IAN STORKEY
INTERNATIONAL CONSULTANT

Cash Balance Targeting and Coordinating with Debt Management

Presentation by:
Ian Storkey

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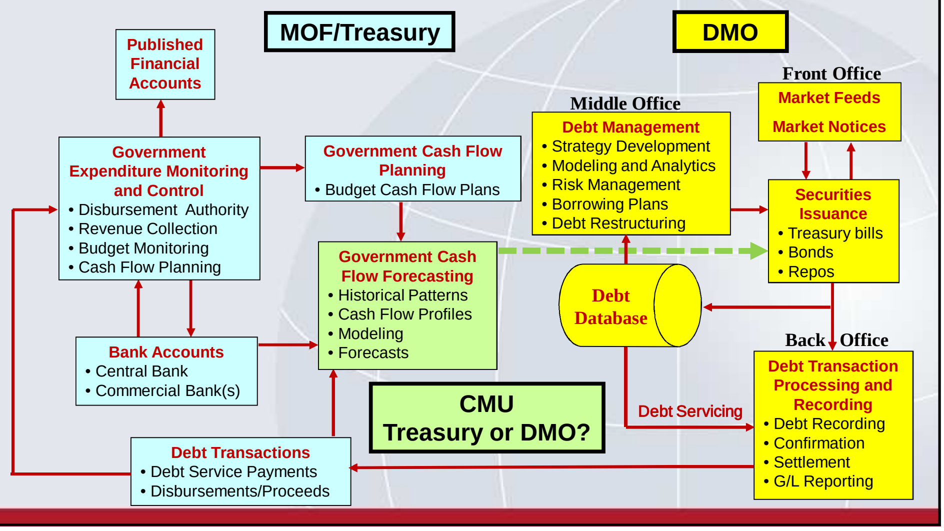
Key Questions

1. Why is it important to coordinate cash and debt management and what are the benefits?
2. How should you manage short-term cash balances and what instruments can we use?
3. What can we learn from international practices, particularly in setting target levels of cash balances?

Cash and Debt Management

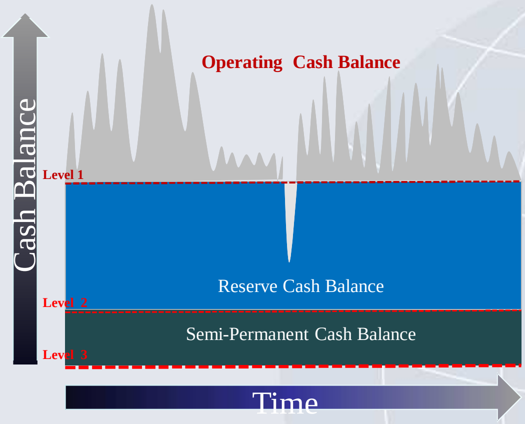
- Integration of (or close coordination between) cash and debt management functions is tending to become the norm internationally, often with the formation of a debt management unit or office (DMU/DMO)
- Ensures:
  - debt issuance decisions are taken in the context of the seasonal nature of government's cash flows
  - MOF and Central Bank have overview of whole market—important when taking decisions about the future balance of short- and long-term debt, including Treasury bills
  - in time, through active management of the short-term cash position, the combined function will be better placed to weaken the link between the timing of cash flows and bond issuance— allows pattern of bond sales to be announced in advance
  - potentially operational and risk management advantages

Institutional Structures & Systems



Cash Balance Targets

Allocating cash into 2-3 tiers of sub-portfolios according to different liquidity needs



- Balance changes frequently
- Actual balance more likely to vary from projection
- Liquidity is primary concern
- Shorter investment horizon (overnight)

- Balance rarely changes
- Serves as a buffer in case actual operating cash balance differ from projection
- Possibility to seek higher returns by extending investment horizon (overnight/monthly)
- *With reliable cash-flow forecasting and short-term funding sources, this tier of cash balance could be reduced or eliminated to reduce debts*

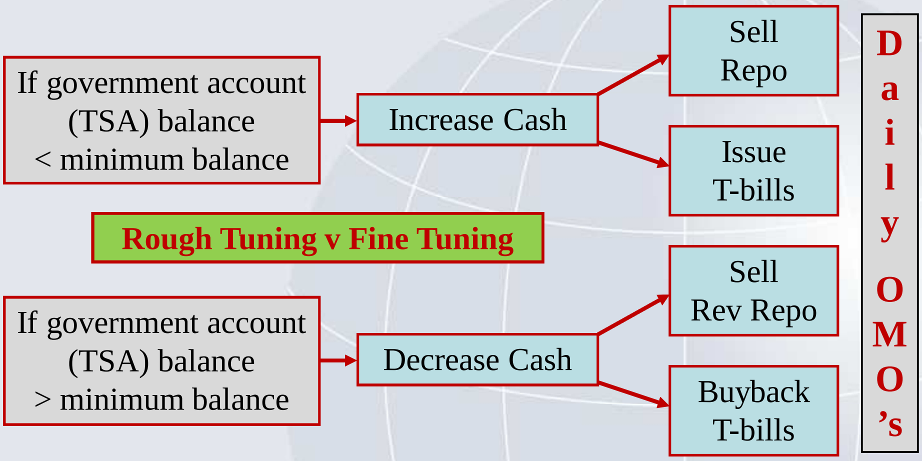
- No foreseeable need for liquidation
- Suitable for seeking higher returns by extending investment horizon (monthly/short-term bond index)
- *Examine if this tier of cash balance is really needed; when financing cost exceeds investment returns, it may be more advantageous to repay the debts*

Hiro Tsubota, World Bank 2009

Cash Management Instruments

- Treasury bills usually main instrument in moving towards more active cash management
  - Treasury bills have different roles as instrument of
    - debt management
    - cash management
    - monetary policy
  - clarify purposes and operational procedures with market and the Central Bank
  - emphasis on shorter-term (e.g. 1 month) Treasury bills for cash management
- Repurchase agreements (repos) usually used when there is a well developed liquid market

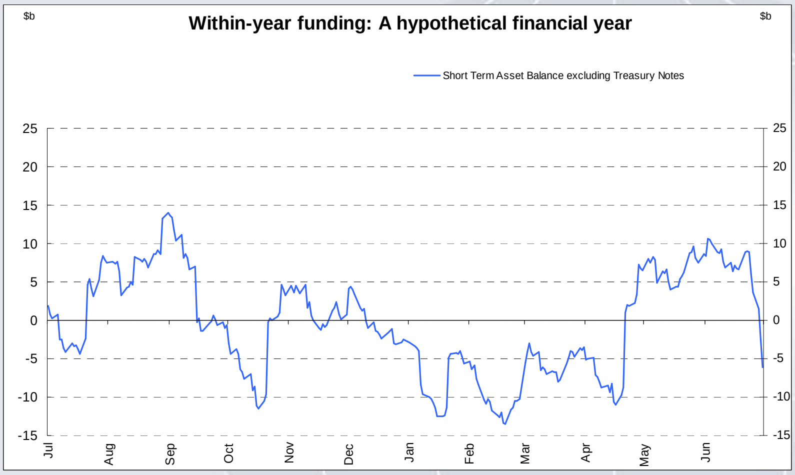
Management of Cash Balances



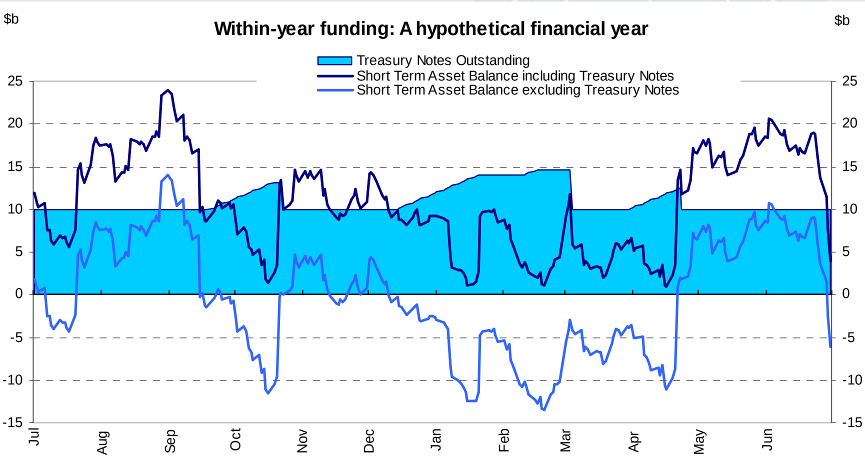
Investment Strategy

- Investment horizon and risk tolerance depends on:
  - stability of cash balance
  - allocating cash into few tiers according to liquidity may help for enhancing returns
  - institutional capacity of MOF to analyze and manage investment risks
- Unless cash balance is solely funded by fiscal surplus, it is almost always more efficient to reduce unnecessary cash balances and pay back outstanding debt (e.g., Treasury bills) than to seek higher returns from investments
- Under the current financial market conditions, however, many governments may prefer to keep large cash balances
  - trade-offs between risk (of being illiquid) and cost (of negative carry) changes depending on financial market conditions

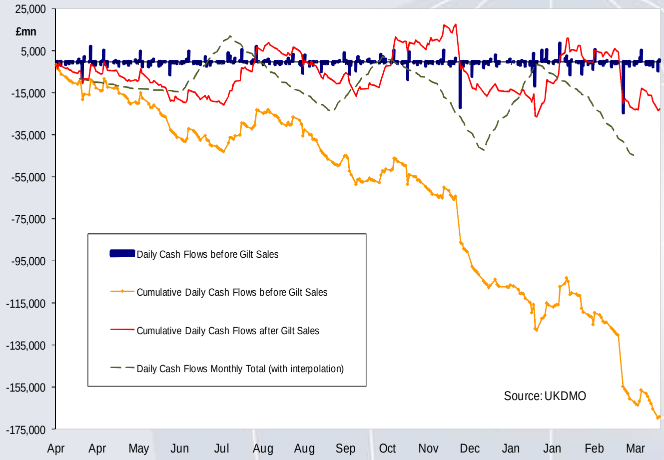
Short-term Financing



Within-year Financing



United Kingdom 2008-09



Mike Williams (2010)

Cash Balance Targets

- On a survey of 22 OECD countries, 16 maintain a target cash balance
- Types of target are diverse
  - minimum floor
  - maximum ceiling
  - different objectives and incentives
- Target cash balance level depends on
  - fiscal position and its long-term trend
  - source of cash balance (e.g., if it is debt-funded)
  - accuracy of cash flow forecasts
  - short-term funding availability (and reliability)
  - carry (the difference between investment return and funding cost)
  - risk tolerance

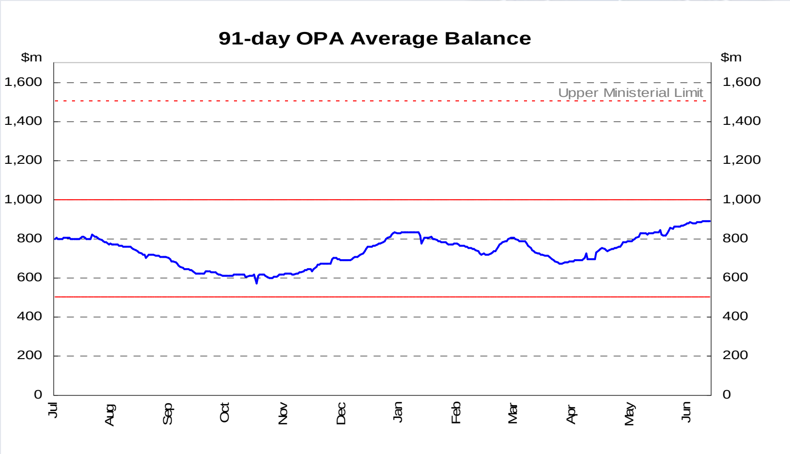
Country Examples

- **Australia:** A$750 million ± A$250 million
- **France:** €100 million
- **Sweden:** Zero
- **U.K.:** Weekly Target (set between the UK DMO & Bank of England)
- **U.S.A.:** US$5 billion (US$7 billion when there is high tax volatility)

Example: Australia

- **Official Public Account average balance:**
  - Ministerial (Policy) Limit: Rolling 91-day average balance less than A$1,500 million
  - Operational Limit: 91-day average upper limit A$1,000 million, lower limit A$500 million – therefore, central target of A$750 million
- A$750 million is considered an appropriate "liquidity buffer" to allow for volatility in revenue and expenditure
- Interest is paid on OPA balances at the Reserve Bank of Australia at the Overnight Cash Rate

91-day OPA Average Balance



Source: Australian Office of Financial Management