POLICY RECOMMENDATIONS OF THE
8TH MEETING OF THE COMCEC
FINANCIAL COOPERATION WORKING GROUP MEETING

The COMCEC Financial Cooperation Working Group (FCWG) held its 8th Meeting on March 30th, 2017 in Ankara / Turkey with the theme of "Improving Public Debt Management in the OIC Member Countries". During the Meeting, the participants discussed some crucial policy issues in light of the main findings of the research report prepared specifically for the Meeting and the responses of the Member Countries to the policy questions that were sent by the CCO in advance of the Meeting. Accordingly, the working group has come up with the policy advices below.

Policy Advice 1: Strengthening/Setting up an independent Public Debt Management Unit with well-defined functions and a dedicated debt management strategy

Rationale: In several OIC member countries the delineation of competences between different institutions involved in public debt management remains vague. Especially the partial lack of centralization at a dedicated Public Debt Management Unit (DMU) might prove to be challenging for further management improvements. Therefore, all OIC member countries are encouraged to either set up a new independent DMU or institutionally strengthen an existing one, possibly located at the Ministry of Finance or the Central Bank. Moreover, the development of a formal debt management strategy, including quantitative strategic targets, is recommended. The DeMPA Performance Indicators of the World Bank can serve as an initial reference point. In order to support the transition process, OIC member countries that have already professionalized public debt management practices may advise partner countries in establishing such institutional frameworks. This could include policy recommendations with regards to specific areas of debt management, including but not limited to a long-term strategy development, risk management, debt monitoring or institutional coordination. Besides exemplary institutional settings and public debt management documents, the exchange about challenging experiences and the respective 'lessons learned' might prove to be especially helpful during the process.

Policy Advice 2: Developing/improving domestic debt market.

Rationale: Domestic debt markets are important sources of funding for public budgets. A well-functioning, liquid domestic market encourages the investments from domestic creditors due to lower transaction costs and hence provides additional diversification opportunities for the government. As domestic investors tend to react less to the global macroeconomic and financial shocks, refinancing risks may be lowered in addition to a decreased currency risk. However, a number of domestic public debt markets in the OIC member countries still show potential for improvements. Most importantly, strengthening the legal accountability and regulatory frameworks while maintaining political stability is a key aspect for the member countries faced with some political changes in the past few years. Moreover, low and stable inflation rates as well as an independent central bank may help to keep savings in the domestic financial market, which might be especially relevant for the Sub-Saharan countries group. Additionally, governments should reduce their reliance on the domestic banking sector by encouraging institutional investors such as insurance companies or pension funds to participate in the market. Finally, the introduction or further development of Islamic finance instruments, especially Islamic sukuk bonds, can deepen domestic financial markets and mobilize additional financial resources from both, private and institutional investors. Overall, a high share of marketable securities in total domestic debt, a broad participation of different financial agents and a high ratio of fixed versus floating bonds usually describe a sound domestic bond market.

Policy Advice 3: Broadening and diversifying the creditor base.

Rationale: In many OIC member countries, the limited investor base is perceived to be one of the most relevant challenges for realizing efficient public debt operations. Along with an improvement of domestic debt markets, a further opening towards global markets as well as offering new investment vehicles may address this problem. Generally, the issuance of Islamic sukuk bonds may broaden the credit base as new (international) investors, who are specializing in Sharia-compliant financial instruments, may be attracted. While even non-OIC member countries experience greater popularity of such Islamic sovereign bonds, this development is especially relevant for cross-border investments between OIC countries, particularly through sovereign wealth funds of OIC member states. Moreover, recent innovation efforts such as state contingent debt instruments or Master Collateralized Murabahah Agreements (which are bundled assets based on rent-to-own agreements) might be evaluated in order to broaden the investor base and better management of risks. It should be also noted that to attract international investors, it is crucial to increase the transparency and information availability regarding public debt data, procedures and (predictable) management strategies. It is generally recommended that OIC countries with a yet developing domestic market avoid a large dependence on either domestic or foreign borrowings, but strive for a balanced exposure to both markets to mitigate global macroeconomic as well as country-specific shocks.

Policy Advice 4: Lengthening the average maturity of the public debt.

Rationale: Governments have a tendency to issue short-term rather than long-term bonds. Currently, the average maturity of new external debt commitments of private creditors (excluding official creditors such as the IMF) in the OIC member countries hovers at only 4-5 years, and has even shown a declining trend since 2013. Although interest rates on short-term obligations are usually lower than long-term ones due to an additional maturity premium investors demand for a long tie-up of their capital, a tradeoff arises as short-term debt is subject to a higher refinancing risk. Moreover, the concentration of short-term bonds may prevent the establishment or further development of a domestic debt market which is supposed to satisfy both the investors' preferences and the government's needs for medium- to long-term financing. Hence, OIC member countries which are negatively affected by those factors are encouraged to expand the maturity mix of their public debt portfolio. Especially governments in the high- and median-income group with access to global debt markets may consider increasing bond issuances with longer time horizons relative to short-term bills if the domestic market conditions permit such operations, given the current period of low interest rates in many developed economies. Overall, it is advisable to exploit the benefits of all maturity categories, from short- over medium to long-term, and achieve a sustainable maturity balance without an exclusive dependence on either one category.

Policy Advice 5: Applying macroeconomic risk management methods.

<u>Rationale:</u> Macroeconomic developments pose a significant risk for public debt management as the respective shocks are often difficult to mitigate in the short-run. Thus, OIC member countries are encouraged to implement quantitative information and analysis systems based on adequate frequency data which provide early warning indications. A basic set of macroeconomic indicators include the ratio of the net present value of debt relative to GDP and government revenues, external debt servicing costs relative to exports or the consolidated general government net lending relative to GDP. Best practices include the OECD System of Composite Leading Indicators which is designed to provide early signals of turning points in business cycles. OIC countries with a high degree of integration into the global financial system might find the signal approach methods (such as ifo Signal Approach) helpful, which assesses the probability of a currency and banking crisis. Nations which have a high natural disaster risk may consider negotiating standing backup credit lines for immediate release of additional funding. Finally, the public budgets in many OIC the member countries strongly depend on commodities which are prone to global macroeconomic shocks. Especially the recent decline in oil prices has led to a strong increase in newly issued public debt in some member countries. Concerned countries should aim to diversify their economic activities into less volatile sectors, which admittedly differ from case to case. Overall, synergies from macroeconomic risk management may be achieved if the responsible authorities built strong communication and coordination channels with the DMU.

Instruments to Realize the Policy Advices:

COMCEC Financial Cooperation Working Group: In its subsequent meetings, the Working Group may elaborate on the above-mentioned policy areas in a more detailed manner.

COMCEC Project Funding: Under the COMCEC Project Funding, the COMCEC Coordination Office issues calls for project proposals each year. With the COMCEC Project Funding, the member countries participating in the Working Groups can submit multilateral cooperation projects to be financed through grants by the COMCEC Coordination Office. For realizing above-mentioned policy recommendations, the member countries can utilize the COMCEC Project Funding facility. These projects may include organization of seminars, training programs, study visits, exchange of experts, workshops and preparation of analytical studies, needs assessments and training materials/documents, etc.