MINISTRY PAPER NO. 10

DEBT MANAGEMENT STRATEGY- 1999/2000

INTRODUCTION

Effective management of the public debt will be a critical aspect of Government's economic programme in this fiscal year and the medium term. Debt obligations account for an increasing amount of expenditure, thereby reducing the resources available for development priorities. In the current financial year, total debt charges will be $98.9B or 62% of Government expenditure, pointing to the need for effective strategies to deal with the problem.

2. During FY 1998/99, the Government's debt strategy was aimed primarily at:

   a. The reduction of debt servicing costs; and
   b. Extending the maturity profile of the debt.

3. A key component of this strategy was to shift from the heavy reliance on domestic debt financing to loans raised in the international capital market. This was to take advantage of the significantly lower interest rate which obtained in that market. Another component of the strategy was to issue securities both locally and internationally with a relatively long repayment period in order to avoid the bunching of maturing debt in the near term.

4. Despite developments in the international capital market in 1998, Government was partially successful in shifting from domestic to international financing. Some success was also achieved in shifting to longer term securities despite indications that there was a preference for short-term instruments.

5. At the end of March, the total public debt, including guaranteed external debt amounted to $263.4B. This represent a 20% increase over the level in 1998/99. By international standards, the overall level of Jamaica's external debt is not alarming, but the indicators reflecting credit-worthiness and the extent of indebtedness are of concern. In this regard, the indicators on external debt continue to be within the range accepted internationally. However, the domestic indicators are weak, indicating that the burden caused by a large and growing debt is unsustainable. This is therefore the area for focus.

6. At the end of March 1999, the level of domestic debt was $139B and accounted for 53.1% of the total debt outstanding. The growth in domestic debt resulted from:

   a. ongoing support to parastatal entities and entities in the Private Sector with a strategic significance to economic development;

   b. lower than programmed funds from the international capital market;

   c. lower than programmed tax revenue inflows.

7. As a result of recent activities in the private international capital markets, the level of indebtedness to private creditors has increased. Flows from multilateral and bilateral sources still constitute the major share of debt (78%). However, there has been a shift to debt owed to private creditors, largely bond holders. Once the international capital market is approached, the country's economic programme is under constant scrutiny. Therefore, a clearly articulated strategy consistent with the economic programme is critical to the success of efforts to raise funds on the international market.

B. DEBT MANAGEMENT STRATEGY

8. The magnitude of the debt and the substantial debt service burden point to an urgent need to pursue sound and effective strategies to bring the public debt to sustainable levels.

9. To be successful, appropriate debt management strategies must be pursued within the ambit of sound macro-economic policies centered on the achievement of macro-economic stability and growth. Over the medium, term it is envisaged that debt management strategies will be supported by a continuous fall in interest rates, a stable exchange rate environment, a phased reduction of the fiscal deficit and a return to fiscal surplus by FY2001/02.

10. Debt management strategies over the medium term are intended to achieve four broad objectives namely:

- Satisfying the government's annual borrowing requirements;
- Minimising borrowing and debt service costs;
- Achieving a balanced maturity structure;
- Ensuring continued or wider access to markets, both domestic and overseas.

To achieve these objectives, the debt management strategy being considered with respect to the FY1999/2000 budget will involve the following:

- Renegotiating and refinancing domestic debt;
- Lowering interest rates;
- Reducing the volume of Treasury Bills outstanding;
- Introducing a more efficient system for the sale of LRS and other long-term securities.

12. Strategies to be pursued over the medium term will involve:

- Reviewing criteria for government guarantees;
- Revision of deferred financing arrangements;
- Introduction of new and longer term instruments tailored to investor's needs;
- Maintaining a presence in international capital markets;
- Targeting specific debt indicators.

Re-negotiation and Refinancing of Domestic Debt

13. The largest component of the domestic debt portfolio is LRS (76%), therefore the immediate plan is to reschedule the interest due to selected holders of LRS during 1999/2000. Calculations are that interest payments can be deferred in this manner, amounting to overall savings of 3% in interest costs during FY1999/2000. The re-negotiation of interest however, is only a temporary debt relief measure. Since such deferrals actually involve the conversion of the interest payment to a loan, (in effect the capitalisation of interest). However, the longer-term strategy will involve the continued reduction in domestic interest rates to allow for a more permanent reduction in debt servicing.

Lower Interest Rates

14. Persistent high nominal interest rates in recent years have led to significant increases in interest payments. The sensitivity of the domestic debt portfolio to interest rate movements arises because almost 85% of the debt is contracted on a variable interest rate basis. While variable rates provide a valuable saving when interest rates are low, steep costs arise when interest rates are high. Given the current stock of domestic debt, an annual interest saving of some $800 million can be realised for each one (1) percentage point decline in interest rates. However, since the interest payments are made on a semiannual basis, movements in interest rates will have impact only on a proportion of the total debt, as rates are already "locked in" for six (6) month periods.

Reducing the Volume of Treasury Bills Outstanding

15. Treasury Bills outstanding amounted to $10.9 billion at the end of January 1999, or just $1.1 billion below the statutory ceiling of $12.0 billion. The proximity of the Treasury Bills stock to the ceiling has made it difficult to raise cash quickly at relatively low cost. Such short-term cash needs have had to be satisfied from other sources often at significant margins above the very same Treasury Bill rate.

16. The debt strategy for 1999/2000 will entail a further reduction in Treasury Bills outstanding to $9.9 billion. The reduction will be achieved by redeeming some $1 billion in Treasury Bills and not rolling them over, as has been the practice. A similar programme of reductions is contemplated over the medium term with the objective of reducing outstanding Treasury Bills to around $6-7 billion.

17. The reduction in the stock of Treasury Bills will be achieved through issues of longer-term securities, thereby satisfying the main objectives of:

a. Providing the government with greater flexibility in using Treasury Bills as a means to satisfying its cash management needs.

b. Achieving a more balanced maturity structure.

Introduction of an Auction Mechanism for LRS

18. Local Registered Stocks have been the primary vehicle for debt financing in the domestic market. Unlike Treasury Bills which are auctioned, the government and not the market determines the price at which Local Registered Stocks are sold. The market has responded by determining the volume of securities it will purchase at that price. This approach has not provided the budget with any certainty that its domestic financing requirement in any one month will be met. Based on the pricing, funds raised through LRS issues are invariably well below or above the targeted borrowing requirement.

19. The implication of funding over and above the amount targeted is that too high a price may have to be paid to obtain these funds incurring unnecessary debt charges. Conversely, if the Local Registered Stock issues are unattractively priced, requirements may not be met, and the issue described as failed. Such circumstances impose severe stress on the budget when funds are insufficient.

20. The debt management mandate is to ensure that the budget's financing requirements are met in the most cost efficient manner. In a market environment, meeting this objective will require a fundamental change in the method of selling Local Registered Stocks. The most efficient means through which this can be achieved is an auction mechanism.

21. An auction for the sale of Local Registered Stocks will be introduced as an integral part of the debt strategy during 1999/2000. This will:

- Target the financing requirement and allow the market to determine the price at which such instruments should be sold;

- Allow investors to compete for the purchase of these securities with the ultimate objective of minimising borrowing costs;

- Facilitate the development and expansion of the market for debt securities through better price formation.

22. At the same time, consideration will be given to reopening existing Local Registered Stocks to ensure a more liquid secondary market for these securities. Such issues will facilitate easier secondary market trading, which will be more beneficial because the pricing of instruments will be improved and there will be greater willingness in the financial market to hold government paper.

Managing Contingent Liability Exposure

23. Defaults in payments by borrowers to which the government has provided guarantees or Letters of Undertaking have contributed significantly to the increases in both debt service costs and the debt stock over the years. As financial contingencies grow because of FINSAC guarantees, there

is a greater possibility that these liabilities will translate into charges on the fiscal budget. This situation is not sustainable and must be appropriately managed.

24. This strategy will ensure that:

a. Guarantees are provided only to entities in the productive and development sectors;

b. There is stringent monitoring of the entities to reduce the potential for further defaults.

Introduction of New Debt Instruments

25. A priority over the medium term is to introduce new instruments that are more closely tailored to meet the needs of different segments of the local market. In addition to overall capital market development, the benefit to government is a larger pool of resources from which financing can be tapped and on improved terms.

26. As part of the debt management strategy for 1999/2000, it is recommended that certain index-linked securities be introduced to the market on a small-scale. The instruments contemplated are an exchange rate indexed bond linked to the US dollar and an inflation linked bond. The exchange rate linked bond would be denominated in US dollars but payment of interest and principal would be in the Jamaican dollar equivalent. The principal amount of an inflation-linked bond would be adjusted for changes in inflation. These instruments would be attractive to those institutional and retail investors who are uncertain about the future movements in the currency and inflation rate, and who prefer to maintain the value of their assets even at the expense of incremental interest earnings from the domestic market.

27. The main benefit to be derived from issuing an exchange rate linked bond is a reduction in interest costs. Rather than paying domestic market rates, the US-dollar linked instrument would attract a US dollar market rate. With the current differential between Jamaican and US rates, gross interest savings of up to 10% on new domestic issues could be realised. Some US$50 million in exchange rate indexed bonds is planned for FY1999/2000. Obtaining financing through this means rather than through Local Registered Stocks will lead to an estimated saving of J$150 million in FY1999/2000.

Continued Access to the International Capital Markets

28. A debt management objective is to ensure that the financing requirements, in any fiscal year, can be met on the best terms available. Access to funding from the international capital markets will result in Jamaica benefitting from competitive market rates and a substitution of high cost domestic debts with lower cost external debt. The following will therefore be undertaken:

- The timely floating of sovereign bond issues.

- A programme of information dissemination through publications and face-to-face meetings with overseas investors aimed at improving perceptions of Jamaican risk in the international market.

29. An improved credit standing and the eventual attainment of investment grade status (Ba2) for Jamaica's foreign currency issues will also be conditional on the continued pursuit of policies aimed at stability and sustained economic growth. As economic performance and prospects improve, the country is more likely to be adjudged a good credit risk and therefore enjoy more advantageous terms on future issues. The country is currently assigned a Ba3 credit rating on its foreign currencies bonds and notes from the Moody's rating agency.

30. External amortization is projected at approximately US$400 million in FY1999/2000. As a continuation of the strategy adopted since FY1997/98. International capital markets will be approached with a view to raising funds for the amount to be amortized. However, efforts will be made to ensure that:

(A) There will be no net increase in the stock of external debt outstanding at the end of the period.

(B) The debt service ratio, a key creditworthiness indicator, will be kept within the established benchmark of 20%.

31. It is estimated that given present domestic rates of interest, accessing the capital market for financing will save approximately $700 million in interest costs in FY 1999/2000.

Targeting Debt Indicators

32. External debt has been moving towards sustainable levels for much of the 1990s. The debt service ratio at 16% is below the established international benchmark of 20%. External debt to GDP, although not yet below the critical level of 30%, is moving in that direction. While there is progress, these traditional measures of creditworthiness mask the substantial fiscal burden of the debt caused by a large and growing domestic debt. The overall debt portfolio is above sustainable levels.

33. An important step will be to target certain domestic debt indicators so as to determine an acceptable domestic debt level while ensuring that external debt is maintained at a sustainable level. Relating these stock and debt service levels to key fiscal variables will serve to indicate the appropriate borrowing and fiscal stance that will need to be adopted.

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April 14, 1999