Chapter 8. CASH MANAGEMENT AND THE TREASURY FUNCTION[1]

A. THE TREASURY FUNCTION

Governments need to ensure both efficient implementation of their budgets and good management of their financial resources. Spending agencies must be provided with the funds needed to implement the budget in a timely manner, and the cost of government borrowing must be minimized. Sound management of financial assets and liabilities is also required.

Financial management within the government includes various activities: formulation of fiscal policy; budget preparation; budget execution; management of financial operations; accounting; and auditing and evaluation. Within this broad financial management function, the Treasury function is to achieve the set of specific objectives mentioned above. It covers the following activities:[2]

- Cash management;
- Management of government bank accounts;
- Financial planning and forecasting of cash flows;
- Public debt management;
- Administration of foreign grants and counterpart funds from international aid;
- Financial assets management.

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[1] The government's strategy to manage its moneys to maximize financial return s a critical part of overall cash management. The accent of this chapter, however, is on control of cash flows and on the efficiency of payments' arrangements, in keeping with the expenditure focus of this entire book.
[2] Cf, Teresa Ter-Minassian, Pedro P. Parente, and Pedro Martinez-Mendez, "Setting up a Treasury in economies in transition," IMF, 1995.

To carry out these activities, organizational arrangements and distribution of responsibilities vary considerably according to countries. In some countries, the Treasury Department focuses only on cash and debt management functions (which are reviewed in this section). In a few countries, debt management is performed by an autonomous agency. In other countries, the Treasury Department performs budget execution controls (which are reviewed in chapter 6) and/or accounting and budget execution reporting activities (which are reviewed in chapters 10 and 11).

B. CASH MANAGEMENT[3]

Cash management has the following purposes: controlling spending in the aggregate, implementing the budget efficiently, minimizing of the cost of government borrowing, and maximizing the opportunity cost of resources (the last two purposes yielding interest). Control of cash is a key element in macroeconomic and budget management. However, as emphasized in chapter 5, it must be complemented by an adequate system for managing commitment. For efficient budget implementation, it is necessary to ensure that claims will be paid according to the contract terms and that revenues are collected on time. It is necessary to minimize transaction costs; and to borrow at the lowest interest rate or to generate additional cash by investing in revenue-yielding paper. It is also necessary to avoid paying in advance and to track accurately the dates on which payments are due.[4]

In developing countries, governments often do not pay attention to issues related to cash management. Budget execution procedures and the management of cash flows focus on compliance issues, while daily cash needs in are met at low cost by the Central Bank. Spending units are not concerned with borrowing costs since their interests are already taken account in the budget prepared by the Ministry of Finance.

However, the costs of borrowing, the fact that the credit granted to the government by the banking system is a key macroeconomic target and a performance

[3] The relationship between the Treasury and the Central Bank in this and other respects is briefly discussed in section.

criterion in IMF-supported financial programs, and the increasing separation between the activities of the Central Bank and the government budget make cash management more important. Performance concerns have also had an impact on cash management and some countries have implemented reforms to make spending agencies more responsible for cash, while maintaining instruments to ensure fiscal discipline.

Box 26
Cash Management in the Philippines

Until 1985, cash authorizations were issued to government agencies each quarter through the release of cash disbursement ceilings (CDCs) which specify the maximum amounts that the agencies can withdraw from the Bureau of the Treasury (BTr) to pay for their obligations. Even with the creation of a New Disbursement System in 1986 the CDC system, the tendency for agencies to issue checks and Treasury warrants in excess of the amounts provided persisted.

In May 1990, the Synchronized Planning-Programming-Budgeting System (SPPBS) was introduced to improve coordination among the budget, planning and revenue agencies and ensure the consistency of budget plans with development goals and available funds. In the following year, the Department of Budget and Management (DBM) and the Department of Finance (DOF) initiated the creation of an Inter-Agency Committee on Cash Programming composed of representatives from the DBM, DOF, BTr, and the Central Bank. Regular meetings were held to assess the fiscal performance of the national government for the previous month and to discuss prospects for the succeeding months. The Committee determined the disbursement ceiling on which the issuance of Notices of Cash Allocation (NCAs) was based.

The SPPBS did nothing to resolve the situation, and problems with cash float and timeliness of cash releases continued. Accordingly, in 1992, the Modified Disbursement System was established to provide for closer coordination between DBM and DOF in releasing funds, based on shorter-term calculations of cash availability. Agencies, to optimize their use of cash in their priority programs, implemented cash conservation measures.

Under the Modified Disbursement System, the DBM continued to allocate funds appropriated under the General Appropriations Act. The DOF made the corresponding arrangements with the servicing banks, deposited the minimum funding requirements for each government entity, and replenished these deposits regularly. The deposits were maintained by the Treasurer of the Philippines and interest earned accrued to the General Fund.

In the event that the estimated cash balance of the government reached a level where budget cuts could be avoided, the DBM implemented proportionate across-the-

[4] The 1997 annual report of the Western Australia Audit Office, for instance, shows the savings made through the reform of payment techniques and accounting procedures in the main roads agency of the government of Western Australia.

board reductions in the budget. Government agencies, however, continued to determine disbursement priorities, subject only to the prior payment of personal services and mandatory expenditure.

To expedite and standardize the release of funds across agencies in line with specific policy initiatives of the government, the Simplified Fund Release System (SFRS) was implemented in 1995. It standardizes releases across government agencies that are similarly situated. It allows flexibility in the use of funds within limits prescribed by law and simplifies the process, thereby reducing paperwork and facilitating the monitoring of allotment releases.

Source: Darlene Casiano, Department of Budget of Management, January 1999.

1. Control of cash flows[5]

a. Inflows

It is necessary to minimize the interval between the time when cash is received and the time it is available for carrying out expenditure programs. Collected revenues need to be processed promptly and made available for use. When tax collection is done by the tax administration offices (or by Treasury offices) the administrative organization of these offices may have to be reviewed and their equipment modernized.

Commercial banks by virtue of the banking sector infrastructure are often able to collect revenues more efficiently than tax offices, which should therefore focus instead on tracking taxpayers. When revenues are collected by commercial banks, arrangements must be defined to foster competition and ensure prompt transfer of collected revenues to government accounts. Systems of bank remuneration through float, which consists of authorizing the banks to keep the revenues collected for a few days, present inconveniences. Stringent rules to ensure prompt transfers must be established. Moreover, bank remuneration through fees is more transparent and promotes competitive bidding. An appropriate system of penalties for taxpayers is also an important element in avoiding delays in revenue collection.

[5] See Herma R. de Zoysa, Cash Management, in Premchand (1990).

b. Outflows

For cash management, the control of cash outflows, which is directly related to organizational arrangements for budget execution, can pose more difficulties than the control of cash inflows. However, issues related to cash management should not be confused with issues related to the distribution of responsibilities for accounting control and administration of the payment system. The major purpose of controlling cash outflows is to ensure that there will be enough cash until the date payments are due and to minimize the costs of transactions, while keeping cash outflows compatible with cash inflows and fiscal constraints.

The first condition for ensuring that cash outflows fit fiscal constraints is good budget preparation and budget implementation covering both cash and obligations. However, during budget implementation, cash outflows must also be regulated through cash plans to smooth cash outflows.

c. Payment techniques

Payment methods affect the transaction costs of cash outflows. Depending on the banking infrastructure and the nature of expenditures, various payment methods may be considered (check, cash, electronic transfer, debit card, etc.).[6] Modern methods of payment, for example, payment through electronic transfers instead of through checks or cash, allow the government to plan its cash flow more accurately, expedite payments, and simplify administrative and accounting procedures. However, whether one mode of payment is preferable to another depends on many factors, such as the degree of economic development of the country, the banking network, the status of computerization. For payments within government (when an agency provides services to another agency), a number of countries use nonpayable checks, while others make book adjustments. Using nonpayable checks has the advantage of avoiding delays in

[6] Instruments for payment are presented in Premchand, Effective government accounting, IMF, 1995, page 25 (table 1) and page 27 (table 3).

the preparation of accounts. In some aid-dependent countries nonpayable checks are used to pay taxes related to imports financed with external aid, to avoid loopholes in the tax system created by duty-free imports.

2. Centralization of cash balances and Treasury single accounts

a. Centralizing cash balances

To minimize borrowing costs or maximize interest-bearing deposits, operating cash balances should be kept to a minimum. In countries where funds are released through an imprest system, spending agencies often accumulate idle balances their bank accounts. These idle balances increase the borrowing needs of the government, which must borrow to finance the payments of some agencies, even if other agencies have excess cash.

Where imprest accounts are held at a commercial bank, the idle balances can help loosen constraints on credit, by giving the banking sector additional resources for credit.

Daily clearing of accounts with various banks could be more difficult in some countries than daily settlement within a set of accounts at one bank (generally Central Bank). However, in many countries, the Treasury does not perform daily clearing of the balances of the line ministries accounts with the Central Bank. Therefore, despite a positive balance with the Central Bank, the government has to borrow from the financial markets. Daily consolidation of cash balances is also needed when line ministries accounts are held with the Central Bank.

Cash balances are efficiently centralized through a Treasury Single Account. This is an account or set of linked accounts through which the government transacts all payments.

A standard Treasury Single Account is organized along the following lines: (i) line ministries hold accounts at the Central Bank, which are subsidiary accounts of the Treasury's account; (ii) spending agencies under the line ministries hold accounts either at the Central Bank or, for banking convenience, with commercial banks; in both cases, the accounts must be authorized by the Treasury; (iii) spending agencies' accounts are zero-balance accounts, with money being transferred to these accounts as specific approved payments are made; (iv) spending agencies' accounts are automatically swept at the end of each day (where the banking infrastructure allows daily clearing); (v) the central bank consolidates the government position at the end of each day including balances in all the government accounts.

In practice under the notion of a Treasury Single Account, there are a variety of methods of centralizing transactions and cash flows. These can be grouped very broadly into two categories:

- *Treasury Single Account and centralized accounting controls.*[7] Requests for payment are sent to the Treasury which controls them and plans their payment. The Treasury manages the float of outstanding invoices. This solution seem more efficient both for cash management and expenditure control. However, as discussed in chapter 7, the centralization of accounting controls and the central management of float lead to inefficiencies, and even corruption, in countries where the Treasury Department selects the suppliers to be paid.

- *Passive Treasury Single Account.* Payments are made directly by spending agencies, but through a Treasury Single Account. The Treasury, or the budget implementation plan, sets cash limits for the total amount of transactions, but the Treasury does not control individual transactions. In practice, the Treasury Single Account consists of several bank accounts. These accounts may be held only at the Central Bank or also in several other banks (e.g., Agriculture Bank, giro postal service). These accounts are cleared every day and their balance is transferred to the central account of

[7] As in the French system.

the Treasury. This variant has the advantage of making the spending agency responsible for internal management, while keeping central control of cash.

This system allows but does not require diversified banking arrangements. Payments can be made through banks selected on a competitive basis. The banks accept the payment orders sent by spending units up to a certain limit defined by the Treasury or the budget implementation plan. Settlement is made with the Central Bank that holds the Treasury central account at the end of each business day.

Whatever the institutional arrangements, the centralization of cash balances should cover all the government accounts used for payment transactions, including accounts managed by funds.

From a cash management point of view, these modes of centralizing cash balances give identical results. The feasibility of their implementation depends on the level of technological development of the banking sector and the government. Modern technology allows electronic links between spending agencies, the Central Bank (or the commercial banks), and the offices of the Treasury. Actually the concept of a General Ledger System, which is a system into which all transactions are recorded (see chapter 7, for further discussion of the General Ledger System), can fit either decentralized or centralized accounting controls and payment processing systems. Countries with centralized controls (e.g., Brazil) as well as countries without central control (e.g. the U.S.) have set up a General Ledger System into which not only payment transactions but also commitments are posted. The GLS can also be linked with the accounting and management information systems maintained at the agency level.

Poor banking and technological infrastructure in some developing countries is an obstacle to combining centralization of cash balances with decentralization of payment processing. But most countries use the greater portion of their cash either for transactions at the central level (e.g., debt payment and expenditures managed by the central departments of line ministries) or for payments that are due on a fixed date (e.g, wage payments). Therefore, a first step in streamlining cash management could consist of: (i) daily centralization of transactions made at the central level; and (ii) for decentralized agencies, procedures for cash transfer that conform to the in-month distribution of expenditures.

In countries with an underdeveloped banking infrastructure, daily clearing of accounts with various banks could be more difficult than daily settlement within a set of accounts at the Central Bank. Maintaining a large number of accounts could therefore also hinder the implementation of appropriate clearing and consolidation procedures.

For policy analysis and management, it is important to record each transaction and to classify it along functional and economic categories. Thereby centralizing cash balances is not sufficient for this purpose. Information on transactions must also be centralized. Processing payment transactions within the Treasury could facilitate monitoring. However, experience shows that this does not automatically guarantee that monitoring will be satisfactory. Generally in developing countries, the Treasury centralizes its internal cash balances and global information on cash outflows and inflows, but the centralization of payment transactions is not systematic or the data are too much aggregated to allow a sound analysis of budget execution. Moreover, as indicated in chapter 5, cash flow monitoring is insufficient to control budget execution. Issues related to monitoring and reporting are reviewed in more detail in chapter 7.

Arrangements for cash management in several countries aim implicitly at supporting ailing banks. Restructuring the banking system in these countries is generally required. However, banking reform is a policy issue that should be addressed as such. Before considering any reform of cash management, its effect on the banking system should be assessed. On the other hand, entrusting the management of the governments accounts to commercial banks could burden the banks with the governments cash problems, particularly if the Treasury is not able to meet its obligations.

Reform of the cash management system must take into account its possible impact on budget management within spending agencies and must also be cost-effective. For example, it is generally advisable for the central departments of line ministries to replace an imprest system with a system that centralizes cash. But for regional departments, the organization of the payment system must take into account the country's context and infrastructure. Often, developing countries have different arrangements within their payment system according to the location of spending agencies. This can be seen as a fragmentation of the system, but it may be required.

The centralization of cash balances within a single account is meant to optimize cash management. It avoids borrowing and paying additional interest charges to finance the expenditures of some agencies while other agencies keep idle balances their bank accounts.

b. Giving incentives

If value for money is to become a working principle in government, a significant start should be made by establishing businesslike arrangements between the government and the banking system. The principle that the government should earn interest on all its deposits and that it should, in turn, pay for all the banking services it receives should be seriously explored.[8]

Reforms made in New Zealand and being implemented in some other countries,[9] are headed in this direction. In New Zealand, departments negotiate their annual cash requirements with the Treasury, and pay an interest-rate penalty if they run out of cash, or earn interest on their surplus funds. In parallel, the NZDMO, which is the branch of the Treasury that is responsible for cash and debt management, sweeps department bank accounts each evening and invests the surplus in the overnight money market. The departments do not keep idle balances. Incentives given to spending agencies to manage their cash coexist with clearing of government bank accounts and daily centralization of cash balances. Compared with the previous system where departments kept idle balances in their bank accounts, the new system generates yearly savings of about $US 20 million.[10]

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[8] Herma R. de Zoysa, op. cit., page ___
[9] Asia, Sweden, and Australia.
[10] This description is drawn from Graham S. Scott, Government reform in New Zealand, IMF, 1996.

Countries where the spending agencies are responsible for making the payments could consider implementing incentives for cash management at the spending agency level. However, in many developing countries, centralizing cash balances should generally be the first measure to consider, since it would give the most tangible benefits.

Box 27
Incentives for Good Cash Management in Sweden

With efficient financial management as a key feature of the Swedish system, appropriations are now deposited into each agency's interest-bearing account, normally at the rate of one-twelfth each month. If an agency spends its appropriations at a slower rate, it is paid interest on the balance in the account. Similarly, if an agency spends its appropriations at a faster rate, then it must pay interest to reflect the government's cost of borrowing. Agencies, of course, vary greatly in their ability to time individual transactions precisely but this system has served to increase cash-consciousness in agencies.

Another measure to improve cash management was allowing agencies to carry forward their unused appropriations. This was designed to avoid end-of-year spending binges which are an inherent problem of the annual budget process; increase discipline among managers as any overspending in the year gets carried over as well; and foster efficiency gains in agencies beyond those assumed in the budget, as any gains would be retained by the agency. Without the carry-forward option, managers were deemed to have insufficient incentives for seeking efficiency gains.

Source: OECD, "Budgeting in Sweden," 1998.

C. MANAGEMENT OF GOVERNMENT BANK ACCOUNTS

Whatever the organization of tax collection or expenditure payment, the Treasury must be responsible for supervising all central government bank accounts, including any extrabudgetary funds. When commercial banks are involved in revenue collection or expenditure payments, the banking arrangements must be negotiated and contracted by the Treasury. This will enable the government to negotiate better arrangements and to ensure that requirements for cash and budget management are appropriately taken into account.

Besides using bank accounts for budget management, the Treasury may have deposit accounts with commercial banks, which should be selected on a competitive basis to get higher-yielding terms.

D. FINANCIAL PLANNING AND FORECASTS

Financial planning and cash flow forecasts are needed both to ensure that cash outflows are compatible with cash inflows and to prepare borrowing plans. As indicated in chapter 5, cash planning must be done in advance and communicated to spending agencies to allow them to implement their budgets efficiently. Moreover, reducing uncertainty about the borrower debt program is generally rewarded with lower borrowing charges. Therefore, it is also important to prepare and announce borrowing plans in advance .[11]

Financial planning includes the preparation of an annual cash plan and a budget implementation plan, monthly cash plans, and in-month forecasts.

1. Budget implementation plan and cash plans

Annual cash plans must be prepared in advance, and should set out projected monthly cash inflows, cash outflows and borrowing requirements. It is necessary to have: (i) quarterly updates of the projections for the entire fiscal year; and (ii) monthly updates of the projections for the succeding month.

The preparation of the cash plan and its updating require close coordination between the Treasury Department, the Budget Department, and the Tax Administration Department.

Often, the Treasury Department prepares both the budget implementation plan and the overall cash plan on a pure-cash basis. However, in some countries, the Budget Department prepares a budget implementation plan, which can include gross

[11] Montserrat Ferre Carradeco and Peter Dattels, Survey of public debt management frameworks, in V. Sundararajan, Peter Dattels and Hans J. Blommstein, Coordinating public debt and monetary management, IMF, 1997.

flows (e.g., wages, including income taxes), then the Treasury Department prepares a cash plan showing cash flows. In a number of countries, this budget implementation plan is a requirement for commitments or requests for payment, rather than a form of cash control.[12] In other cases, the budget implementation plan merely divides appropriations by four (for quarterly disbursements) or by twelve (for monthly disbursements), but in practice the budget is implemented through cash rationing. Close coordination between the Budget Department and the Treasury Department is required when planning budget implementation. The budget implementation plan and the cash plan must be fully compatible.

a. Budget implementation plan

As discussed in chapter 7, the budget implementation plan must be consistent with the budget, prepared in advance, and communicated to spending agencies. Except when the budget has been badly prepared or the country is in fiscal difficulties, the preparation of the budget implementation plan should be driven by the budget, not by cash management concerns.

The budget implementation plan should take into account the timing of payments and payment obligations arising from commitments over the fiscal year. In particular, it consider the schedule of disbursements for investment projects, which are not equally distributed by month. The plan must be rolled over quarterly, to allow for changes in the macroeconomic environment and progress in budget implementation. However, it should not be used to make nontransparent revisions in the budget.

b. Revenue forecasts

Forecasts of the monthly distribution of revenues should be prepared. These forecasts should be updated regularly, preferably every month, since changes in the

[12] In Turkey, for example, the Budget Department prepares the budget implementation plan and regulates the *tahakkuk*, which is an administrative stage before payment, while the Treasury prepares cash plans. Similar approaches may be found in other countries that have a budget system derived from the French system.

macroeconomic environment or in the tax administration system may affect revenue collection.

The preparation of monthly revenue forecasts requires economic as well as management expertise, to factor in changes in the tax administration system. This exercise should be carried out by the Tax and Customs Administration Departments, in close co-operation with the Treasury and the departments responsible for macroeconomic analysis. In several developing countries, monthly forecasts prepared by the tax administration departments are more administrative than economic. They show the distribution of budgeted revenues over the fiscal year but do not take into account fiscal and economic developments after the budget preparation. The Treasury may therefore have to strengthen the forecasting capacities of tax administration departments.

A good monitoring system is a prerequisite for forecasting. Thus, revenue collections need to be monitored along the major tax categories and adjusted to reflect changes in the assumptions underlying the forecasts. In-year revenue forecasts must be based on revenue assessment and tax collection reports the results of economic surveys, etc. Short-term forecasting tools, such as short-term macroeconomic models and tax forecasting models, are also helpful.

The revenue forecasts must also include forecasts of nontax revenues to be prepared by the Treasury in close coordination with the agencies responsible for their management.

c. Cash plans

The cash plan shows forecasts of financial flows before new borrowing, including reimbursements of loans or bills due from the government, repayment of arrears, and drawings on loans already contracted. The plan should be rolled over every three months, and the projections systematically updated every month.

Monthly forecasts of cash outflows should be derived from the budget implementation plans. Although the budget implementation plan, even in a cashbudget system, is not necessarily on a pure-cash basis, monthly cash plans should be on a pure-cash basis. These monthly cash plans should be updated every month. This updating should be made on technical grounds, to take into account developments in exchange rates and interest rates, changes in the payment schedule of investment projects of a significant size, and outstanding obligations, among other things.

The preparation of monthly cash outflow plans requires good monitoring of both payments and obligations. These monthly cash plans are used to define monthly cash transfers within an imprest system or cash limits for payments within a Treasury Single Account. Except in particular circumstances, these limits should conform to the budget implementation plan. As indicated in chapter 5, planning obligations on a monthly basis is not recommended. Regulating cash by generating arrears must be avoided.

Preparing monthly cash outflow plans is more of a Treasury task than a budgeting task. However, the Treasury should coordinate with the Budget Department, in case a departure from the budget implementation plan appears necessary. Borrowing plans are derived from the monthly forecasts of cash inflows and outflows.

2. In-month forecasts

The in-month distribution of cash flows must be estimated to determine the date of auctions, the date of transfers of funds to agencies within an imprest system, etc.

In-month forecasts of debt servicing and wage payments do not pose major problems. For other expenditures, there is a need for an appropriate recording of obligations and expenditures at the verification stage, including the date on which payments are due. In practice, only spending agencies can do this. Within a centralized payment system and without appropriate tracking of obligations and verified expenditures, the Treasury must focus on forecasts of payments of a very significant amount (e.g., for a few investment projects), based on information from spending agencies, and limit its other payment forecasts to rough estimates.

The preparation of in-month revenue forecasts is better undertaken by the Tax Administration office than by the Treasury, since factors related to tax administration or taxpayers behavior affect strongly the in-month distribution of revenues.

In-month forecasts should be reviewed and updated every week. For this purpose a number of countries have a Treasury Committee that meets weekly. Such arrangements improve cash management, provided they do not slip into day-to-day budget management or the setting of priorities on political grounds.

E. DEBT MANAGEMENT

1. General issues

a. Legal and budgetary arrangements

To avoid uncontrolled indebtedness, only one government authority should be authorized to borrow. It must be the authority responsible for fiscal management (i.e., the Minister of Finance). The Legislation should provide for this point.

Regulations can also provide for the amount of borrowing, which must conform to the annual budget.[13] The annual budget should outline the annual borrowing plan.

A public debt act can also provide guidance on the types of instruments and selling techniques that the government can use. However, this act should be flexible enough to adapt to developments in the financial market and to the level of technological sophistication.

b. Transparency and predictability

[13] In Canada a borrowing bill that sets an annual ceiling on borrowing is prepared at the same time as the budget and submitted to Parliament. In Thailand, foreign borrowing under the law cannot exceed 10 percent of the annual budget (Robin Miller, Canada: Debt management policy and operating practices, in

The objectives of the debt management policy should be clearly stated and made public. The basic objectives are to finance the budget deficit, or specific projects (for project loans), and to minimize the costs of borrowing. Governments also pursue other objectives in debt management, such as the development of financial markets, support for the monetary policy, encouragement of saving. The development of a large and liquid market for government debt facilitates monetary management and the development of financial markets.

As indicated above, reduced uncertainty about the borrower debt program is generally rewarded with lower borrowing charges. Many countries announce their borrowing plans in advance.[14] Taking into account uncertainty in revenue collection, the amount of future auctions can be presented in public borrowing plans within a range of +/- 10—20 percent, and for example, the precise characteristics of a particular auction can be announced the week before it takes place. Issuance and pricing results should be published shortly after auctions.

The government should provide Parliament with regular and detailed reports on its indebtedness and its debt policy, and publish statistics on the government debt, including guarantees.

Debt management has two main aspects: (i) Central Bank borrowing operations as part of monetary policy (in Pakistan, for example, the State Bank of Pakistan manages the issuance of Treasury bills to control liquidity in the banking system and meet monetary targets[15]); and (ii) government borrowing to finance the fiscal deficit. The use of government securities as instruments of monetary policy is seen a stimulus to the development of the financial markets. However, it requires adequate support arrangements, such as coordination between monetary and fiscal authorities regarding the amounts to be issued; protection against overfunding of the government budget for the purpose of monetary management; and sharing the cost of this funding (in the

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V. Sundararajan, Peter Dattels and Hans J. Blommstein, Coordinating public debt and monetary management, IMF, 1997. Premchand, Public expenditure management, IMF, 1993).

[14] In the United Kingdom, the Treasury announces each financial year in its annual debt management report the details of financing requirements, auction plans, and the maturity structure of gilt issuance. In Turkey the borrowing plans are announced every quarter.

Philippines, for instance, the remuneration for the cost of deposits related to overfunding is determined at regular meetings between the Ministry of finance and the Central Bank[16]).

c. Debt policy and responsibilities

The initial step in formulating debt policy for financing the budget deficit is to set borrowing objectives in conformity with fiscal targets. The second step is to determining strategic choices.

Concerning borrowing in the financial markets (issues related to project loans are reviewed below in paragraph 2), the formulation of debt policy includes strategic and tactical policy choices that concern the choice of instruments, currency, targeted markets, etc.[17] The choice of instruments and the establishment of an adequate mix of these instruments must be based on the needs of investors, risk factors, and the objective of promoting the liquidity and the overall development of the market. The choice of maturity is important in balancing the debt profile, adjusting the volatility of debt, and exploiting investor preferences. Targeting the wholesale domestic market reduces interest costs, but the development of the retail market may promote household savings.

In developing countries and transition economies, extreme caution is required before considering certain instruments that increase volatility in debt service (such as index-linked rate instruments and currency-linked instruments). Although portfolio theory suggests that borrowing in a variety of currencies diversifies risks and reduces the cost of borrowing, borrowing in foreign currency presents higher risks and costs in most developing countries. The use of derivatives requires high degree of expertise and should generally not be considered in developing countries.

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[15] Montserrat in V. Sundararajan, Peter Dattels and Hans J. Blommstein, *Coordinating public debt and monetary management*, IMF, 1997.
[16] See Marc Quintyn, Government securities versus Central Bank securities, IMF, 1994.
[17] Montserrat op. cit., page ___

The formulation of debt policy, for financing the budget deficit, should rest with the Ministry of Finance, but close coordination with the Central Bank is required, and the effects on monetary policy should be considered. In developing countries, Central Banks are more knowledgeable about the functioning of the financial markets than Ministries of Finance. The distribution of responsibility for implementing the debt policy should be established according to technical capacities within the Ministry of Finance, the degree of development of the financial markets, and the objectives pursued. In several developing countries, the Central Bank is responsible for implementing the debt policy and securities management. In developed countries, there is currently a move toward placing debt management fully under the responsibility of the Ministry of Finance, with a view to avoiding any policy conflict between debt and monetary management.[18]

d. Accounting

Even in a cash-based budget system, double entry accounting should be: (i) a double-entry system that permits the debit and credit sides of transactions to be recorded; (ii) on an accrual basis. The accounting system must distinguish repayments from interest. Risks related to contingent liabilities must be assessed and recognized.

2. Medium- and long-term external debt management

In middle-income countries, increased openness of financial markets tends to diminish differences between external debt and domestic debt. Market rating covers both external and domestic bills or bonds which may be issued in foreign currency and held by foreign lenders. However, the management of project and program loans needs specific procedures. In low-income countries, project loans and program loans make up the major part of external debt.

Systems and procedures for managing medium-term external debt must cover the following features and functions:

[18] See, for instance, U.K. Treasury, The future of UK government debt and cash management, 1998.

Contracting loans. Only one government authority should be authorized to contract external loans and grant guarantees.

Program loans (support for the balance of payments and/or the budget) should be included in the financial plan annexed to the budget. In some countries the signing of these loans is subject to the approval of Parliament. This increases transparency, but may cause delays. Global authorization of the financing plans might be preferable, but this depends on circumstances and the legal and constitutional framework of the country.

Project loans should finance only projects included in the MYEs or the PIP (if a sound PIP is prepared). The total amount of project loans should be presented in these documents. However, the amount of a loan under negotiation cannot be determined precisely. If MYEs or a sound PIP is not prepared or not made public, a list of project loans should be annexed to the annual budget. This list should show their total amount and their terms.

Recording transactions. Every loan transaction should be recorded, including loans contracted and guaranteed, disbursements, payments due, payments, rescheduling, debt remission, cancellation of the nondisbursed part of a loan, and change in the terms of a loan.

To facilitate comparison and accounting, it is better to register individual transactions than aggregated data. For example, it is easier to compare individual drawings expressed in foreign currency with actual expenditures expressed in domestic currency than to compare monthly aggregated data. The average exchange rate for a month is rarely equal to the exchange rate weighted by drawings made within the month.

A crucial problem is the collection of information. In many developing countries, information on drawings is not readily available. The Debt Management Office often records disbursements only on the basis of information communicated by lenders, but not every lender transmits this information in a timely manner. Consequently, as stressed by different National Auditing Offices (NAOs) (e.g., in Turkey and Nepal), National Auditors cannot perform audits satisfactorily since data on debt cannot be compared with budget execution reports. Information dissemination between line ministries, project managers, and the Debt Management Office is often inadequate. Drawings on guaranteed loans are not systematically communicated to the Debt Management Office. Procedures for disseminating information need generally to be strengthened, by establishing, for example, a monthly system of reporting by project managers and beneficiaries of guarantees to the Debt Management Office. Data from lenders and users must be systematically compared. This needs appropriate bookkeeping for special accounts of projects financed by IFIs and adequate treatment of exchange rate variations in the accounting system.

Managing debt. Future payment schedules and drawings, and the impact of rescheduling operations, should be kept and regularly updated, to provide a basis for macroeconomic forecasts and debt policy.

Payment forecasts are based on the terms of the agreements. But determining exactly the amount of payments due requires additional information. Many countries rely solely on the claims from lenders. Often the Debt Management Office does not know exactly how lenders calculate payments (for example, when the amount of payments depends on the value of a currency pool). Debt accountants must be trained, and basic information on methods of calculating payments must be obtained from lenders.

In the same way, some Debt Management Offices in developing countries do not take full control of the payment schedules for rescheduling agreements. To forecast rescheduling, a simple spreadsheet model is sufficient. To manage rescheduling, the schedule of payments related to the rescheduling agreements must be calculated accurately. This problem is currently being addressed through the implementation of debt management systems that incorporate the management of rescheduling.[19] Often, public enterprise debts and even private debts are passed on to the government through a rescheduling. The government should account for this operation and be

[19] As in the British Commonwealth, UNCTAD systems, and systems developed in a number of countries.

reimbursed by the entity that benefited from this rescheduling. Normally, rescheduling agreements should benefit only the government, and enterprises should pay back the government on the basis of the initial payment schedule.

Reporting. The reporting system for debt transactions should fit the needs of macro analysis, negotiations with lenders or with countries, the preparation of financial programs, budget monitoring, etc. For this purpose, lenders, countries, etc., must appropriately classify loans. The system of notification to the World Bank gives a basic framework for debt reporting, but must be supplemented to take into account other needs related to financial monitoring and forecasting, notably for the preparation of financial programs or debt negotiations.

Accounting. Developing countries with a cash accounting system generally also monitor debt service obligations, but this is not sufficient. A double-entry accrual accounting system is required. Payments are made not only in cash from government bank accounts, but also through debt operations (rescheduling, remissions, etc.). An increase in liabilities (e.g., drawings from external loans) may correspond to an increase in assets (e.g. through a non-lending operation). The risks related to guarantees and on-lending should be assessed and account for. Accounting should be based on accounting standards, not on debt policy. For example, an expected rescheduling may be taken into account in a financial program, but should be accrued into the accounts only when it takes effect. Noncompliance with accounting standards, confusion between forecasted data or policy objectives and actual data, and confusion between new operations (such as debt remission) and revisions in actual data create difficulties in the interpretation of many debt reports. Accounting methods used for specific operations, such as debt remissions, should be indicated in the debt reports.

In several countries, organizational arrangements for the management of external debt are fragmented. The Ministry of Finance, the Ministry of Planning, the Financial Comptroller, the Ministry of Foreign Affairs, etc., may all be involved in debt management.[20]

[20] See Ishrat Husain, Organizing for efficient debt management, in World Bank, *Managing external debt in developing countries*, 1990.

The Ministry of Finance, which is responsible for fiscal management, should be responsible for debt management and should determine the debt policy, review draft agreements, verify whether the loan terms fit debt policy and whether its purpose fits the budgetary policy, assess the future impact on the debt service, conduct financial negotiations, and keep books and the debt recording system.

In several countries, statistics on debt are kept by the Central Bank. Although the government is responsible and accountable for debt management, this organizational arrangement is acceptable. It could ensure more comprehensive coverage of transactions, since every payment is made through the Central Bank. However, where such distribution of responsibilities is made, the statistics unit of the Central Bank must also be made to report to the Ministry of Finance, which is responsible for managing and implementing the medium-term external debt policy. The existence of two statistics units, one at the Central Bank and one within the Ministry of Finance, is generally a source of confusion.

A distinction must be made between functions related to debt management, budgeting and investment programming, and aid management. Budgeting and investment programming consist of prioritizing expenditure programs, and the Debt Management Office should not interfere in this aspect of public expenditure management. On the one hand, project loans should finance only projects included in the MYEs or the PIP. On the other hand, every loan must be submitted to the scrutiny of the Debt Management Office. If budgeting and financial responsibilities are divided between the Ministry of Finance and the Ministry of Planning, neither one should be allowed to borrow for a project not included in the development budget, the MYEs, or the PIP.

Aid management covers the relationships between the country and the lenders/donors. To avoid conflict of competencies, this function should be located within the Ministry of Finance, or within either the Ministry of Finance or the Ministry of Planning in a dual budgeting system. Some countries have adopted other types of institutional arrangement, for instance, by installing an aid management unit within the

Ministry of Foreign Affairs. Where such arrangements are made, the aid management unit must not be allowed to interfere in financial programming and expenditure programming. The unit responsible for aid management should not make decisions on contracting loans or launching a development project and should not be responsible for preparing a PIP.

3. Monitoring borrowings by subnational governments[21]

In a few developed countries, the central government does not control the borrowings of local governments. Control of local-government borrowings relies both on market discipline and public information. Many other developed countries have more stringent controls. In developing countries or transition economies, the stage of development of financial markets and weaknesses in the system of information do not allow the central government to rely on market discipline to control the borrowing policy of local governments.

Control of subnational government borrowing by the central government is needed in developing or transition countries. As discussed in chapter 4, fiscal targets, such as the deficit and the net borrowing requirements should be set for the general government. The central government can control its deficit directly through expenditure control. Since subnational governments have their own budgets, the central government needs to control their deficit through borrowing control. The nature and the coverage of this control must take into account the country's experience and context.

Developing as well as developed countries have, in several instances, either adopted a golden rule, which stipulates that the amount borrowed cannot exceed the current deficit of the local government budget,[22] or prohibited local governments from incurring a deficit. However, these stringent rules can have perverse effects, since they may be bypassed through misclassification of expenditures or the setting up of ad hoc funds for borrowing.[23]

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[21] See Teresa Ter-Minassian, Fiscal federalism in theory and practice, IMF, 1997.
[22] As in Germany.
[23] In China, local governments are not permitted by law to run deficits or to borrow from the local branches of the Peoples Bank of China. However local governments undertake indirect borrowing mainly by creating

In a number of countries, the central government has direct control over borrowing. These controls may take different forms such as annual borrowing ceilings; ex-ante authorization of individual borrowing operations; or centralization of all government borrowing associated with on-lending mechanisms to finance local projects.[24]

Two elements need to be considered when designing or revising procedures for controlling local government borrowing. First, the objective of increasing devolution and diminishing bureaucratic procedures suggests developing a system based on rules rather than on ex-ante control of individual operations, at least for domestic borrowing. Second, rules should be appropriately designed to avoid the creation of mechanisms to bypass them. They could, for example, be based on the ratio of the current and projected levels of debt to revenues. Korea sets detailed eligibility criteria that determine which local governments are allowed to borrow.[25] These criteria are based on the soundness of the local government policy, and the nature of projects that can be financed from borrowing.

Concerning external borrowing, central coordination of the external debt policy is required. Its impact on the balance of payments must be taken into account. Approach to foreign markets and negotiations with international financial institutions need to be coordinated well. Moreover, foreign lenders, when lending to local governments, generally count on an explicit or implicit guarantee from the central government. Therefore, lending operations made abroad by local governments should comply with conditions set by the central authorities.

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financial companies that borrow to finance local government expenditures. See Ehtisham Ahmad, China in Teresa Ter-Minassian, *Fiscal federalism in theory and practice*, IMF, 1997.

[24] In India according to the Constitution only the central government is entitled to borrow abroad. The states are, in principle, entitled to borrow domestically, but they have to get permission from the central government if they have any outstanding liabilities to the center. All state governments have such liabilities and therefore need authorization to borrow. However, the central government sometimes provides special assistance to the states to clear their short-term outstanding debts. The total indebtness of the states in 1992/93 accounted for more than 20 percent of GDP, of which nearly two-thirds was outstanding liabilities to the central government, (Hemming, Mates, and Potter, in Teresa Ter-Minassian, *Fiscal federalism in theory and practice,* IMF. 1997, op. cit., page ___.

[25] Ke-young Chu and John Norregaard, in Teresa Ter-Minassian, *Fiscal federalism in theory and practice*, IMF, 1997.

F. TREASURY ASPECTS OF AID MANAGEMENT[26]

Foreign grants must be budgeted, whether they are given as grants or in kind. The use of counterpart funds from sales of granted goods needs to be budgeted, recorded and accounted for. A central system of recording foreign grants and related transactions is needed.

Institutional arrangements generally vary according to the country or the donor, but the minimum requirements for good management of grants should be the following: (i) expenditures financed with grants must be submitted to the same scrutiny and prioritization as other expenditures, whatever the organization for aid coordination; (ii) transactions relating to grants must be accounted for and data collected and recorded at the central level; and (iii) accounts for counterpart funds should be controlled and audited along the same lines as other government accounts.

Generally, this suggests placing the management of counterpart funds within the Treasury. The central registration of grants should be performed either by the Treasury or by the Ministry of Planning, which has an existing network for collecting information in countries with a dual budgeting system. As for debt management, there should not be any overlap between the activities of an eventual aid management unit, coordinating the relationships between the government and donors, and the programming of expenditures and their management.

G. MANAGEMENT OF GOVERNMENT FINANCIAL ASSETS

Government financial assets consist of shares in enterprises, loans granted by the government, payments of guarantees not honored by debtors, etc. The Treasury has to record and account for these assets. It should manage the loans granted by the government, notably by authorizing disbursements and tracking payments. It has to get financial information on enterprises in which the government has shares, monitor the dividend payments, and deal with the financial aspects of privatization.

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[26] This section covers different aspects from those of “aid management” discussed in Chapter 17.

H. RELATIONSHIP WITH THE CENTRAL BANK IN PUBLIC EXPENDITURE MANAGEMENT

The Central Bank is, in most countries, the main cashier of the government. Even where spending agencies hold their bank accounts at commercial banks, funds are released from a Treasury account at the Central Bank. More generally, central banks are the fiscal agents of governments and perform activities in such areas as government issuing, public debt management, intervention on the secondary market for government securities, etc.[27]

In many countries, the central banks provide the governments with overdraft facilities. However, to avoid assigning responsibilities to the Central Bank that could conflict with its price stability mandate, more and more countries set stringent limits for government borrowing from the Central Bank or forbid it. From the cash management point of view, prohibiting borrowing from the Central Bank requires an active policy of issuing government securities in the capital market and also intervening in the secondary market. The prohibition may be unrealistic in the short run for countries with underdeveloped markets,[28] but it needs to be strictly regulated in conformity with monetary and fiscal policy.

In principle, profits or losses of the Central Bank are, in most countries, transferred to the government, although actual practices vary. Often, losses of the Central Bank are not included in the government accounts (see discussion on quasi-fiscal expenditures in chapter 2). To encourage the government to optimize its cash management and to limit nontransparent quasi-fiscal expenditures, commercial terms should be applied to overdraft facilities granted by the Central Bank to the government. For transparency, profits or losses of the Central Bank should be treated as revenues or expenditures in the budget. On the other hand, adopting these rules requires the Central Bank to reimburse the Treasurys deposits on commercial terms.

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[27] See Hans J. Blommestein and Eva C.Thunhoml, Institutional and operational arrangements for coordinating monetary, fiscal and public debt management in OECD countries, in V. Sundararajan, Peter Dattels and Hans J. Blommstein, *Coordinating Public Debt and Monetary Management,* IMF, 1997. Teresa Ter-Minassian, Pedro P.Parente, and Pedro Martinez-Mendez, op. cit., page ____

[28] Teresa Ter-Minassian, Pedro P.Parente, and Pedro Martinez-Mendez op. cit.. See also C.Cottarelli Limiting Central Bank Credit to the Government, IMF, 1993.

I. KEY POINTS AND DIRECTIONS IN REFORMS

1. Key points

Cash management has the following purposes: aggregate control of spending, efficient implementation of the budget, minimization of the cost of government borrowing, and maximization of the opportunity cost of resources (the last two purposes yielding interest).

- Centralization of cash balances is required. This centralization should be made through a Treasury Single Account. This is an account or a set of linked accounts through which all government payment transactions are made. It should have at least the following features: (i) daily centralization of the cash balance (when possible); (ii) accounts open under the responsibility of the Treasury; and (iii) transactions recorded into these accounts along the same set of classifications. This model could fit both centralized and decentralized arrangements in public expenditure management, provided that modern technology is available.

- Cash planning is essential. It includes: (i) the preparation of an annual budget implementation plan, which should be rolled over quarterly; (ii) within this annual budget implementation plan, the preparation of a monthly cash and borrowing plan; and (iii) weekly review of the implementation of the monthly cash plan. To prepare the monthly cash plan it is necessary to monitor commitments, in order to avoid arrears generation or delays in payment.

- The borrowing policy needs to be prepared in advance, and the borrowing plan made public. Borrowing from subnational governments must be controlled, and fit overall fiscal targets.

- Guarantees, insurance schemes and other contingent government liabilities should be evaluated for risk and political cost, and reserves appropriately set to prevent cash management from being disrupted by unanticipated claims on government.

The medium-term external debt, should be contracted in accordance with the budget or multiyear expenditure programs, and drawings and loans accurately monitored.

2. Directions in reforms

In most countries priority actions should concern the following areas:

- Centralization of cash balances should be ensured (together with a centralization of the monitoring of transactions). In countries, where the payments system has broken down, a centralized Treasury system may have to be implemented from scratch. In other countries, banking arrangements and procedures for transferring funds will have to be reviewed to ensure better control of cash and avoidance of idle balances. The following should be taken into account: (i) constraints due to the localization of local agencies and the infrastructure of the country; and (ii) modern technologies.

- Sound cash planning should be abolished, together with other measures such as improving revenue forecast and instituting commitment accounting.

- Debt management should be reinforced.

Once cash flows are centralized, incentives for managing and forecasting cash flows more efficiently could be considered, but in practice this concerns only a limited number of developing countries.

Box 28

Building a Treasury System

In Kyrgyz, after the collapse of the FSU, the payment system broke down. The following approach has therefore been adopted:

The development of the Treasury, with IMF technical assistance, has significantly enhanced government control over public expenditure and cash management. The Treasury, now fully in operation, has achieved comprehensive coverage of government finance including the budgetary as well as extrabudgetary activities of both republican and local governments. In addition, a new government payment system has been introduced, and a Treasury Single Account established at the Central Bank replacing over 5,000 separate bank accounts. Monthly and annual reports on all fiscal operations passing through the Treasury are now generated.

Source: T. Abed, “Fiscal reforms in low-income countries. IMF, 1998.