraction from 17.7 percent of GDP in 2001 to 24.8 percent in 2004, and an estimated 28 percent in 2005.

260. **Capital markets are extremely underdeveloped in Nicaragua.** Although a securities exchange was created in 1994 through a decree, the market capitalization of listed private securities is paltry, reaching a mere 0.1 percent of GDP in 2005. The primary capital market instruments are public bonds. Moreover, while banking intermediation has recovered since the 1999 crisis, capital market activities have generally declined, with the trading volume of bonds in the securities exchange declining from 20.5 percent of GDP in 2000 to 11.2 percent in 2005, and the outstanding volume of domestic debt declining from 36.4 percent in 2002 to an estimated 26 percent in September 2005. In the absence of an enabling legal framework for pension and mutual funds, institutional investors consist primarily of insurance companies, whose total assets were under 2 percent of GDP in 2004.

B. Structure and Composition of Public Debt

261. **Nicaragua suffers from a very high debt burden owing to the substantial fiscal deficits incurred during the late 1980s and early 1990s associated with hyperinflation and economic collapse**. More recently, Nicaragua—as part of the Heavily Indebted Poor Countries (HIPC) initiative—has sought debt relief and committed itself to improve public debt sustainability. Although still high, public debt has declined rapidly to an estimated 132.1 percent of GDP in September 2005 from 193.3 percent in 2003 and 147.7 percent in 2004. The bulk of the outstanding public debt is in the form of external debt, which accounted for 106.8 percent of GDP in 2005. Domestic debt was relatively moderate, under 26 percent of GDP in September 2005.

[99] The principal author of this paper is Laura Valderrama.

Table 50. Nicaragua: Structure of the Financial System

	2000	2001	2002	2003	2004	2005
Number of:						
Banks (all private)					10	7
Insurance companies			5	4	4	5
Collective investment institutions			0	0	0	0
Financial holding corporations						3
Securities dealers						14
Private issuers in exchange						6
Private securities listed in exchange						425
Financial system indicators (in millions of U.S. dollars)						
Banks' assets	1,816	1,907	1,993	2,150	2,402	2,673
Total deposits of banking system	1,416	1,498	1,602	1,724	1,908	2,055
Deposits (relative to assets)	78.0	78.6	80.4	80.2	79	77
Private credit	1,167	707	765	912	1,130	1,401
Insurance sector's assets		65	68	77	84	97
Securities dealers					4	4
Number of private issuers						
Market capitalization of listed private securities					9	6
Market capitalization of listed public securities					470	556
Trading volume of bonds	785	600	589	547	479	563
Trading volume of transactions	624	368	303	323	343	446
(In percent of GDP)						
Banks' assets	47.5	47.8	49.5	51.8	52.7	53.4
Insurance sector's assets		1.6	1.7	1.9	1.8	1.9
Private credit	30.5	17.7	19.0	22.0	24.8	28.0
Market capitalization of listed private securities					0.2	0.1
Market capitalization of listed public securities					10.3	11.1
Turnover of bonds	20.5	15.1	14.6	13.2	10.5	11.2
Volume of transactions	16.3	9.2	7.5	7.8	7.5	8.9
GDP	3,825	3,985	4,025	4,147	4,556	5,008
Cordobas per U.S. dollar	13.06	13.84	14.25	15.11	16.3291	17.1455

Sources: Nicaraguan Central Bank and Stock Exchange; and IMF estimates.

262. **The bulk of the external debt is concessional.** External public debt stood at $5,348 million in 2005, with the government and the central bank accounting for $3,400 million and $1,921 million, respectively (Table 51). Of the total outstanding public debt in 2005, 56 percent was of a concessional nature. Most of external public debt was long term, with multinational organisms as the main creditor, and with short-term debt accounting for only 11 percent of the total. During 2005, an additional $88 million of external concessional debt was contracted, with an average maturity of 36.8 years and an average lending rate of 1.7 percent. International financial institutions and bilateral official organizations are the main creditors, accounting for 57 percent and 39 percent of external public debt, respectively (Table 52).

Table 51. Nicaragua: Outstanding of Aggregate Public Debt
(In millions of U.S. dollars)

	2002	2003	2004	2005	February 2006
External public debt	6,363	6,596	5,391	5,348	5,194
Government	4,387	4,590	3,447	3,400	3,420
Central bank	1,931	1,988	1,927	1,921	1,746
Remaining nonfinancial public sector	17	10	7	7	9
Remaining financial public sector	28	9	10	20	19
Domestic public debt	1,466	1,426	1,339	-	-
Government	843	897	936	-	-
Central bank	623	529	403	-	-
Total public debt	7,829	8,022	6,730	-	-

Source: Nicaraguan Central Bank.

Table 52. Nicaragua: Outstanding External Public Debt by Creditor
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005	February 2006
Multilateral	2,260	2,343	2,564	2,916	3,061	3,056	2,892
Central American Bank for Economic Integration	442	421	391	379	185	199	200
Inter-American Development Bank	923	999	1,101	1,225	1,368	1,417	1,425
World Bank	658	689	812	1,001	1,166	1,132	1,138
International Monetary Fund	169	157	174	213	247	201	20
Other	68	77	86	97	95	107	108
Bilateral	4,124	3,740	3,555	3,437	2,110	2,076	2,085
Paris Club	1,493	1,480	1,638	1,503	165	105	107
Latin America	1,458	944	812	821	870	897	901
Ex-socialist countries	473	455	220	205	169	155	156
Other	699	862	885	908	905	919	922
Commercial banks	235	243	207	205	202	200	201
Suppliers	41	48	37	37	19	16	16
Total	6,660	6,374	6,363	6,596	5,391	5,348	5,194

Source: Nicaraguan Central Bank.

263. **Domestic public debt outstanding reached $1,308 million in September 2005**, of which $972 was central government debt, and $336 million was issued by the central bank (Table 53).

Table 53. Nicaragua: Outstanding Domestic Public Debt by Instrument
(In millions of U.S. dollars)

	2003	2004	September 2005
Government	897	936	972
Bonds	14	11	18
BPI	853	910	933
Promissory notes	18	11	10
Treasury bills	6	3	9
Certificates	2	0	0
Shares	0	0	0
Contracts	3	1	2
Central bank	529	403	336
Bank securities	340	282	265
CENI for bailout[1]	5	0	0
Bank bonds	336	282	265
Other securities	189	121	71
CENI 1/	143	0	0
Short-term bills	46	106	56
Bonds	0	15	15
Total domestic debt	1,426	1,339	1,308

Source: Nicaraguan Central Bank.

[1]A negotiable investment certificate (*certificado negociable de inversión* - CENI) that is a zero-coupon bond issued by the central bank for liquidity management. CENIs were discontinued in 2003 following the introduction of standardized short-term bills.

264. **Virtually all of central government debt has been issued in nonstandard form.** *Indemnization Payment Bonds* (BPI), issued to indemnify owners of confiscated assets, accounted for 96 percent of outstanding government paper (Table 53). As these bonds were issued to each owner for a specific amount, they carry nonstandard face values. They are complex 15-year instruments with a different coupon each year, and with amortization of the principal during the last five years, rendering them difficult to trade in outright transactions.[100] Moreover, $265 million, or 79 percent of domestic debt issued by the central bank, is also in the form of nonstandardized bonds that were issued to recapitalize weak banks following the banking crisis of 1999.

265. **The predominance of nonstandard BPI bonds among government instruments, and of bank recapitalization bonds among central bank securities, has led to a highly segmented market for domestic public debt**, with the nonfinancial private sector holding 99 percent of government paper and the financial sector holding 99 percent of central bank

[100] The BPI bond is a 15-year sovereign bond issued from 1993 to citizens who had property confiscated by the central government from 1979 through 1990. It is a cordoba-denominated bond indexed to the U.S. dollar, carrying a generally below-market coupon, and with annual amortization during the last five years. The first two years this bond capitalizes at 3 percent; between years three and seven, coupon payments are received every six months at a rate of 4.5 percent, and during the last eight years the coupon is set at 5 percent.

paper. Since 2003, the bank has been successful in placing standardized securities in the form of central bank short-term bills and long-term central bank bonds. Their outstanding amounts in September 2005 were $71 million and $15 million, respectively. Likewise, the finance ministry in February 2004 started to issue 12-month standardized bonds, with an outstanding amount of $9 million by September 2005. Nonetheless, the stock of BPI compensation bonds continued to grow in 2005, with the issuance of $88.9 million during the first three quarters.

C. Legal and Institutional Structure of Public Debt Management

266. **The government of Nicaragua is strongly committed to place public debt on a sustainable path**, as reflected in several recent legislative initiatives.

267. **The general public debt law (2003)** regulates the process of public indebtedness so that the financial needs of the government are met at the lowest possible cost. It gives priority to servicing of public debt (principal, interest, and commissions) over other government expenditures.

268. **The proposed fiscal responsibility law,** still awaiting passage, would limit public debt to prudent levels compatible with tax revenues and public assets; adopt a stable and predictable tax policy; establish a multiyear budgetary planning framework including medium-term fiscal targets; adopt international public sector accounting standards; and create a fiscal stabilization fund to help to reduce the procyclical bias of fiscal policy.

269. **The Nicaraguan parliament has the authority to control not only expenditure but also issuance of all forms of debt other than three-month t-bills.** The 2005 budget limited 2006 domestic issuance to $30 million, with no explicit breakdown into treasury bills and bonds. International placement is not authorized under the provisions of the HIPC initiative. Although the 2006 budget was approved in a timely fashion in December 2005, it is expected to be subject to reform during the course of the year.

270. **Public debt issuance and management responsibilities are shared between the central bank and the finance ministry,** with the former acting as a fiscal agent for the latter. However, the amount, calendar, and structure of public issuance are determined jointly by the central bank and the finance ministry, taking into account the fiscal needs of the government, as endorsed by Parliament, and monetary policy considerations. A concomitant objective is to develop secondary markets through the issuance of standardized securities.

D. Primary Issuance of Public Debt

271. **In Nicaragua**, **primary issuance of public debt is undertaken by both the central bank and the finance ministry.**

Primary Issuance by the Ministry of Finance

272. **The Ministry of Finance issued $89 million of BPIs (indemnity bonds) in the first three quarters of 2005, with a total outstanding of $933 million in September 2005.** In 2004, the government had committed to issue $450 million over the next five years to compensate for pending confiscation liabilities. In addition to BPI securities, the finance

ministry initiated the issuance of standardized instruments in February 2004. The main features of central government instruments are described in Table 54.

Table 54. Nicaragua: Instruments Issued by the Ministry of Finance

Security	Currency	Maturity	Interest	Placement	Purpose
BPI	Dollar-indexed, cordoba-denominated	15 years	Six- month coupon	Direct issuance to individual creditor; partially standardized	Confiscation payment
T-bills	Dollar-denominated, payable in cordobas	3, 6, 9, and 12 months	Discount	Competitive auction, standardized	Deficit financing
Bonds	Cordoba-denominated	3 and 5 years	Discount	Competitive auction, standardized	Deficit financing

Source: Nicaraguan Ministry of Finance.

273. **The government has a long way to go to establish itself as a sovereign issuer.** Because of the fiscal and debt situation, the legacy of arrears, and government issuance primarily for confiscated assets, the government has yet to establish itself as a sovereign issuer. Investors generally prefer to hold central bank paper to that of the government. The standardization program was relatively successful in 2004, when $16 million face-value securities were placed (out of an initial projection of $20 million), but the program encountered more difficulties in 2005, with only $7.3 million of the $30 million approved by Parliament placed (Table 55).

Table 55. Nicaragua: Issuance of Standardized Securities by the Ministry of Finance

(January–December 2005)

Auction Number	Date	Issuance Code	Original Maturity (In months)	Remaining Maturity (In days)	Placement (In millions of U.S. dollars)	Average Price (In percent)	Average Rate of Return (In percent)
SLT-06-07-05	6-Jul	MHCP-L-03-03-06	12	238	5.0	96.03	6.25
SLT-24-08-05	24-Aug	MHCP-L-03-03-06	12	189	1.0	96.24	7.45
SLT-12-10-05	12-Oct	MHCP-L-08-09-06	12	329	1.0	93.39	7.74
SLT-14-12-05	14-Dec	MHCP-L-08-09-06	12	266	0.3	94.42	8.0

Source: Nicaraguan Ministry of Finance.

274. **There is a sizable divergence between the authorities and the market with respect to longer-term interest rates.** Although the public debt program envisaged by the Nicaraguan authorities allows the finance ministry to issue securities of one-, three-, and five-

year maturities, the ministry was only been able to place one-year securities in 2005 due to investors' preferences for short-term debt and the government's reluctance to accept higher market clearing rates on long-term debt.[101] From March 9 to November 9, 12 of 15 auctions were rejected entirely. Several of the rejected bids were of the order of 12 percent, while the weighted average rate of the accepted bids was 6.6 percent, suggesting substantial divergence between the authorities and the market.

275. **As a result, Nicaragua has been forced to drastically revise its longer-term issuance plan.** The initial public issuance program envisaged for 2005 contemplated the issuance of $11 million of one-year bonds, $11 million of three-year bonds, and $8 million of five-year bonds. The aim was to develop a yield curve. As of November 14, 2005, the series of five-year bonds had been abandoned, and the prospective placement of $11 million three-year securities had been reduced to $3 million. The revised projections point at a more feasible overall placement for 2005 of $15 million.

276. **The central bank's market access is somewhat better, but still highly uncertain.** Improved credibility of the central bank in terms of timely payments may explain the somewhat better reception to bank securities and the lower interest rates vis-à-vis those of government bonds. For instance, the weighted average rate on the central bank short-term bills issued in June 2005 was 5.55 percent, 70 basis points below the 12-month t-bills issued by the Ministry of Finance in July 2005. However, central bank auctions also have a very high undersubscription and rejection rate, resulting in very uncertain access to the domestic market.

Primary Issuance by the Central Bank

277. **The central bank has been the main issuer of public securities in the domestic market.** Its issuance is aimed at both liquidity management and financing its quasi-fiscal deficit that arose from exchange rate interventions and from the bailout of failing banks in 1999. The main features of the instruments issued by the central bank are shown in Table 56. Until 2003, the bank used the issuance of negotiable investment certificates (*certificados negociables de inversión* - CENIs) as the main instrument for liquidity management. CENIs were offered at maturities of 28, 91, 273, 360, 510, 720, and 900 days. Further, CENIs were denominated in U.S. dollars, though issued and settled in the local currency (cordobas), and were issued at discount. Issuance of CENIs was discontinued in 2003 and replaced by issuance of standardized securities, including bills and bonds. These securities comply with

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[101]The preference for short-term debt may also be partly driven by the HIPC initiative's quantitative performance criteria, which set a quarterly ceiling on net domestic financing of the combined public sector, and a quarterly floor on the public sector overall balance. The target for the end of March 2006 was set at 1,449 million cordobas ($86.6 million). For cumulative flows starting in July 2005 it was set at—1,594 million cordobas (–$95.3 million).

the standards established in the Central America Monetary Council's Public Debt Harmonization Program.[102]

Table 56. Nicaragua: Instruments Issued by Central Bank

Security	Currency	Maturity	Interest	Placement	Purpose
Bills	Dollar- denominated, payable in cordobas	3, 6, 9, and 12 months	Discount	Competitive auction, standardized	Liquidity management
Bonds	Dollar -denominated, payable in cordobas	3, 5, 7, and 10 years	Six-month coupon	Competitive auction, standardized	Quasi-deficit financing
Bank bonds	Dollar- denominated, payable in cordobas	1 to 10 years	Six-month coupon	Direct placement, nonstandardized	Debt exchange of failing banks
Titulos especiales de inversión (TEI)	Cordoba-denominated	30 days to 3 years	Discount, coupon	Direct placement, nonstandardized	Build-up of international reserves

Source: Nicaraguan Central Bank.

278. **Central bank bills are now the main instrument it issues.** Bills are issued at three, six, nine, and 12 months, although most of the issuance in 2005 corresponded to one-year bills (Table 57). The bills are zero-coupon discount securities. The outstanding stock of bills reached $58 million in November 2005. The central bank also contemplates issuance of long-term bonds of maturities of three, five, seven, and 10 year; however, as of November 2005 there had only been one placement of a three-year maturity bond (in 2004, for $15 million). As with bills, bonds have a face value of $10,000 and $100,000 and are issued in dollars and settled in cordobas. Furthermore, the central bank places nonstandardized securities called *Special Investment Securities* (TEIs) with public entities with the aim of strengthening the bank's international reserves. Whereas their maturity is subject to bilateral negotiation typically ranging from 30 days to three years, their rate of return is standardized by maturity and linked to bills. The outstanding value of TEIs reached $260 million in November 2005, and there is a plan to standardize their issuance in 2006.

279. **Central bank issuance is extremely fragmented, as shown in Table 57.** During the first three quarters of 2005, the bank issued one series of six-month bills for $15 million and four series' of 12-month bills for $20 million, with aggregate issuance of $95 million. Seven auctions were needed to allocate $5.9 million of six-month bills*,* with a ratio of allocated to offered volume of 39 percent. Likewise, 33 auctions were run to allocate $55.7 million of 12-month bills*,* with a higher ratio (70 percent) of allocation.

[102] This program, approved by the Central American Monetary Council's resolution CMCA/CMH-RE-02/11/03, promotes the adoption of standards to govern the harmonization of regional public markets in the Central America isthmus and the Dominican Republic, with a view to gradually developing the regional public debt market.

280. **The central bank's fragmented issuance and failure to place the full amount auctioned (only $62 million of the $95 million offered), may suggest an unwillingness to accept market rates.** Analysis of the weighted average rate of return of accepted bids for six-month bills of 4.6 percent, compared with the average six-month U.S. t-bill yield of 2.35 to 3 percent during the first semester of 2005, indicates that the yield premium did not adequately reflect the higher risks and lower liquidity.

Table 57. Nicaragua: Issuance of Standardized Securities by the Central Bank in 2005
(In millions of U.S. dollars)

Date in 2005	Issuance Code	Maturity (In months)	Amount Offered	Amount Allocated	Allocated/Offered (In percent)	Average Return (In percent)
02-Feb	L-06-2005-1	6	15.0	0	0.0	...
	L-12-2005-1	12	20.0	1.6	8.0	4.81
09-Feb	L-06-2005-1	6	15.0	2.3	15.3	4.34
	L-12-2005-1	12	18.4	0	0.0	...
16-Feb	L-06-2005-1	6	12.7	1	7.9	4.63
	L-12-2005-1	12	18.4	0	0.0	...
23-Feb	L-06-2005-1	6	11.7	0.1	0.9	4.50
	L-12-2005-1	12	18.4	5	27.2	5.00
02-Mar	L-06-2005-1	6	11.6	2.5	21.6	5.00
	L-12-2005-1	12	13.4	0	0.0	...
09-Mar	L-06-2005-1	6	9.1	0	0.0	...
	L-12-2005-1	12	13.4	0	0.0	...
16-Mar	L-06-2005-1	6	9.1	0	0.0	...
	L-12-2005-1	12	13.4	0	0.0	...
30-Mar	L-12-2005-1	12	13.4	2.1	15.7	4.95
06-Abr	L-12-2005-2	12	20.0	0.5	2.5	4.64
13-Abr	L-12-2005-2	12	19.5	0	0.0	...
20-Abr	L-12-2005-2	12	19.5	0	0.0	...
27-Abr	L-12-2005-2	12	19.5	0.3	1.5	5.43
04-May	L-12-2005-2	12	19.2	0.8	4.2	6.50
11-May	L-12-2005-2	12	18.4	4	21.7	6.75
18-May	L-12-2005-2	12	14.4	6.4	44.4	6.75
25-May	L-12-2005-2	12	8.0	5	62.5	6.65
01-Jun	L-12-2005-2	12	3.0	3	100.0	6.57
08-Jun	L-12-2005-3	12	20.0	0.7	3.5	5.63
15-Jun	L-12-2005-3	12	19.4	0	0.0	...
22-Jun	L-12-2005-3	12	19.4	0.4	2.1	5.31
29-Jun	L-12-2005-3	12	19.0	0.4	2.1	5.54
6-Jul	L-12-2005-3	12	18.6	10.3	55.4	6.76
13-Jul	L-12-2005-3	12	8.3	0.2	2.4	6.50
20-Jul	L-12-2005-3	12	8.1	0	0.0	...
27-Jul	L-12-2005-3	12	8.1	3.2	39.5	6.62
3-Aug	L-12-2005-4	12	20.0	0.1	0.5	6.50
9-Aug	L-12-2005-4	12	19.9	0.5	2.5	6.36
17-Aug	L-12-2005-4	12	19.5	7.4	37.9	6.97
24-Aug	L-12-2005-4	12	12.1	3.8	31.4	7.00
31-Aug	L-12-2005-4	12	8.3	0	0.0	...
7-Sep	L-12-2005-4	12	8.3	0	0.0	...
21-Sep	L-12-2005-4	12	8.3	0	0.0	...
28-Sep	L-12-2005-4	12	8.3	0	0.0	...
	Total		95.0	61.6	64.8	

Source: Nicaraguan Central Bank.

281. **While the Ministry of Finance and the central bank issue their own paper separately, they coordinate the placement method, timing, and maturity of issuance.** Both use competitive auctions (held each Wednesday) as their principal issuance mechanism; noncompetitive bids are not allowed. Also, both use the uniform price auction whereby allotment is determined by the common cutoff price paid by all successful bidders. To date only the central bank places securities regularly, with placement by the finance ministry more sporadic. Securities are issued in tranches, i.e., the same series is reopened until the totality of the amount announced in the series' opening auction has been entirely placed, or a maximum period of two months for t-bills, after which a new series is issued.

282. **Only brokers and commercial banks can directly transact in government securities.** As in most countries of the region, Nicaragua does not employ a system of primary dealers or dedicated market-makers that provide two-way quotes. Participation is open to *puestos de bolsa* (securities exchange brokers), and commercial banks. Institutional investors, for which a legal framework has been proposed under the current draft of the securities market law, will be required to transact government securities through exchange brokers. This draft law also provides for the development of trading platforms between the central bank and commercial banks in order to foster liquidity in the interbank market.

283. **Banks and insurance companies hold virtually all central bank paper.** An estimated 80 percent of central bank paper is held by banks (including both local and regional banks), and the remaining 20 percent by insurance companies. In the absence of an enabling law, mutual and pension funds do not exist.

284. **Banking regulations discourage investment in foreign securities.** The investment behavior of banks is governed by General Bank Law 324, Resolution XXXII-1-95 on investment restrictions abroad, and SIB-188-2-2001 on capital adequacy. Banks are subject to a nonremunerated cash/reserve requirement of 16.25 percent of total deposits, with no additional liquidity requirement. The acquisition by banks of foreign or multinational securities, excluding U.S. sovereign securities, is subject to previous authorization by the Banking Commission and other financial institutions. In addition, such investments (including U.S. securities) are treated as trading portfolio and are required to be marked-to-market. Moreover, the risk-based capital adequacy requirements apply to foreign government securities but not those of Nicaragua,[103] and thus penalize the holding of public securities issued by regional governments or central banks by requiring a weight of 100 percent on paper rated between BB+ to B- by Standard & Poor's, and a weight of 150 percent on paper below B- or nonrated.[104] Likewise, the 2005 bill regulating the investment portfolio of

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[103] While the Basel II accord allows country authorities to decide whether to apply risk-based capital adequacy requirements to sovereign local currency debt, it does require their application to foreign currency debt. Since Nicaragua's debt is essentially dollar-denominated (even if payable in cordobas), it may be more consistent with Basel norms to apply risk-based weights and capital requirements without discriminating between (effectively dollar-denominated) domestic and foreign sovereign securities.

[104] As of December 2005, the distribution of country credit profiles by S&P in the region was as follows: El Salvador BB+, Costa Rica and Panama BB, Guatemala BB-, and Honduras and Nicaragua nonrated.

insurance and reinsurance companies requires prior authorization by the Banking Commission and other financial institutions for the acquisition of all foreign sovereign securities. These restrictions may hinder the development of a regional market of public debt.

E. Secondary Market of Public Debt

285. **In 2004, the trading volume of the Nicaraguan Securities Exchange reached $558 million, or 11.1 percent of GDP (Table 58).** Option transactions dominated, reaching 74.4 percent of total trading in 2005, with outright transactions accounting for 19.5 percent, and repos for the remaining 6 percent. Option transactions are substantially more frequent than repo transactions in the interbank market, as the former are exempt from the reserve requirements applicable to transactions. In the absence of interbank lines of credit, commercial banks typically transact through the stock exchange for liquidity management purposes.

Table 58. Nicaragua: Trading Volume in the Stock Exchange
(In millions of U.S. dollars)

	2003	2004	2005
Private sector	8.5	1.1	0.1
Options market	0.6	0.9	0.1
Repo Market	7.8	0.2	0.0
Outright market	0.1	0.0	0.0
Public sector	437.9	463.7	557.4
Options market	296.0	332.6	415.0
Repo Market	24.6	12.9	33.8
Outright market	117.3	118.2	108.6
Total	446.4	464.8	557.6
Total as a percent of GDP	11.1	10.5	11.1

Source: Nicaraguan Stock Exchange.

286. **Typically, the underlying security of an option transaction is a central bank security and the most frequent maturity is seven days.** By contrast, transactions mainly use government BPIs as the underlying security, with the most recurrent maturity also seven days. In 2005, 40 percent of option transactions were denominated in cordobas (of which 78 percent were of central bank bonds and 16 percent of BPIs), and 60 percent in U.S. dollars (43 percent BPIs, 36 percent central bank bonds, and 20 percent central bank bills).

287. **The turnover of public debt in the stock exchange reached 8.2 percent in 2005** (computed as the trading volume on public debt securities relative to the average outstanding stock of domestic public debt during the period).

288. **Transaction costs in the securities exchange are high.** The fees imposed by the Nicaraguan stock exchange vary according to the type of transaction executed. In the primary market, the issuer has to pay an annualized 0.50 percent fee to the stock exchange and a

brokerage fee that varies between 1 and 2 percentage points. In the secondary market, for an outright transaction the buyer and the seller each pays 0.25 percent of the annualized commission to the stock exchange, and between 1 and 2 percent to the broker, resulting in total roundtrip costs of 1.5 to 2.5 percent of the market price. Likewise, the commission paid to the stock exchange is 0.25 percent for options and transactions, but the brokerage fee ranges from 0.50 to 2 percent, resulting in roundtrip transaction costs of 1 to 2.5 percent.

F. Market Infrastructure: Clearing, Settlement, and Payment

289. **The Central Securities Depository System (CENIVAL) is the central custodial and settlement agency.** The Nicaraguan stock market holds 90 percent of the capital of CENIVAL, which manages the custody, administration and settlement of securities in the Nicaraguan market. It acts as a central depository, since deposits in CENIVAL are mandatory to carry out any transaction in the stock exchange. CENIVAL began its operations in 1997 and became a separate firm in 2001. The main services offered by CENIVAL include physical custody and book-entry of securities, clearing and settlement of securities for the stock market, and management of payment of interest and dividends of securities as well as the exchange of securities. Currently, CENIVAL offers a centralized settlement of cash and securities providing delivery versus payment while being connected to the payment system of the central bank. Payment can also be executed via certified check. Transactions carried out in the secondary market of the stock exchange (including outright transactions, options, and repos) are executed under a batch system three times a day. Short selling transactions are not allowed. CENIVAL is regulated by the Banking Commission and other financial institutions. The dematerialization of securities is provisioned under the current draft of the securities market law.

G. Problems in the Public Debt Market

290. **Neither of the two sovereign issuers have reasonably assured access to domestic market.** Both the government and the central bank face fundamental and significant problems in placing their paper, with the problems being particularly severe for the government. The auctions are frequently undersubscribed and often fail to attract any bids. The largest single issuance in recent years was placement of the central banks' three-year standardized bonds in 2004 for $15 million. During the first three quarters of 2005, the average weekly placement of the central bank's six-month (12-month) treasury-bills was $800,000 ($1.7 million). Moreover, only $62 million of the $95 million offered by the central bank was placed during the same period. Likewise, the three issues of 12-month treasury bills placed by the finance ministry in 2005 reached tepid volumes of $5 million, $1 million, and $1 million, respectively. The limited credibility of the finance ministry in the securities market, the presidential election scheduled for November 2006, and the restrictions imposed by the IMF program on net domestic financing and public sector overall balance may further constrain the feasibility of the government to match market demand at the required risk premium. Given the destructive effects of repeated auction undersubscription and the sovereign issuer's limited credibility, a substantial effort is needed by both issuers in understanding the demand for sovereign paper and the market clearing rates, approaching the market only for saleable volume, and accepting the clearing rates.

291. **Sovereign debt issuance is extremely fragmented.** Although the central bank and the finance ministry started the issuance of standardized securities in July 2003 and February 2004, respectively, the inability of both issuers to place their paper results in a very low volume per individual issue. While some of the issues are reopened and consolidated, this excessive fragmentation may hinder the development of a liquid secondary market.

292. **Nonstandard securities continue to dominate issuance**. Whereas the central bank discontinued the issuance of nonstandardized CENIs in 2003, the finance ministry still issues nonstandardized BPIs (indemnity bonds) to compensate land owners for expropriation liabilities. In the first three quarters of 2005, $89 million BPIs were issued by the finance ministry. BPIs are traded in the secondary market. In December 2005, one-third of all transactions of public debt instruments used BPIs as underlying securities, mainly for operations, with the remaining two-thirds of central bank's bonds. While the central bank issued only standardized 12-month treasury bills in 2005, it had placed $260 million of TEIs (special investment securities) among public entities as of November 2005 in order to strengthen the net international reserves held at the central bank.

293. **There is a large outstanding stock of nonstandard securities.** The current amount of outstanding domestic debt reached $1,308 million in September 2005, including finance ministry debt of $972 million and central bank debt of $336 million. By contrast, the standardized debt of the finance ministry and the central bank amounts only to $26 million and $71 million, respectively. The limited amount of standardized securities constrains secondary market trading, and the absence of liquidity in the bulk of issued public debt reduces interest in and raises the cost of future issuance. It also makes it difficult for the two issuers to extend the yield curve and raise longer-term funding. While the restructuring of this debt is likely to be complex, a comprehensive effort is needed to examine the possibility of swapping at least parts of these illiquid instruments for more standardized, liquid securities that may be more actively traded.

294. **There have been efforts at coordination between the two issuers, but challenges remain**. Whereas the central bank acts as a fiscal agent for the finance ministry, the latter bears the responsibility for debt management under the 2003 public debt law. Both entities hold regular meetings to coordinate auction days (typically each Wednesday) and volumes to be placed. However, credibility issues and political restrictions have hindered the initially-planned segmentation of the market, wherein the central bank was to concentrate its issuance in three-month to 12-month bills and the finance ministry in three-year and five-year bonds. Instead, the current issuance of 12-month quasi-fungible securities by both entities creates undue competition in the market while hampering the gradual lengthening of the yield curve.

295. **Inadequate development of capital markets hampers and distorts public debt management.** There is no regulatory framework for mutual funds and pension funds. A 2003 project to allow for creation of private pension funds was abandoned following a vigorous debate in Congress. The 1995 regulatory framework for commercial banks' investments requires prior authorization of the Banking Commission and other financial institutions for the acquisition of sovereign securities, with the exception of Nicaraguan and U.S. instruments. The 2005 bill regulating the investment portfolio of insurance and

reinsurance companies requires prior authorization by the Banking Commission for the acquisition of all sovereign securities. The requirement does not apply to purchase of Nicaraguan public securities. Concerning legislation on financial markets more generally, the current draft of the securities market law allows for creation of institutional investors, thus fostering demand for long maturity instruments. The bill, still pending congressional approval, would allow dematerialization of securities and issuance of asset-backed instruments, hence widening the set of available securities and facilitating development of a liquid secondary market.

296. **There are several problems in secondary market trading**. Trading in the Nicaraguan Stock Exchange is both very expensive and relatively thin. High transaction costs in the form of an annualized 0.25 percent fee paid to the exchange, and a brokerage fee ranging between 1 and 2 percent for outright transactions and 0.50 and 2 percent for and option transactions, deter more active trading in the secondary market. Daily secondary market trading averaged only $2.3 million in 2005 (with only $400,000 of outright transactions) on public debt securities, with 67.4 percent of trading on seven-day instruments. While low trading may justify high brokerage and bolsa fees, they create a chicken-and-egg problem. More importantly, low liquidity eventually must raise the market-clearing interest rates demanded by investors. The simultaneous solution to this requires a reduction in the exchange and brokerage fees coupled with conversion of some of the nonstandard government debt into more standardized and tradable instruments.

H. Policy Recommendations

297. **The high debt burden in Nicaragua and the associated concerns about debt sustainability clearly dominate the financial sector.** While that problem can only be addressed in the context of an overarching medium-term macroeconomic plan, including debt relief, the following improvements in debt management policies—while playing a secondary role--could help contain high interest rates and develop the local capital market.

298. **There is a need to reduce the frequency of auctions but increase their volume, guarantee a minimum volume of issuance, and separate the maturities of central bank and government issuance.** The central bank and the finance ministry run joint weekly auctions implemented in tranches. However, the inability to accept market rates has often led to deserted auctions that in 2005 slowed the average volume placed per auction to $800,000 and $1.7 million for six-month and 12-month central bank instruments, respectively, and to $700,000 for finance ministry securities. Moreover, the size of the current series ($15 million and $20 million for bills and $10 million for treasury bills) may not be of sufficient fungible volume to foster depth and liquidity in the secondary market. Furthermore, nearly all of the placement of standardized instruments issued by the central bank and the finance ministry were one-year instruments ($56 million of $62 million for the central bank, and all $7 million issued by the finance ministry), creating competition between issuers and hindering the signaling role of monetary policy.

299. **Noncompetitive bidding and participation of retail investors should be permitted.** Nicaragua should take measures to broaden the investment base by allowing noncompetitive bids and by promoting and facilitating participation by retail investors.

300. **The authorities need to restructure the stock of nonstandard instruments to improve liquidity in the secondary market.** The bulk of domestic debt is in the form of nonstandard instruments, principally BPIs and TEIs, which accounted for 71.4 percent and 20.2 percent, respectively, of overall outstanding debt in September 2005. The importance of creating a portfolio of standard securities is highlighted by the bunching of maturing BPIs within the next 10 years adding up refinancing risks.

301. **The central bank's accumulated deficits need to be covered by issuance of standard government securities.** The quasi-fiscal deficit of the central bank, estimated at around 20 percent of GDP as of the end of 2005,[105] should be gradually assumed by the government through the issuance of tradable instruments, and in accordance with the 1992 Central Bank Law.

302. **Debt servicing in public debt management need to be given priority in order to regain investor confidence.** The government needs to make a strong effort to make debt service payments on a timely basis. The inability to service scheduled debt repayments that came due in January 2005—they were ultimately serviced in June and in November 2005--has undermined investor confidence, precipitating a failure in the weekly finance ministry auctions throughout the year. As a result of these arrears, only $11 million (of the $30 million offered) were placed in the course of 15 auctions. Moreover, placements were confined to one-year instruments (instead of the one-, three-, and five-year maturities initially intended), creating undue competition with central bank issues and delaying the extension of the yield curve.

303. **Passage of the securities market law is important to create a wider base of institutional investors in public debt.** The provision of a sound regulatory framework for the securities market based on laws rather than partial and ad hoc presidential decrees would enhance investor confidence. The proposed securities market law also allows for creation of trading platforms at the central bank to facilitate interbank trading, dematerialization of securities, introduction of asset-backed securities, and establishment of institutional investors that should guarantee a stable demand for long-term securities. On the other hand, the authorities may want to revise the current draft to open auctions on public securities to institutional investors (under the current provisions they are constrained to operate through exchange brokers). Separately, the authorities may wish to revisit banking regulation to eliminate the cash reserve on operations in the interbank market. This would ease the transition from the current option transactions to repos, thus mitigating the risk involved in option contracts when used for liquidity management. Likewise, consideration should be given to changing the regulatory framework to allow domestic investors to hold regional paper in order to foster regional financial integration.

304. **There is a need to strengthen the dialogue with market participants to advance in price discovery.** The existence of a thin market and the high level of uncertainty about prices may have contributed to creating a dichotomy between the public sector and domestic

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[105] This estimate corresponds only to the operational losses incurred by the central bank. It therefore excludes exchange rate losses, which authorities have yet to estimate.

investors, hindering price discovery. The government's systematic inability to accept market rates may bias the portfolio of domestic investors toward foreign securities, particularly U.S. instruments (as they do not require prior authorization by the Banking Commission). Information gathered through discriminatory auctions or through regular contact with market participants may be used to further develop the market. Also, reporting interbank operations to the central bank could enhance information and minimize the recurrent failure of public auctions.

VIII. The Public Debt Market in Panama[106]

A. Financial Sector

305. **Panama continues to witness sustained and strong economic growth.** Real GDP grew by about 7.6 percent in 2004 and 6.4 percent in 2005, led by a boom in export-oriented services. Construction and tourism were leading growth sectors before 2004 due to temporary tax breaks for new property development and other tax incentives. Despite the recent hike in oil prices, inflation has remained low, at an estimated 2.9 percent in 2005 (up from 0.3 percent in 2001).

306. **Panama has a well-developed and liquid banking sector.** In the absence of a central bank, the money supply in Panama's dollarized financial system is largely determined by the balance of payments. The free entry of foreign banks has helped Panama develop an efficient, liquid, and highly competitive private banking sector. There are 74 banks (Table 59) whose gross assets reached 234.2 percent of GDP in 2005 (despite a drop from 327.4 percent in 2000), which is the highest level of banking intermediation in Central America. The banking system comprises onshore and offshore banks, which together form the International Banking Center. The 70 private banks (including 17 domestic banks, 22 foreign banks and 31 offshore banks), accounted for 84 percent of total domestic bank assets in 2005, with the four public banks accounting for the remainder.

307. **Panama's banking system is still recovering from the turmoil in financial markets in South America during 2002.** After several regulatory reforms[107] and the relocation of several foreign offshore banks, credit to the private sector gradually increased from 135.9 percent of GDP in 2003 to 141.7 percent in 2005, a fourth of which originated in public banks. From 2001 to 2005, short-term commercial lending rates decreased from 10 to 8.5 percent, while deposit rates declined from 5.5 to 2.1 percent.

[106] The principal author of this Chapter is Andy Jobst.

[107] Banking supervision was strengthened by passage of Decree Law No. 9 as part of a banking law 1998 under which the autonomous Banking Superintendency replaced the National Banking Commission as the supervisory agency. As a result, Panama was certified in August 2004 by the IMF's Offshore Financial Center Module II assessment as compliant with 23 of 25 Basel Core Principles.

Table 59. Panama: Structure of the Financial System

	2000	2001	2002	2003	2004	2005[1]
Banks	82	80	77	75	71	74
Nondeposit taking public banks	2	2	2	2	2	2
General license banks	51	49	43	43	41	41
Public banks	2	2	2	2	2	2
Private Panamanian banks	20	20	17	18	17	17
Foreign banks	29	27	24	23	22	22
International license banks	29	29	32	30	28	31
Insurance companies	19	18	17	16	16	18
Collective investment institutions						
Mutual funds	13	13	14	14	16	16
Pension funds	2	2	2	2	2	2
Companies with listed stocks	154	125	107	96	81	83
Bank assets	38,044.0	38,053.0	34,022.8	32,304.3	34,609.8	36,225.2
Total deposits of banking system	26,956.0	26,598.0	24,120.5	23,621.2	24,531.8	25,118.4
Deposits (In percent of assets)	70.9	69.9	70.9	73.1	70.9	69.3
Private credit (*cartera crediticia*)	21,495.0	22,047.0	18,638.0	17,578.5	19,899.8	21,918.4
Insurance sector assets	688.9	699.6	678.6	704.2	765.2	n.a.
Insurance sector AUM 2/	93.5	100.0	96.6	99.7	107.3	n.a.
Collective investment institutions						
Mutual funds AUM	221.0	270.0	304.0	282.0	494.0	527.0
Pension funds AUM	11.7	21.6	27.3	34.4	52.1	72.0
Trading volume (primary and secondary)	1,361.0	1,046.7	1,413.7	1,434.2	1,343.4	1,681.3
Volume of repo transactions	...	214.3	234.5	210.6	80.4	56.9
Market capitalization	...	n.a.	4,702.0	4,997.0	5,927.0	8,060.8
Bank assets	327.4	322.3	277.2	249.8	243.7	234.2
Private credit	185.0	186.7	151.9	135.9	140.1	141.7
Insurance sector assets (all)	6.7	6.9	6.7	6.9	7.5	n.a.
Collective investment institutions						
Mutual funds AUM	1.9	2.3	2.6	2.4	4.3	3.4
Pension funds AUM	0.1	0.2	0.2	0.3	0.4	0.5
Trading volume (primary and secondary)	11.7	8.9	11.5	11.1	9.5	10.9
Volume of repo transactions	...	1.8	1.9	1.6	0.6	0.4
Market capitalization	...	n.a.	38.3	38.6	41.7	52.1
Memorandum items						
GDP (in millions of U.S. dollars)	11,620	11,808	12,272	12,933	14,204	15,467

Sources: Ministry of Finance, National Stock Exchange (BVP), Banking Superintendency, National Securities Commission (CNV), and IMF staff calculations.

[1]The number of banks in 2005 refers to September 2005.

[2]AUM denotes assets under management.

308. **Public sector banks include two commercial and two development banks.** The commercial bank, *Banco Nacional de Panamá* (BNP), is by far the largest public bank and maintains the largest network of branches. The other commercial public bank is the national savings bank, *Caja de Ahorro* (CA), a medium-size bank with an extensive branch network similar to the largest private banks. The two public development banks, the National Mortgage Bank (BHN) and the Agricultural Development Bank (BDA), are nondeposit-taking institutions (i.e., second-tier banks) that provide financing to low-income borrowers, and benefit from low-cost public sector funding. For example, most of the BNP's funding comes from mandatory deposits of public sector entities, mostly the Social Security Agency (*Caja de Seguridad Social*—CSS). A large share of these deposits is held as noninterest bearing sight deposits. Consequently, the average rate of interest paid by BNP has been about 200 to 250 basis points (about one-third) lower than that paid by the private banking sector.[108]

309. **By contrast, nonbank financial sector is still small.** Insurance sector assets amounted to 7.5 percent of GDP at end-2004, up from 6.7 percent in 2000 Investment funds have steadily increased their market share and now challenge the insurance industry as the most important nonbank financial sector. The assets of mutual funds and pension funds grew from 1.9 percent and 0.1 percent of GDP, respectively, in 2000 to 4.5 percent and 0.6 percent of GDP in 2005. Investment funds in Panama did not appear to have been significantly affected by the mutual fund crisis in neighboring Costa Rica in 2004.

310. **The stock market has grown steadily, but secondary market development is still nascent.** The stock exchange, *Bolsa de Valores de Panamá S.A.* (BVP), is the third largest in Central America. Market capitalization rose from $4,558 million (or 37.1 percent of GDP) in 2002 to $8,061 million (52.1 percent) in 2005. Panama has the largest equity listing among Central American stock exchanges. Primary equity issuance volume was $194.2 million while secondary and equity trading volume was $202.9 million in 2005. Total exchange-based trading, which includes primary issuance and secondary trading of private and public debt securities, has stagnated at around 11 percent of GDP in recent years. Repo transactions have declined dramatically over the last three years, reflecting declining transactions on public debt.

311. **Although bank-based finance is still dominant, the current tax system has helped to further deepen financial markets.** Domestic income is only lightly taxed and foreign-sourced earnings as well as dividends and capital gains from exchange-listed companies are tax-exempt. Interest income from nonlisted securities is subject to a flat tax rate of 5 percent.

B. Structure and Composition of Public Debt

312. **The budget deficit has been largely financed by external borrowing,** . Given the formal dollarization, the central bank does not have the usual monetary policy role and the central government is the main public sector borrower in Panama. Annual public debt issuance is limited to the amounts authorized in the national budget by the Legislative

[108] The resulting deterioration of CSS finances has prompted a significant withdrawal of its deposits from BNP (of more than 10 percent of BNPs total assets) over the last five years.

Assembly. Pursuant to the Fiscal Responsibility Law (2002), Panama has established limits for deficit and debt in relation to GDP for the next 15 years. In any year, the fiscal deficit is limited to 2 percent of GDP, the stock of public debt to 50 percent of GDP, and the stock of external debt to 35 percent of GDP. In 2004, the authorities suspended the application of the Fiscal Responsibility Law with the aim to amend the legislation on the public debt target by end-2006. At the same time, the practice of including the surpluses and assets of the Panama Canal Authority in the definition of the public sector deficit and debt was abandoned. In 2005, the public debt outstanding and external debt exceeded criteria set forth in the original Fiscal Responsibility Law. Total public debt at was $10 billion or about 64.8 percent of GDP (70.2 percent in 2004), of which more than 70 percent (45.4 percent of GDP) comprised of external debt in the form of global bonds (Table 60). Local government debt was $2,593 million (or 16.8 percent of GDP).

Table 60. Panama: Aggregate Public Debt
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005
Domestic debt	2,128.0	2,138.0	2,155.7	2,158.0	2,757.6	2,592.9
External debt	5,604.1	6,262.8	6,349.1	6,503.6	7,219.2	7,436.2
Total	7,732.1	8,400.8	8,504.8	8,661.6	9,976.8	10,029.2
Debt as a percent of GDP						
Domestic debt	18.3	18.1	17.6	16.7	19.4	16.8
External debt	48.2	53.0	51.7	50.3	50.8	48.1
Total	66.5	71.1	69.3	67.0	70.2	64.8
Issuer credit rating						
Fitch rating						
Local currency rating[1]	BB+	BB+	BB+	BB+	BB+	BB+
Rating outlook	Stable	Stable	Negative	Stable	Stable	Stable
Local currency rating[1]	B	B	B	B	B	B
Standard & Poor's						
Local currency rating[1]	BB+	BB	BB	BB	BB	BB
Rating outlook	Stable	Stable	Stable	Negative	Negative	Stable
Local currency rating[1]	B	B	B	B	B	B
Moody's						
Local currency rating[1]	Ba1	Ba1	Ba1	Ba1	Ba1	Ba1
Rating outlook	Stable	Stable	Stable	Stable	Stable	Stable
Local currency rating[1]	P-2	P-2	P-2	P-2	P-2	P-2
Memorandum items:						
GDP (in millions of U.S. dollars)	11,620	11,808	12,272	12,933	14,204	15,631
Exchange rate (balboas to U.S. dollars)	1	1	1	1	1	1

Sources: Ministry of Finance and IMF staff calculations.
[1]Since Panama is fully dollarized, the foreign currency rating is identical to the local currency rating.

313. **Fiscal measures are being taken to reduce Panama's budget deficit and sovereign debt.** In July 2002, the authorities implemented a revenue-enhancing tax reform, including efforts to broaden the tax base, strengthen enforcement, and extend the value-added tax to cover services. In February 2004, the legislature approved a new 1.4 percent tax on

companies' gross revenues and a levy on firms operating in the Colón Free Trade Zone, the largest free port in the Americas. Further fiscal reforms have focused on the reduction of expenditure alongside the introduction of new taxes and measures aimed at closing existing tax loopholes.[109] The budget deficit was expected to fall to 3.6 percent of GDP in 2005 (after a deficit of $700 million or 4.9 percent in 2004).

314. **External finance remains the mainstay of bonded public debt.** External government debt was $7,436.2 million (or 47.6 percent of GDP) at end-2005. The preference for external finance began in 2001, when Panama was taken off the list of noncooperating countries on money laundering by the United States and the Organization for Economic Cooperation and Development (OECD). Although strong economic growth has led to a decrease of external debt GDP ratio by more than three percentage points since 2004, its share in total public debt has been hovering within a range of 71 to 75 percent since 2000 (Tables 60 to 62).

Table 61. Panama: Outstanding External Debt of Central Government
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005
Foreign creditors	5,604.1	6,262.8	6,349.1	6,503.6	7,219.2	7,436.2
Official creditors	1,493.1	1,428.9	1,506.2	1,541.4	1,507.1	1,416.5
Bilateral	380.0	330.2	331.2	313.8	294.2	265.4
Multilateral	1,113.1	1,098.7	1,175.0	1,227.7	1,212.9	1,151.2
Others						
Private creditors	4,111.0	4,834.0	4,842.8	4,962.2	5,712.1	6,019.7
Bank loans	12.7	12.5	9.1	7.2	9.3	79.6
Bonds	4,098.3	4,821.4	4,833.8	4,955.0	5,702.9	5,940.1
Supplier's credit	0.0	0.0	0.0	0.0	0.0	0.0
Total	5,604.1	6,262.8	6,349.1	6,503.6	7,219.2	7,436.2

Sources: Ministry of Finance and IMF staff calculations.

[109] These reforms are directed in particular at corporations, which receive an estimated $200 million a year in subsidies but contribute less than $180 million in taxes. Other revenue-raising measures include introduction of new formulae for calculating the minimum tax payable by corporations and individuals, and elimination of a number of existing tax incentives with alternatives to be worked out at a later date. Moreover, the government committed to reduce its payroll by 30 percent in 2005, 20 percent in 2006, and 10 percent in 2007.

Table 62. Panama: Outstanding Domestic Debt of Central Government
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005
Private creditors	620.1	747.6	869.6	1,136.0	1,301.4	1,182.1
Bank loans	15.3	10.8	6.3	5.8	14.0	3.1
Bonds	579.9	706.7	848.2	1,123.8	1,283.5	1,175.8
Short-term	114.0	250.0	243.4	218.0	236.6	136.1
Medium-term	0.0	0.0	159.5	500.0	708.2	746.3
Long-term	465.9	456.7	445.4	405.8	338.7	293.5
Supplier's credit	0.0	0.0	0.0	0.0	0.0	0.0
Others (private)	24.9	30.1	15.1	6.4	3.9	3.2
Public creditors						
Banco Nacional de Panama (BNP)	683.9	602.6	579.2	505.6	833.7	806.7
Others (public sector)	824.0	787.8	707.0	516.4	622.6	604.2
Total	2,128.0	2,138.0	2,155.7	2,158.0	2,757.6	2,592.9

Sources: Ministry of Finance and IMF staff calculations.

315. **Panama has also actively managed its external debt profile taking advantage of benign credit conditions.** In 2005 and 2006, Panama initiated external debt exchanges to extend the sovereign yield curve and lower cost, taking advantage of favorable liquidity and market conditions in international capital markets (Box 4). This active debt management also underscores the importance of external debt in overall debt management strategy.

Box 4. The Panama Debt Exchange Program of 2005–06

Since being taken off the list of noncooperating countries on money laundering by the United States and the OECD, Panama's access to the international capital market has improved rapidly. Since 2001, Panama has raised external finance through international bond issues in order to both meet funding needs and restructure its foreign debt.

In January 2001, Panama filed a shelf registration with the U.S. Securities and Exchange Commission (SEC) for up to $1 billion in debt securities, of which $850 million was new and $150 million was being registered. The shelf registration allows Panama to sell securities in one or more offerings, determining details such as size and price at the time of sale.

In February 2001, Panama issued $750 million of 10-year global bonds (*Global 11*) with a coupon rate of 9.625 percent at 468 basis points over the equivalent U.S. Treasury benchmark rate (Table 63). In July 2001, Panama used the funds from this issue to buy back $160 million of existing debt (which was due on January 16, 2002). Additionally, bondholders received two warrants for each $1,000 of principal turned in, which entitled them to buy $1,000 worth of 10-year global bonds (*Global 12*) with a coupon of 9.375 percent for $990.

After Panama had filed another shelf registration with the SEC for $1.1 billion in debt securities, of which $433.3 million was unsold debt from the previous registration, the government began to buy back more of its global bonds. In February 2002, Panama repaid an outstanding sum of $341.6 million on a eurobond issue it reopened in July 2001. In July 2002, the government reopened its *Global 12* bond issue with an extra $150 million.

Following fiscal reform, the government embarked on more extensive refinancing and debt restructuring in 2005. On August 4, 2005, Panama reopened its 2034 global bond issue (8.125 percent coupon) for an additional issuance volume of $250 million at a significantly lower spread level than previous issues, and extended its debt maturity profile by swapping earlier-maturing debt into longer-dated debt.

On November 29, 2005, Panama completed a second debt exchange of $980 million worth of global bonds (*Global 26*). It swapping global bonds maturing in 2008, 2011, and 2020[1] in exchange for a new global bond issue, maturing in 2026, (Table 63). This debt exchange resulted in estimated savings of $154 million in present value terms. Before the debt exchanges, Panama had already filed with the SEC for an issuance volume of up to $2 billion worth of debt to raise money for general refinancing and other spending needs.[2]

Two months later, on January 17, 2006, Panama undertook a more ambitious transaction, issuing 30-year *Global 36* to replace five shorter-dated bonds due in 2020, with a combined outstanding amount of $1.36 billion. This transaction generated savings of $68 million in present value terms. This issue was rated "Ba1" (Moody's)/ "BB"(S&P) and priced at 230 basis points over the U.S. Treasury 30-year benchmark rate.

Table 63. Summary of Debt Exchange Program 2005/06

Instrument (Type of global bond)	Issue Volume (In millions of U.S. dollars)	Coupon Rate (In percent)	Maturity Date	Affected by Debt Exchange #1 and/or #2
Yankees 08	650	8.250	22-Apr-08	1
Global 11	750	9.625	8-Aug-11	1
Global 12	500	9.375	23-Jul-12	
Global 15	600	7.250	15-Mar-15	
Global 20	350	10.750	15-May-20	1 and 2
Global 23	756	9.375	16-Jan-23	2
Global 27 [1,2]	975	8.875	30-Sep-27	2*
Global 29 [2]	500	9.375	1-Apr-29	2*
Global 34	500	8.125	28-Apr-34	2
Total	5,581			
(1) Debt exchange on November 29, 2005				
Global 26	980.0	7.125	29-Jan-26	
(2) Debt Exchange on January 17, 2006				
Global 36	1,363.4	6.680	26-Jan-36	
Total	2,343.4			

Sources: Ministry of Finance, HSBC (Panama), and IMF staff calculations.

[1]The *Global 29* bonds offered investors an early redemption option in 2006.

[2] Since Panama did not intend to increase its nominal debt stock after execution of the second debt exchange on January 17, 2006,, it decided to accept 100 percent of the bids received for old bonds due in 2020, 2023, and 2034, and eventually refused all bids for the exchange the old bonds due in 2027 and 2029 (*).

316. **In contrast, there is some uncertainty about the government's plans for the development of a local public debt market.** Outstanding local public debt amounts to slightly more than a quarter of total central government debt. It comprises auctioned short-term treasury bills and medium- and long-term treasury notes, as well as privately negotiated and individually placed long-term government bonds outside the auction mechanism. Most of these private placements are bonds (*bonos reconocimientos)* the government issued in 1997 to fund the creation of the public pension system (*Sistema de Ahorro y Capitalización de Pensiones de los Servidores Públicos*—SIACAP).[110] In 2002, the government started issuing treasury notes in a bid to create a liquid domestic market for government debt. However, three years later, in January 2005, it suspended the program out of concern that the auction-based

[110] An amount of $395 million of such bonds was issued in 1997. As part of a broader government strategy to phase out long-term nonstandardized government bond holdings by public sector entities, Law No. 29 (2001) allowed SIACAP to issue participation certificates (*certificados de participación negociable*) on the back of its stock of government bonds. These certificates were used in lieu of cash payments to compensate contributors to SIACAP for past overpayment to the public pension fund.

primary issuance would not foster efficient price formation as private sector participation began to wane.[111] That decision effectively curtailed primary public debt issuance in the local market to short-term issuances averaging $17 million a month. At the end of 2005, medium-term bonds comprised most of the local debt, of which 88 percent were treasury notes.

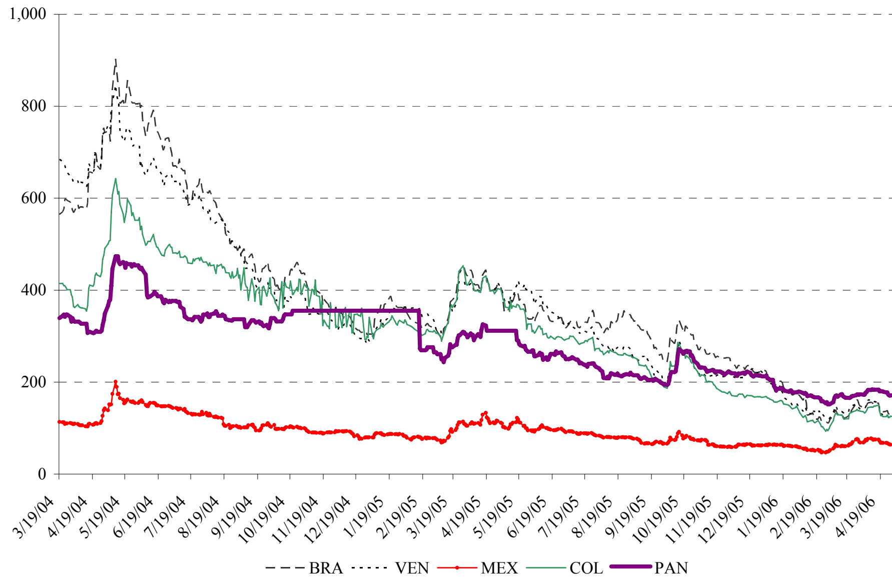
317. **The authorities justify the preference for external debt based on the cost advantage of issuing global bonds.** Panama's debt management strategy seeks to obtain the lowest cost funding. While development of domestic debt market remains an important objective, it is apparently easy for Panama to secure least cost funding via the issuance of global bonds, which are held by both foreign and domestic investors. Panama is among the highest-rated developing countries, though still slightly below investment grade. As a result, Panama enjoys relatively low-cost external funding (Figures 14 and 15), the benefits of which might outweigh the long-term incentives of creating a sustainable local debt market. The sovereign spreads of Panama's global bonds in the Emerging Market Bond Index Plus (EMBI+) and spreads of five-year credit default swap contracts on these bond issues place the external funding cost slightly above Mexico and Colombia, which are currently rated "BBB" and "BBB-" (local currency long-term rating) by Fitch and S&P.

C. Primary Issuance in the Domestic Market

318. **The government issues standardized public debt with maturity terms of up to 10 years via a public auction process.** The Office of Public Debt (*Dirección de Crédito Público*—CP) is responsible for the integrated management of public debt. As part CP issues treasury bills at three, six, and 12 months (Table 64), and treasury notes with fixed interest at maturities of two to 10 years. Interest is paid semiannually on a 30/360-day basis. The current maturities are three, four, six and eight years. Both bills and notes are completely fungible and have homogenous characteristics (standardized).

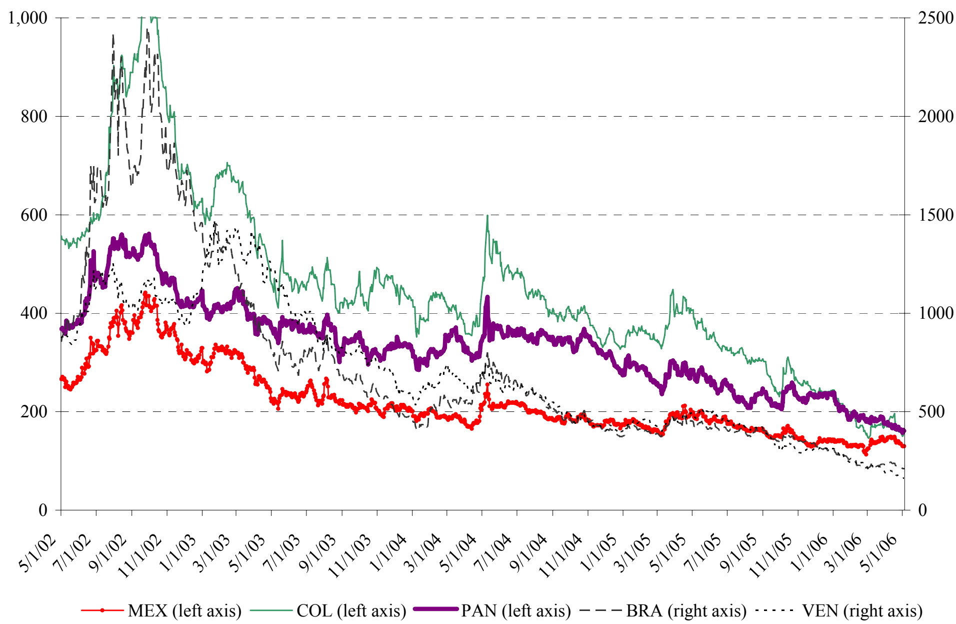
[111] Market participants have attributed the declining private sector interest in auctioned government debt to the government's unwillingness to accept higher discounts based on a fair market valuation of the public debt.

Figure 14. Five-Year Credit Default Swap Spreads of Selected Latin American Countries (Brazil, Venezuela, Mexico, Colombia, and Panama)



Source: JP Morgan

Figure 15. EMBI+ Index Spreads of Selected Latin American Countries (Brazil, Venezuela, Mexico, Colombia, and Panama)



Source: JP Morgan

Table 64. Panama: Type of Securities Issued by the Ministry of Finance, 2005

Issuer/Security	Maturity (months)	Discount or Coupon Interest Rate	Placement - Auction	Pricing	Standardization	Tradability
Treasury bills *(Letras del tesoro)*	3, 5, 6, 11, 12	Zero coupon	Competitive/ noncompetitive	Discriminatory	Yes	Yes
Treasury notes *(Notas del tesoro)*	24, 48, 72, 96	6.25, 7.25 (fixed, percent)	Competitive/ noncompetitive	Discriminatory	Yes	Yes

Source: Ministry of Finance.

319. **Domestic public debt is issued in a series of electronic multiple-price auctions with competitive and noncompetitive bidders.** Treasury bills are auctioned on the third Tuesday and treasury notes on the first Tuesday of each month according to an annual auction schedule. The auction is administered by the national stock exchange (BVP), for which the primary placement of government debt securities has become an important activity. The CP usually announces the (indicative) auction volume,[112] the maturity, and the day of liquidation eight days prior to the auction date. Any national and foreign natural and legal entity can participate in the auction via authorized and registered brokerage firms *(casas de valores)* or dealers *(puestos de bolsa)* only. Interested parties may present either competitive or noncompetitive bids. However, nonfinancial public institutions, such as Social Security Agency, can only submit noncompetitive bids (via BNP as agent). After the auction closes, the bids are categorized into private competitive bids, private noncompetitive bids, and noncompetitive bids by public entities. The issuer then decides on the minimum acceptable price and allocates the issue to all successful competitive bids at their individual bid prices (discriminatory price). If the cut-off price results in oversubscription, allocations to competitive bidders are prorated. Unless the available auction volume is exhausted, the residual is offered to private noncompetitive bids before public bidders receive any allotment. Noncompetitive auctions are allocated at the average price of successful bids. Settlement occurs at T+3 through the clearing system of the *Central Latinoamericana de Valores* (LatinClear),[113] the exclusive custody system for clearing and settlement of securities traded at BVP.[114] The transfer of ownership happens via book entry.

320. **The BVP fee structure for primary issuers requires marginal registration and listing fees.** The debt issuers pay BVP a one-time registration fee of $250 plus a basic (or listing) fee of $50 for each series of debt listed, plus an annual fee of $100 and $25 for each outstanding series as long as the debt instruments are listed. In addition, primary issuers pay

[112] However, CP is entitled to change the volume of tendered securities after the auction.

[113] LatinClear was created in 1994 under the auspices of the Inter-American Development Bank and the Stock Exchange Association for Central America and Panama. It is jointly owned by brokerage houses and banks. LatinClear was authorized to administer the custody, clearing, and settlement of securities by the *Comisión Nacional de Valores* on July 23, 1997.

[114] BVP provides custody and settlement services through its internal department, *Caja de Valores,* to exchange brokers and other institutional entities and corporations authorized to receive these services.

fees ranging from 1/8 to 1/32 of 1 percent, depending on the issue volume. Currently there are 15 brokerage houses registered with BVP, of which nine are authorized to receive and present bids for both treasury bills and notes.[115] All brokers are privately owned, with the exception of BNP, which intermediates bids from public sector entities.

321. **Public sector investors have substantial influence in determining auction rates in the primary market for public debt.** The price formation in the auction process of public debt differs for short- and medium-term debt instruments. The auction results of 2005 suggest that both treasury bills and notes attract comparable levels of demand of around $50 million on average, against an indicative offer volume of $17 million and $32 million of treasury bills and notes, respectively. While bills were sometimes underallocated (i.e., the issued amount was lower than the indicative amount), both bills and notes are consistently oversubscribed. Moreover, bidders are on average more than twice as likely to be successful in auctions of notes (54 percent) than in auctions of bills (24 percent).

322. **Despite their restriction to noncompetitive participation in the primary market, public sector bidders influence price formation.** Large public sector demand allows the government to curtail competitive bids at a high cut-off price (i.e., a low offered interest rate). Although both auctions of bills and notes are heavily oversubscribed, noncompetitive public sector bids receive an above-average allocation rate at the average auction price.

323. **The authorities believe that external finance is generally less costly than domestic public funding.** There is the spread difference between domestic and external debt, which, according to market participants, has averaged approximately 60 basis points over the last year (after adjustment for different issuance costs) for comparable maturity terms. In 2005, bills and notes sold at respective spreads of about 19 and 144 basis points over the equivalent U.S. Treasury rate (Table 65). Given that the last external bond issuance of 30-year global bonds on January 17, 2006 generated a spread of 230 basis points over the U.S. Treasury 30-year benchmark rate, medium-term domestic funding via the notes program indeed appears costly. This might encourage the government to abandon the local market for more externally issued debt.

324. **Panamanian authorities face an important choice in balancing the objectives of securing least cost funding and developing domestic debt market.** The lower secondary market yields of global bonds versus domestic bonds (to the limited extent such comparisons can be made) may be explained by a variety of factors including the much larger volume and higher liquidity of global bonds, larger and more international investor base, and the preference for international settlement, governing law, and jurisdiction. These advantages are likely to persist. Moreover, as Panama is formally dollarized, avoiding currency risk is not a reason for domestic issuance. Treasury bills would have to be issued domestically for several obvious reasons. But potential reasons for domestic issuance of bonds would have to be essentially long term and strategic, such as developing a domestic institutional and retail

[115] Four of the brokers can only trade in notes, while one broker only participates in the auction of treasury bills. Moreover, brokers are not subject to capital rules.

Table 65. Panama: Secondary Trading of Fixed Income Domestic Securities

(In millions of U.S. dollars)

	2002				2003				2004				2005			
		Trading Volume				Trading Volume				Trading Volume				Trading Volume		
	Average outstanding stock		In percent of market	In percent of stock	Average outstanding stock		In percent of market	In percent of stock	Average outstanding stock		In percent of market	In percent of stock	Average outstanding stock		In percent of market	In percent of stock
Repo	**292.3**	**234.5**	**45.7**	**80.2**	**258.9**	**210.6**	**44.6**	**81.3**	**94.3**	**80.4**	**18.8**	**85.3**	**73.1**	**56.9**	**12.5**	**77.9**
Private securities	287.5	3.3	0.6	1.1	227.7	23.9	5.1	10.5	84.9	6.8	1.6	8.1	25.5	33.6	8.5	131.9
Public securities	4.8	231.3	45.1	4778.6	31.2	186.7	39.6	597.8	9.4	73.6	17.2	783.7	47.6	23.3	5.9	48.9
Outright	**1,460.1**	**182.7**	**35.6**	**12.5**	**1,663.0**	**181.1**	**38.4**	**10.9**	**1,785.4**	**223.9**	**52.2**	**12.5**	**2,256.1**	**194.2**	**48.9**	**8.6**
Private securities	1,057.2	77.8	15.2	7.4	945.0	64.8	13.7	6.9	840.6	67.3	15.7	8.0	1317.8	74.0	18.6	5.6
Public securities	402.9	104.9	20.5	26.0	718.0	116.3	24.6	16.2	944.8	156.6	36.5	16.6	938.3	120.2	30.3	12.8
Equity	**2,949.5**	**95.5**	**18.6**	**3.2**	**3,075.0**	**80.2**	**17.0**	**2.6**	**4,047.4**	**124.2**	**29.0**	**3.1**	**5,731.6**	**202.9**	**51.1**	**3.5**
Total	**4,702.0**	**512.8**	**100.0**	**10.9**	**4,997.0**	**471.9**	**100.0**	**9.4**	**5,927.0**	**428.5**	**100.0**	**7.2**	**8,060.8**	**397.1**	**100.0**	**4.9**
Memorandum item:																
Primary Issuance		900.9				962.4				914.8				1,227.5		

Sources: National Stock Exchange (BVP) and IMF staff calculations.

investor base, supporting local exchange and brokerages, and encouraging greater issuance by Panamanian corporations in the local exchange. While Panama enjoys good market access, exclusive reliance does carry some risk of sudden stops of capital flows and changes in risk appetite for the emerging market assets. For strategic risk reduction and domestic financial sector development, it may be reasonable for Panama to maintain a significant domestic issuance, as envisaged in its fiscal responsibility laws. If it decides to do so, it may be useful to focus on specific maturities, say, up to 5 or 10 years, while relying on global bonds for other maturities. Panama may also be able to reduce the cost of such domestic funding by seeking both domestic and foreign investors in such locally issued debt, issuing such bonds domestically in volumes that would attract foreign investors, and incorporating the standard provisions of eurobonds into its local issuance to the maximum possible extent.

D. Secondary Market for Public Debt

325. **Secondary market trading is organized by the national stock exchange.** BVP was created in 1989 by Resolution No. 349 of the National Securities Commission (*Comisión Nacional de Valores or CNV*) and commenced operations on June 26, 1990 as the national stock exchange. As the sole securities market regulator in Panama, the CNV acts as an autonomous unit of the Ministry of Economy and Finance subject to the control of the General Comptroller's Office. However, national law in Panama does not bestow exclusive rights to the BVP as the only authorized stock exchange. The BVP handles dematerialized equity and debt securities (including public debt) under the custodianship of LatinClear. Investors can obtain LatinClear's services through any of the 23 participant organizations (brokerage houses, licensed banks, and other qualified financial institutions). With the exception of government debt, all exchange-listed securities must be registered with the CNV. LatinClear operates on a continuous netting system for all transactions conducted through the electronic trading system (*Sistema Transaccional Electrónico*—SITREL).[116]

326. **While market capitalization continues to rise, it fails to stimulate more trading.** The market capitalization of securities traded on the BVP almost doubled from $4,702 million in 2002 to $8,061 million in 2005 (Table 65). BVP is small and limited in offerings, with a total of 83 authorized issuers of shares or debt instruments.[117] Securities traded in the secondary market of the BVP are charged an annual trading fee of 1/16 of 1 percent. Notwithstanding a sound exchange-trading infrastructure, a comprehensive trading platform and low trading costs, secondary market trading of public debt either via the BVP[118] or the interbank over-the-counter market is low, at a turnover rate of only 5.6 percent of market capitalization. While reported overall trading volume has risen from $1.05 billion to $1.68

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[116] LatinClear has also opened reciprocal accounts with other securities depositories in the region and with Clearstream in Luxembourg.

[117] For instance, the national exchanges in Costa Rica (BNV) and El Salvador (BVES) are by far larger in market capitalization, reporting trading volumes of $34.2 billion and $8.7 billion, respectively, in 2004.

[118] The stock exchange operates for trades only from 10 a.m. to 3 p.m. from Monday to Friday, except for holidays.

billion over the last five years, secondary trading without primary issuance dwindled from $512 million to $454 million from 2002 to 2005.

327. **Most exchange-based secondary market activity centers on equity and medium-term government debt, but trading in corporate bonds remains thin.** Based on primary issuance and secondary market trading at BVP, government notes and bonds ($672.9 million, or 50 percent of exchange-based trading) were the most frequently traded securities in 2004,[119] with corporate debt/commercial paper ($296.4 million, or 22.1 percent of exchange-based trading) and equity ($293.7 million, or 21.8 percent) accounting for the remaining trading activity. However, once exchange-based primary issuance is excluded, equity ($202.9 million, or 44.6 percent) was the single most traded asset class,[120] followed by public debt securities ($120.2 million, or 26.8 percent of total trading) and private debt securities ($74 million, or 16.3 percent). Private debt securities tend to be thinly traded and only play a minor role in terms of primary issuance at the BVP.[121] As opposed to the larger exchanges in Costa Rica and El Salvador, where most of exchange-based trading is on short-term securities (86.1 and 96.3 percent of total trading, respectively), the BVP conducts most trading on securities with maturity terms beyond one year (64.4 percent). Repo trading, which used to account for bulk of the secondary trading, has declined substantially in recent years.

328. **The current organization of the primary market restricts the development of a liquid secondary market for public debt.** The limited issuance of public debt has resulted in frequently oversubscribed and under-allocated primary market auctions. The large allocation to noncompetitive public bidders has curtailed greater private sector participation and impedes greater diversification of demand across the financial system. Moreover, the short-term nature of public debt encourages a large investor base of nonfinancial public agencies, insurance companies, and private pension funds (Table 66) to hold public debt until maturity ("buy and hold"), which prevents secondary market trading and the development of a liquid yield curve.

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[119] In contrast, in Costa Rica and El Salvador, public debt accounts for 42 and 24 percent, respectively, of total trading.

[120] However, trading relative to outstanding market capitalization is poor for outright private debt securities and equity, with respective amounts of only 5.6 and 3.5 percent of outstanding stock traded.

[121] Equity and private debt securities have recovered from several unexpected bankruptcies and corporate defaults in recent years. Foreign and domestic banks as well as BVP were affected by the bankruptcies of the Adelag Group in 2000, the Panamanian franchise of Sears in 2001, and Fotokina in 2002 (all large retailers), which prompted the Superintendency of Banks to enact new regulations regarding corporate governance. In 2003, the legislature approved a comprehensive bankruptcy bill (drafted by the Panamanian Chamber of Commerce) that will allow companies with financial difficulties to restructure their debts.

Table 66. Panama: Investor Breakdown of Public Debt
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004	2005
Domestic investors	1,140.00	2,500.00	4,008.54	6,936.84	9,171.68	9,164.13
Banks and quasi-banks	675.93	1,788.08	2,144.75	2,875.34	2,563.09	2,495.28
Insurance companies	0.00	0.00	11.00	174.84	183.54	116.79
Mutual funds	8.67	0.00	6.00	177.72	59.05	232.26
Pension funds and social security programs	0.00	0.00	50.00	576.99	1,408.42	1,480.83
Nonfinancial public sector	85.65	478.25	1,346.82	1,779.51	1,979.88	2,289.44
Nonfinancial private sector	361.80	228.86	400.00	930.29	2,202.99	1,871.15
Of which: retail investors	7.95	4.81	49.97	422.16	774.71	678.38
Foreign investors	0.00	0.00	19.96	243.16	275.89	507.29
Total	1,140.00	2,500.00	4,028.50	7,180.00	9,447.57	9,671.42
Decomposition by currency						
Denominated in local currency	-	-	-	-	-	-
Denominated in foreign currency	1,140.00	2,500.00	4,028.50	7,180.00	9,447.57	9,671.42

Sources: Ministry of Finance and IMF staff calculations.

E. Investor Universe and Regulation of Investments in Public Debt

329. **Banks are the single largest holders of public debt, followed by nonfinancial public and private institutional investors.** Investment in public debt is diverse, with domestic banks and quasi-banks constituting the largest domestic investor group ($2,495 million, or 25.8 percent). Banks hold public debt mainly because of a lack of alternative investment instruments. Reserve requirements are rather low at a flat charge of $10 million per bank. However, the share of banks has declined significantly since 2000, when banks held 59.3 percent ($676 million) of the total outstanding public debt of $1,140 million. Nonfinancial public and private (largely institutional) investors comprise 23.7 percent ($2,289 million) and 19.3 percent ($1,871 million), respectively, of the overall investor base. The share of foreign investors has increased from 0.5 percent to 5.2 percent ($507 million) over the last three years. While domestic retail investment increased appreciably from $20 million (0.5 percent) in 2002 to $678 million in 2005 (7 percent), the intermediation of public debt markets by stock exchange brokers seems to have inhibited a larger presence of institutional investors. The largest institutional investor in public debt is the Social Security Agency, which maintains public pension funds and other social security benefit plans. It holds about 4.5 percent of all public debt ($435 million or 2.8 percent of GDP). Other significant institutional investors include private pension funds and insurance and reinsurance companies.

330. **Existing investment regulations for public and private institutional investors create a captive investor base for public debt and leave little room for public pension funds to diversify into alternative asset classes.** The current regulatory framework for institutional investors implies a stable and consistent demand for public debt (Box 5). Public

Box 5. Investment Regulations of Pension Funds and Insurance Companies in Panama

The reserves of private and public pension funds as well as insurance and reinsurance companies are subject to investment regulations that require significant asset holdings of public debt.

Social Security System

The reserves of the social security system can only be invested in the following assets according to Article 27 of Law No. 54 of 27 December 2000: deposits with national or foreign banks that are investment-grade rated; securities issued or guaranteed by the Republic of Panama; securities issued by the Panama Canal Zone Authority; and investment-grade-rated debt securities that, unless liquid and publicly quoted, cannot exceed 10 percent of the total amount of issued debt or 5 percent of the volume of a single debt issuance. All investment except public debt is subject to a 50 percent cap of core capital. Excess funds are to be transferred as mandatory deposits to the BNP, which "fences out" these investments according to a prudential arrangement. The revised version of the social security law (Law No. 51 of December 27, 2005) extends the scope of investment by the social security system. Under Article 105, investment by the social security system has to support "productive projects" for the benefit of a "sustainable national development." Under Article 106, up to 25 percent of investment can be in state-guaranteed public projects, but no more than 20 percent of the total project cost can be financed by the social security system. Moreover, only a maximum of 25 percent of investments can be in investment-grade-rated nongovernment assets (foreign government or domestic/foreign corporate).[1]

Private Pension Funds

Private pension funds were established under Law No. 10 of April 16, 1993, which regulates the formation of voluntary pension and retirement plans to complement the mandatory public pension fund system administered by the social security system. CNV defines investment parameters for pension and retirement funds to ensure their compliance with statutory objectives and principles according to Law No. 1 of 1999. These were revised in *Acuerdo No. 11-2005* (August 5, 2005), which stipulates requirements for creation of pension and retirement funds and the activities of administrators thereof. Besides various registration and disclosure requirements, Article 28 defines the limits of private pension funds by investment type, e.g., 50 percent in public debt, 60 percent in bank deposits, 40 percent in corporate bonds, and 40 percent in ordinary or preferred stock. At no time must foreign-asset holdings exceed 50 percent of investments in each asset class.

Insurance and Reinsurance Companies

Insurance and reinsurance companies share investment requirements similar to those of private and public pension funds. Law No. 59 (July 29, 1997) regulates insurance companies and insurance agents. The *Consejo Técnico de Seguros* of the *Superintendencia de Seguros y Reaseguros*, the national supervisory agency for insurance and reinsurance companies, amended this regulation by *Resolución CTS-03* (June 24, 1997), which was later incorporated into the articles of agreement of the national association of insurance companies, the *Asociación de Productores de Seguros de Panamá*.[2] Reserve guidelines are defined by Article 29 of Law No. 59, which permits investment of insurance companies in all types of private and public debt, stocks, and bank deposits without individual limits as long as no more than 25 percent are invested in foreign debt, which must be investment-grade rated.

[1]Some public social security plans, such as the *Sistema de Ahorro y Capitalización de Pensiones de los Servidores Públicos*, which grants disability benefits to public servants, are administered by private pension funds. Their investments are subject to Article 18 of Law No. 8 (February 6, 1997): up to 50 percent of internal or external debt issued or guaranteed by the Republic of Panama, securities issued by the BNP and the national savings bank (CA), mortgage obligations issued by autonomous state agencies; up to 30 percent in fixed-rate bank deposits and other investment products offered by banks; and up to 30 percent in liquid bonds, stock, and other publicly quoted security in the local market authorized by CNV, which must not exceed 5 percent of the total outstanding amount of the issuer. All investments in foreign securities and entities must be investment-grade rated and must not exceed 10 percent of the total investment portfolio.
[2]Panama's other professional insurance company organization is the *Panamanian Association of Insurers.*

and private institutional investors are required to hold substantial parts of reserves in domestic and external government debt. However, the recent suspension of domestic issuance of treasury notes leaves only short-term treasury bills and external government bonds to accommodate domestic demand for public debt. However, greater reliance on alternative forms of public debt, such as government-issued eurobonds, might compromise the return expectations of most institutional investors with large domestic exposures as they adjust their investment portfolios.[122] Greater accessibility of public debt from other Central American governments in the wake of greater regional integration and further recovery of the corporate bond market might help fill the void that the changed public debt policy has left in the local debt market.

F. Problems and Recommendations

331. **To improve the maturity profile of public debt, the government has continued to pursue a debt management strategy of external debt exchanges and reopenings of global bond series to a point where domestic debt issuance is becoming increasingly marginalized.** Notwithstanding the attenuating effect of a liquid banking sector and offshore capital inflows, the absence of a deep local market exacerbates financial shocks in the event of a large-scale sell-off of global bonds by external investors.

332. **The large demand of public sector entities allows the government to curtail competitive bids and allocate a disproportionately large share of auctioned debt to noncompetitive public bidders at high cut-off rates (above the fair market rate).** While the current configuration of primary issuance lowers the government's borrowing cost, it tends to frustrate competitive private bidders, who receive a small share of theirs bids. Noncompetitive bidding by public entities is usually a welcome feature of primary auctions, provided it does not influence the competitive price formation or curtail competitive bids excessively. Otherwise, private bidders would rationally prefer to exit the market. The suspension of the notes program may be suggestive of such problems. While there may be few perfect solutions to this problem, Panama may want to consider allowing public sector investors access to competitive bids, together with full operational freedom to bid at arms length.

333. **The primary market also inhibits secondary-market trading of public debt.** Although public debt is standardized, the current state of the primary market auction hinders secondary market deepening due to insufficient primary issuance to private bidders and the high prevalence of public bidders, which tend to hold public debt until maturity.

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[122] This situation might also exacerbate the deterioration of pension fund finances due to growing pension payments. The only two authorized private pension funds have already been forced to alter their investment strategy in favor of more nonpublic and foreign securities. For instance, the current investment portfolio of *Progreso* consists of 55 percent local, medium-term public debt, and 27 percent Panamanian debt (20 percent local and 80 percent external). Also note that pension funds will change from fair value to mark-to-market accounting only on January 1.

334. **In light of continued demand from a captive local investor base, the authorities are encouraged to resuscitate domestic debt issuance.** The authorities should revisit the trade-off between the short-term benefit of external debt issuance and the long-term payoff of a stable local debt market with regard to debt sustainability in times of stress. A clear commitment to development of the domestic market would be desirable. Hence, the treasury notes program should be reintroduced.

335. **Further options are available for the stimulation of secondary market trading, which might further help develop local debt markets.** Initiatives to facilitate the development of the secondary market require a wider range of public debt instruments to establish a liquid yield curve. A larger volumes of public debt at longer maturities should be issued to foster secondary market trading. In this regard, the current auction mechanism, particularly the participation of private and public bidders and the allocation between competitive and noncompetitive bids, needs to be reconsidered in order to ensure sufficient private sector demand for public debt. This requires the close cooperation with local financial institutions, given the dominating role of banks within the financial system and their controlling influence on the execution of brokerage services. Possible initiatives should also be combined with the conversion of almost $400 million of nonstandardized government debt *(bonos reconocimientos)* held by the public pension system (SIACAP), the relaxation of regulatory requirements for institutional investors, and the solicitation of greater demand from foreign investors.