BOOK REVIEWS

Emancipating the Banking System and Developing Markets for Government Debt, Maxwell J. Fry, The Bank of England, Routledge, London, New York, 1997, pp. XVII + 280.

It was often stated that inflation was positively related to the proportion of government borrowing from the central bank and in total domestic credit, and that inflation was negatively related to growth. This gave rise to the question : how should a government best meet its borrowing requirements? This was the question which was addressed at the Central Bank Governors' Symposium, hosted by the Bank of En-gland in June 1996. The papers presented at the Symposium and the discussions which followed form the basis of this book.

Since monetary policy to achieve price stability must be integrated with fiscal and exchange rate policy, the central bank cannot, in practice, stand passive in respect of policies in these areas. There must be a proper synthesis between fiscal adjustment and macro economic performance which influences price dynamics. Empirical applications differ widely. There is, however, a general agreement that the use of indirect market based techniques of monetary control is conducive to achieving sustainable price stability. The central bank is thus obliged to play a role in developing voluntary domestic markets for government debt.

The process of developing voluntary domestic markets for government debt requires not only conducive macro economic conditions and appropriate market structures, but also financial infrastructure. But the appropriate financial infrastructure is highly country specific. It depends on the legal system, tax treatment, accounting conventions, geographical characteristics, the state of technological progress etc. Although the Bank of England had been involved in government debt financing for over 300 years, practices are still developing. Over time, the Bank of England has developed four guiding principles for the UK's debt management policy:

1. The marketing exercise: Since the government has a product to sell, market intelligence is crucial. The Bank of England has, therefore, to maintain a dialogue with both financial intermediaries and final investors.

2. Keeping it simple: Experience indicated that, since the markets' understanding of new products could be patchy, it was important to keep products clear and comprehensible. Index-linked securities offered several benefits to both issuer and investor, but they are inherently complex and the UK market has taken some time to digest them. The conference on index-linked securities organised by the Bank of England in 1995 constituted part of the Bank's efforts to educate the market.

3. A variety of instruments and selling techniques could broaden appeal.

4. The central bank's involvement in the secondary market should be developmental. For example, with the introduction of index-linked government securities in the UK, the Bank of England acted initially as a market maker to promote this market. Obviously, however, care was taken not to substitute for the market.

In countries that are just starting to develop voluntary domestic markets for government debt, considerable central bank involvement in government debt management is highly appropriate.

Developing voluntary domestic markets for government debt demands a sea change in the approach to financing the government deficit. To obtain a better understanding of the change in approach towards voluntary market financing, the Bank of England requested some central banks (Ghana, India, Jamaica, Malaysia, Mexico, New Zealand, Sri Lanka and Zimbabwe) that had recently developed voluntary domestic markets for government debt, to answer several questions relating to monetary policy implementation, government financing, and debt management including market development.

The questionnaire responses, together with other sources, suggest that successful development of voluntary domestic markets for government debt hinges on four key elements:

1. Macroeconomic stability involving monetary control; fiscal discipline and consistent monetary, fiscal and exchange rate policies.

2. Coordination, necessitating establishing a coordinating committee including the central bank and ministry of finance; sharing information; limiting central bank credit to the government; and promoting secondary market development.

3. Supervision and regulation, to ensure that weak financial institutions are detected early, and to prevent Ponzi-type borrowing that escalates real interest rates to pathologically high levels.

4. Sequencing the reforms, among which some of the more important measures that require initial planning for the subsequent market development process include auctioning treasury bills; reducing reserve and liquid asset requirements; lengthening the maturity of debt offered at auction; and opening up the market to foreign buyers.

At the microeconomic level, five essential elements have been identified as essential.

1. Market-clearing yields on government paper.

2. Relatively stable money market conditions.

3. A predictable or preannounced schedule of issues.

4. Some market-making arrangement.

5. Financial infrastructure ensuring transparency, low risk and low cost.

Three key groups of players that need to be considered at the start of any market development programme:

1. The ministry of finance which needs to:

   Acquire expertise in treasury management; forecast its cash flow; plan the maturity structure of its debt; determine an optimal menu of debt types; announce an issue schedule; and stimulate costs of alternative funding strategies.

2. The central bank which may have to assume tasks such as :

   The responsibility for the smooth and efficient functioning of the government debt market; vetting and regulating market participants; providing depository, registry and electronic delivery-versus-payment systems; implementing monetary policy to avoid excessive short-term interest rate volatility; and implementing monetary policy to allow a normal degree of short-term interest rate fluctuation.

3. Financial institutions which require the central bank's attention in at least three areas:

   Facilitating the acquisition of treasury expertise and the expansion of Treasury activities; dismantling or at least controlling any bank cartel; and selecting, where appropriate, primary dealers.

   As primary dealers, financial institutions are typically obliged to act as market maker and support auctions. In return, they may receive various privileges such as exclusive right to bid at auction; exemption from prepayment with bids; right to make telephone or electronic bids; access to borrowing from the central bank; and tax breaks.

Various issues namely financial repression, foreign debt accumulation, prerequisites, persuasion and pitfalls for developing voluntary domestic markets have been chapterised. Two key points on the development of voluntary domestic markets for government debt which emerge from the questionnaire responses of the case study countries are important. These are: success is critically dependent on the implementation of any required concomitant fiscal reform; and real as opposed to illusory success is critically dependent on taking the plunge and really letting market forces determine the price of government debt. Emancipating all captive buyers is essential.

The lessons of experience indicate that governments must be prepared to accept the

rough with the smooth, with more of the rough likely during the early stages. In other words, strong commitment to market development at the outset is a prerequisite for success in the longer run. One of the litmus tests of commitment and acceptance of the principle of the market determination of the price of government debt lies in the way the treasury bill auction market works. Specifically, market development is likely to take root and flourish only when the authorities resist the very strong temptation to set a reserve price. There are four advantages of a clean auction in which all bills are sold at whatever price the market offers: First, it informs the government of the true opportunity cost of its borrowing. Secondly, it avoids recourse to the central bank and so avoids the road back to inflationary finance. Thirdly, it provides important feedback signals from the market for use in monetary policy making. Finally, the treasury bill yield can and soon will be used as a crucial reference rate for the pricing of other financial claims in new markets.

The volume has done an outstanding job discussing issues that need to be addressed and identifying process of move towards emancipating the banking system and developing markets for government debt. However, it might be suggested that fiscal policies affect private investment through three major channels: public investment, public deficits, and the user cost of capital. The complementarity of public and private capital should not be disregarded. It is thus useful that fiscal adjustment is tried mainly through improving the quality of public expenditure, not mainly raising the cost of expenditure which is inherent in the initial phase of developing markets for government debt.

There is no doubt that each country will learn much from its own experience as it develops its own markets for its own government debt. Nevertheless, countries could benefit from the experiences of other countries, which are described in Part III of this book. This is a very important aspect of the book. Besides, the book is strong on analysis as well as documentation. It is probably the most useful reference on the subject, and that is a great deal to be thankful for.

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