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DEBT MANAGEMENT STRATEGY
FY 2003/2004

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Ministry of Finance & Planning

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INTRODUCTION

1. Since 1998/99, debt financing activities have been guided by the Government's medium term *Debt Management Strategy*. The strategy is critical to the management of the fiscal operations and the Government's overall macro-economic programme. The key objective of debt management has been modified to broaden the focus from minimizing borrowing costs to include risk management. Such an objective is consistent with the guidelines for public debt management established by the IMF and the World Bank.

2. FY2002/03 proved to be a particularly challenging year for debt management. The Government met the need for increased financing consequent on the higher than programmed fiscal deficit and a deteriorating borrowing environment locally and internationally. Interest rates fell in the first half of the fiscal year followed by dramatic increases in rates during the second half of the year. The money market was particularly tight during the last quarter. The relative stability in the international capital markets deteriorated towards the end of the fiscal year due largely to uncertainty caused by the threat of war. In light of these market developments, the Government had to adjust its borrowing programme, particularly in the second half of the fiscal year.

3. The credit rating agencies re-assessed Jamaica's credit standings. Moody's Investors Service again re-affirmed its Ba3/Stable outlook for Jamaica's foreign currency external debt. Standard and Poor's changed its outlook from "Stable" to "Negative" but maintained its B+ rating in December 2002.

4. Government achieved some success during the fiscal year in increasing the fixed rate portion of the debt portfolio and further extending the maturity profile of the domestic debt to include securities with 20- to 30-year maturities. The debt portfolio was further diversified in terms of the range of maturities, the type and geographic distribution of investors. The Government continued to maintain a presence in the international capital markets.

5. Despite the challenges, the Government has and will continue to service its debt obligations. In accordance with Section 116 of the Constitution which stipulates that all loans (both external and domestic) represent a statutory charge on the revenues and assets of the country.

Review of FY2002/03 Debt Strategy

6. At the end of March 2003, total public sector debt stood at $601.2 billion or 151.8% of GDP. This represented an increase of 21.0% over the $497.1 billion at the end of March 2002. The stock of public and publicly guaranteed external debt stood at $235.1 billion (US$4,180.0 million) or 59.4% of GDP and Central Government domestic debt totaled

$366.2 billion or 92.4 % of GDP. The main factors accounting for the increase was the issuance of debt instruments to correct the imbalance on the Central Bank's balance sheet; the assumption of contingent liabilities; the higher-than-programmed fiscal deficit; disbursements under the Social Safety Net programme and the sharp depreciation in exchange rates.

7. The stock of domestic debt stood at $366.2 billion or 92.4 % of GDP at the end of March 2003. This represented an increase of 22.0% relative to the $300.2 billion at the end of March 2002. The increase is attributable to:

- the need to finance a higher-than-programmed fiscal deficit;
- the fallout in external financing due to unfavourable conditions in the international capital markets;
- the issuance of additional debt instruments to the Bank of Jamaica finalizing the arrangement to convert BOJ/FINSAC bonds to LRS;
- the issuance of debt instruments to cover the Bank of Jamaica losses;
- the assumption of debt obligations of public sector entities such as the National Water Commission; and
- the sharp depreciation in the J$ vis-à-vis the US$, given the increased share of US$-indexed bonds in the portfolio. While the stock of US$-denominated bonds increased by 1.2% in US$ terms, the increase in J$ terms was a significant 19.6%.

8. Public and publicly guaranteed external debt increased by 19.4% to $235.1 billion or 59.4% of GDP at the end of March 2003. In US$ terms, the external debt rose by a mere 1.1% from US$4,135.3 million at the end of March 2002 to US$4,180.0 million. This growth primarily reflected:

- the final disbursement of funds from the multilateral institutions for the restructuring of the financial sector which were used to redeem the LRS converted FINSAC bonds
- flows under the Social Safety Net programme;
- increased Government guarantees mainly for the Government-supported portion of Highway 2000; and
- adverse movements in the Euro/US$ and J$/US$ exchange rates.

9. The FY2002/03 debt management strategy sought to:

- Maintain a prudent debt structure;
- Further diversify the debt portfolio;
- Increase reliance on market-determined instruments for domestic debt issuance;
- Promote and build a liquid and efficient market for government securities;
- Increase the transparency and predictability of primary market debt issuance.

Maintaining a Prudent Debt Structure

Increasing the Share of Fixed-Rate Debt

10. A priority of the debt strategy has been to insulate the debt portfolio from adverse movements in interest rates by increasing the share of fixed rate debt. . At the end of FY2002/03, 48.4% of the outstanding domestic debt was issued at fixed rates. This was an improvement over the 43.2% recorded at the end of FY2001/02, and compared favourably to fixed rate shares of 32.8% and 7.0% in FY2000/01 and FY1999/2000, respectively.

Extending the Maturity Structure

11. Despite the challenges, there was success in extending the maturity structure of the debt. An inaugural issue of a 15-year LRS in June 2002 met with significant success. Offers of $805 million chased the $300 million stock offered. Building on this success, the Government auctioned its first 30-year LRS in August 2002. Similarly, there was strong demand for this offer, with subscriptions of $1,104.3 million in response to the $300 million LRS offered. A subsequent 30-year $300 million LRS was issued in September 2002, with subscriptions amounting to $1,423.0 million.

12. The demand for long-term instruments continued into the third quarter of FY2002/03 in an apparent need by institutional investors to ensure an appropriate mix of maturities on their balance sheets. A significant 41.5% of the funds raised through private placements had maturities in the 15- to 30-year range. The Government modified its stance and adopted the strategy of entering the market less frequently for funds offering instruments of shorter maturities when the interest rate climate changed.

13. Of the total new domestic debt issued in FY2002/03, 51.9% had maturities of 5 years and over compared with 49.4% in FY2001/02. Of this amount, 33.9% had maturities of 10- to 20 years, up from 15.5% in FY2001/02; 17.0% had maturities of over 20 years and up to 30 years compared with 2.3% in FY2001/02. Issues with a maturity of 30 years accounted for 3.6% of new issuance compared with none previously.

14. In keeping with the strategy of offering investors a wide range of instruments, the Government continued to offer US$ indexed bonds in the domestic market. The objective of issuing US$ indexed bonds is to offer risk-averse investors protection against currency depreciation. The strategy is to offer this instrument within specific limits in order to minimize the risk to the debt portfolio. US$-indexed bonds amounted to $42.3 billion (US$752.5 million equivalent) or 11.6% of total domestic debt at the end of FY2002/03. This compared to $20.8 billion (US$435.9 million equivalent) or 6.9% in FY2001/02. The stock of US$-denominated bonds in the domestic debt portfolio stood at US$543.8 million at the end of March 2003, an increase of 1.2% from the US$537.1 million at the end of March 2002. However, in J$ terms, the value of these bonds rose a significant 19.6% to $30.6 billion, accounting for 8.2% of outstanding domestic debt. The frequency with which US$-indexed bonds were issued in the last quarter of FY2002/03 increased in order to support efforts by the Central Bank to stabilize the foreign exchange market. These instruments were offered with relatively short maturities.

Diversification of the Debt Portfolio

15. During FY2002/03, the Government sought to diversify the portfolio by offering instruments of various types and maturities, taking into account the cost vis-a-vis the risk preferences of investors. On the domestic side, instruments were issued across the yield curve including long-term securities with maturities of 15, 20, 25, and 30 years. A range of instruments were issued - LRS, investment debentures, US$-indexed bonds and loans - satisfying the needs of institutional and retail investors.

16. On the external side, in keeping with the policy of approaching the international capital markets for funding to the extent of gross external amortization, the Government sought US$500 million from these markets. In June 2002, Government successfully issued a 15-year 10.625% US$300 million Eurobond in the international capital markets. Long-term institutional investors such as insurance companies, mutual funds and pension funds participated actively in the issue, a number of whom had not participated in previous GOJ Eurobond issues. There was also a broad geographic distribution of the transaction. Attempts to raise Euro-denominated funds in the European markets during the last quarter of the fiscal year were postponed despite strong demand. Sharp increases in yields on existing GOJ US$ eurobonds meant that the Government would have had to pay higher premiums for the contemplated transaction.

Use of the Market Mechanism

17. One of the key objectives of the Government's FY2002/03 debt strategy was to increase the use of the auction for the sale of government securities in the domestic market. While Treasury Bills have been auctioned for many decades, the auction of LRS, the Government's primary debt raising instrument, was introduced in October 1999. The sale of these securities through the auction has been widely accepted by the domestic market.

18. The plan in FY2002/03 was to expand the range of government securities sold through the auction. The rationale was that auctioning these securities would, through the competitive bidding process, allow the Government to realize lower borrowing costs. A stable market environment is an important precondition to the first-time sale of other instruments by auction. The growing market instability which characterized FY2002/03 militated against expanding the range of securities offered for sale through the auction.

19. Auctions were the primary means by which LRS were sold during the first half of FY2002/03. A landmark development during this period year was the successful public issue, by auction, of the Government's first 15-year and 30-year LRS. The issues underscored the market's confidence in the use of this mechanism to appropriately price Government securities of various maturities.

20. The stance taken to stabilize the foreign exchange market during the second half of FY2002/03 led to a retreat by the market from purchasing longer-term government securities and a general rise in uncertainty about the direction of money market rates. The Government adjusted to these adverse market conditions by relying more heavily on private placements for budgetary financing. The selection of financial institutions for these private placements was done through a competitive bidding process, in keeping with the Government's stated policy. Of the new debt, $37.2 billion or 30.5% was raised through private placements.

Developing the Domestic Securities Market

21. As the dominant player in the debt securities market, the Government views the development of an efficient domestic capital market as vital to meeting its debt financing requirements in a cost-effective and efficient manner. Government has therefore taken an active role in the discussions and development of the market. This includes measures to increase transparency and accountability, to provide more comprehensive data on a timely basis, and to use market-based mechanisms for debt issuance. In FY2002/03, debt financing activities continued to benefit from the steps being taken to develop the domestic capital market. Government met 78.5% of its total funding requirement from the domestic market.

22. As part of the strategy for developing the capital markets in FY2002/03, the Government committed to initiating efforts to promote a more liquid secondary market through the re-opening of existing LRS. Towards this end, in conjunction with the Bank of Jamaica, measures were implemented for the necessary technical enhancements to be made to facilitate the re-opening of securities on E-GATE, the central bank's electronic treasury management system.

23. Steps were initiated during the fiscal year to assess the feasibility of the gradual introduction of the "immobilization" of Government securities, i.e., the reduction in the issuance of paper certificates. A preliminary study was done and working in conjunction with the Financial Services Commission, efforts are underway to determine the levels of readiness of the market and the systems for immobilization.

24. The Government continued to maintain a transparent relationship with the market. Quality information continued to be made available with an expansion in the coverage and medium through which it is circulated. In January 2003, the Government began subscribing economic and financial data to the IMF's General Data Dissemination System (GDDS). The GDDS was established to guide participating countries in the provision of timely, comprehensive, accessible and reliable economic, financial and socio-demographic data to the public.

25. Over the course of the fiscal year, the Government maintained frequent contacts with local and international investors, financial institutions and the credit rating agencies through meetings, conference calls and investor presentations. The interaction was at the ministerial and technical levels.

DEBT STRATEGY FY2003/04

26. The Government's medium term strategy is to return the fiscal operations to a balanced budget by FY2005/06. The debt management strategy for FY2003/04 is developed within this context. The primary objective is to minimize debt service costs subject to the containment of risks within acceptable limits.

27. The core debt objectives have been established since FY1998/99 and these remain unchanged. The debt management strategy to be implemented in FY2003/04 will continue to:

- Maintain a prudent debt structure;
- Use market mechanisms for domestic debt issuance;
- Promote and build a liquid and efficient market for government securities;
- Increase the transparency and predictability of primary market debt issuance;
- Finance the fiscal deficit and debt redemption;
- Access the external markets for funds to the extent of gross external amortization.

28. The emphasis in FY2003/04 will be modified in light of prevailing market developments, the fiscal performance and the size of the debt while keeping the broad objectives of the strategy unchanged.

Maintaining a Prudent Debt Structure

29. Given the size of the debt stock, the Government will continue to focus on achieving a prudent debt structure in terms of composition and maturity. Government will therefore seek to borrow using a variety of instruments and a range of maturities to minimize costs and limit the risk to the debt portfolio.

Increasing the Share of Fixed-Rate Debt

30. The main risk to the debt portfolio is that of higher interest costs as a result of increases in interest rates. In FY2003/04, the policy of increasing the share of fixed rate debt in the domestic portfolio will remain foremost among the debt strategies. This should reduce refinancing risk. The fixed rate target of 60% of the domestic debt portfolio will be maintained, in keeping with international best practice. However, the target will be kept under constant review in order to ensure an optimal distribution.

Extending the Maturity Structure of the Debt

31. Longer-term issues will allow for the achievement of a more balanced maturity structure and therefore reduce the risk associated with shorter maturities of rolling over the debt under adverse interest rate conditions.

32. Building on the success over the years, extending the maturity profile of both the external and domestic debt will remain a priority for the debt strategy during FY2003/04. Market conditions prevailing, the strategy is to increase the number of offers of LRS with maturity of 10 years and over.

33. In the domestic market, the Government will initiate a limited programme of exchange offers with the objective of smoothing the distribution of the maturities. With the exchange offers, the Government will offer investors the opportunity to exchange securities nearing maturity (of up to one year) with new securities being offered with longer maturities. Similar types of debt buyback will be explored for the GOJ international bonds, mainly for market management reasons.

Minimizing Currency Exposure

34. The Government is committed to providing an array of instruments to the domestic markets. Maintaining a prudent domestic debt structure requires that the foreign currency exposure of the portfolio be reduced to internationally accepted standards. Consistent with this, the Government will restrict the use of US$-denominated and US$-indexed bonds to facilitate the gradual reduction of the foreign currency exposure of the domestic debt portfolio over the medium term. Hedging mechanisms to minimize Government's exposure to adverse movements in currencies other than the US$ will be kept under constant review.

Use of Market-Based Mechanisms

35. Government domestic securities are offered for sale in the primary market by auctions, the placing of fixed rate instruments and through private placements. The FY2003/04 debt strategy will continue to use market-based mechanisms for the sale of government securities in the domestic market. Subject to market conditions, the Government will hold monthly auctions.

36. While remaining committed to the use of market-based mechanisms as the primary vehicle for raising the necessary budgetary financing, the Government intends to maintain flexibility in terms of its financing and market timing. Consequently, the Government will continue to tap the market utilizing the option of raising funds at short notice through private placements. These will be arranged with institutional investors on a competitive bidding basis when changes in the financing requirements and unforeseen market conditions deem it necessary.

Developing the Domestic Securities Market

Re-opening and the Development of Benchmark Issues

37. With the necessary technological enhancements to E-GATE expected to be completed in the first half of FY2003/04, the re-opening of existing stock of LRS will be implemented. The re-opening will facilitate the development of "benchmark" securities in the market. This measure will help to boost market liquidity and lower debt costs. This will be done through Government offering larger and more liquid instruments. In FY2003/04, the process will commence in the second half of the year after the E-GATE enhancements have been completed. Existing stocks of LRS will be re-opened and a limited number of larger issues in key maturities will be introduced on a gradual basis to create benchmark securities.

Immobilization of Domestic Securities

38. Immobilization allows for the electronic registration and settlement of Government securities and hence the reduction of paper certificates. This will increase the efficiency of the domestic capital market and reduce the risks associated with the holding, trading and settlement of securities.

39. The Government will continue to focus on the development of a modern and efficient domestic capital market infrastructure. During FY2003/04, a comprehensive study of the local market will be undertaken in order to ascertain the feasibility of immobilization of securities. In addition, a review of the relevant pieces of legislation will be undertaken.

Increased Transparency

40. The Government publishes comprehensive debt data on the domestic and external markets on a regular basis. Information on Government's debt operations are publicly disclosed by means of advanced notices of upcoming issues, LRS and Treasury Bills auction calendars. Information on Government's debt, its strategy, operations and relevant investor information are available on the Ministry's website (www.mof.gov.jm/dmu). The Government attaches a high level of importance to providing the markets with accurate and timely data.

Calendar of Announcements

41. To further increase transparency and predictability in Government's debt operations and to maintain a well-functioning market for government securities, the Government will continue to keep the market informed of its financing plans. This will be done through the regular announcement of debt issues, the publication of an annual calendar for Treasury Bills and a calendar of LRS auctions on a quarterly basis.

42. The calendars will indicate the timing of such issues while the market will be notified of the amounts and terms of the issues no less than four business days prior to the tender dates. The Government will provide similar notices to the market in respect of other debt securities.

43. The Government will advise the market on a regular basis of the quarterly financing requirements. Details on the amounts, the type of instruments to be issued and the timing will be announced on a timely basis.

44. Transparency and predictability do not prevent changes in borrowing plans or the type of instruments used. As far as possible, the Government will seek to adhere to a strategy of regular debt issuance but will retain some degree of flexibility to take account of changes in the financing requirements and unforeseen market conditions. As in the past, such changes will be communicated to the market on a timely basis.

45. Given its demonstrated commitment to transparency, the Government will continue to select international bank(s), through a process of competitive bidding, to act as lead manager(s) for its international capital markets issues.

Market Consultations

46. While technological advances have facilitated and promoted increased efficiency and effectiveness in operations, personal interaction with the financial markets remains a priority. The global nature of the capital markets further emphasises the importance of investor relationships. The Government will continue to actively engage local and international investors and market players in dialogue to ensure a better understanding of their needs as well as market developments in order to ascertain the most favourable borrowing terms.

47. While a forum already exists for such dialogue through regular meetings of the Primary Dealers with Government agents, Government's debt managers aim to hold meetings twice yearly with market participants.

Medium-Term Target

48. Management of the debt dynamics is a critical aspect of the fiscal and macro-economic programme. The principal objective is to reduce the debt to sustainable levels. As a result, an active debt management strategy has been adopted over the years. Despite the challenges, progress has been madein insulating the debt from volatility in the interest rates by increasing the fixed rate component of the debt, extending the maturity profile of the debt to reduce

refinancing risks, diversifying the debt portfolio in terms of instrument types, maturities, investors and geographic distribution, increasing transparency and accountability, and maintaining access to external and domestic markets.

49. Reducing the debt stock, and hence debt servicing costs, is part of the Government's overall medium term strategy and will be facilitated by accelerated growth and the return of the fiscal operations to surplus. The medium-term programme is designed to attain a balanced budget by FY2005/06. Within this context, and supported by an improving macroeconomic environment, the debt to GDP ratio is projected to decline over the medium term.

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