

CHAPTER 10. MEDIUM TERM DEBT STRATEGY

10.1 OVERVIEW

10.1.1 Objective and Context

The objective of the Medium Term Debt Strategy 2011–2015 (Debt Strategy) is to minimize the cost of debt consistent with the Government's tolerance for financial risk. There are three major strategies: (i) maintain debt at sustainable levels; (ii) change the composition of the debt portfolio so as to maintain financial risk at prudent levels; and (iii) develop the domestic debt market. The Debt Strategy is aligned to the Medium Term Fiscal Strategy and Development Strategic Plan.

The Debt Strategy covers debt issued by the State and secured by a claim against consolidated revenue (Central Government debt). It does not cover the management of the debt of State Owned Enterprises and other contingent exposures. However, these general State liabilities were considered in the formulation of this strategy.

Over the last five years, the Government has made excellent progress in implementing the Debt Strategy by reducing Central Government debt, particularly foreign currency debt, to prudent levels. However, this has been offset by an increase in off-balance sheet foreign currency liabilities. Due to the high level of State liabilities, maintaining debt at prudent levels and managing financial risks remain important objectives of this Strategy.

10.1.2 The Updated Debt Strategy

The Debt Strategy has been updated for the financial and macroeconomic forecasts in the 2011 Budget and Medium Term Fiscal Strategy (2008-2012). There are also several changes from the previous Debt Strategy and these include:

- Previously the strategy focused on reducing the level of debt, in particular foreign currency debt. This has brought the debt to GDP ratio to below 30.0 per cent and foreign currency debt to 40.0 per cent of the portfolio.
- The strategy now aims to keep debt to GDP at or below 30.0 per cent consistent with the Development Strategic Plan.
- The strategy also aims to have foreign currency debt at 40.0 per cent of the portfolio, however recognizes that there may be times when this percentage will vary as borrowing can be lumpy due to large-scale investment projects.
- Circumvention of budget and debt controls by proponents of public-sector capital expenditure funded by foreign-currency debt remains a threat to this strategy.

10.2 MAINTAINING DEBT AT SUSTAINABLE LEVELS

PNG's debt sustainability will be improved through four major means: (i) the growth in the economy; (ii) improvements in public sector management and governance; (iii) prudent

management of public debt, other liabilities and assets; and (iv) reducing reliance on high-risk, complex debt and increasing reliance on low-risk, simple debt securities.

The most widely accepted and used measure of debt sustainability for a State is its sovereign credit rating. The State has a foreign currency debt rating of B plus. This means that the rating agencies believe PNG is vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments. One of the factors that prevented an improvement in the rating was an increase use of off-budget borrowing and expenditure.

All State liabilities will impact the sustainability of the Government's debt. State liabilities in addition to Central Government debt include the Independent Public Business Corporation's borrowing to fund its share of the PNG LNG project of AUD1.7 billion (K4.3 billion) and the State's share of the PNG LNG project debt (K5.3 billion) which is guaranteed by the State until the project construction reaches completion. Through these liabilities, the State's finances are heavily exposed to the success of the PNG LNG project. In addition, the State has unfunded public service superannuation liabilities of K1.9 billion.

Treasury analysis indicates that due to the high level of State liabilities, further significant increases in debt would be imprudent. Therefore, the Government aims to keep Central Government debt at or below 30.0 per cent of GDP. In the event that debt increases above this level the Government will use budget surpluses and windfall revenue to reduce its liabilities.

10.3 REDUCING FINANCIAL RISKS

Treasury aims to minimize the cost of debt and keep the risk of debt at tolerable levels through competitive auction of simple financial securities denominated in Kina and borrowing limited amounts of highly concessional debt from international financial institutions or other development partners.

Treasury's analysis indicates that complex financial instruments and opaque off-balance sheet structures are inappropriate for PNG due to lack of skills, technology and systems. The international financial crisis has also provided strong support for a "keep it simple strategy" with large international financial institutions failing to manage the risks of complex financial instruments and off-balance sheet structures.

10.3.1 Foreign Currency Risk

The level of Central Government external debt has been reduced from 40.0 per cent of GDP in 2002 to around 11.0 per cent in 2010. However, this has been offset by an increase in foreign currency denominated off-balance sheet liabilities related to the PNG LNG project. Central Government external debt plus Independent Public Business Cooperation's borrowing for the State's equity share in the PNG LNG project and the State's guarantee of the project debt total 53.0 per cent of GDP. Managing the level of foreign currency risk therefore remains an important objective of this strategy.

The Government aims to maintain foreign currency debt at around 40.0 per cent of the total Central Government debt portfolio by restricting the amount of new foreign currency loans it enters into. In addition, where it is appropriate on a risk/return basis, the Government may borrow domestic funds to retire foreign-currency debt.

New foreign-currency loans will still be considered if:

- (i) The loan is highly concessional and in a low risk currency. The criteria for considering concessional financing shall be a grant element of 35.0 per cent or more. This is in line with international debt management practice and as recommended by the IMF and the World Bank.
- (ii) A project is a high priority under the Medium Term Development Plan and will not significantly increase the level of external debt above 40.0 per cent of the total debt portfolio or increase the level of Central Government debt above 30.0 per cent of GDP.
- (iii) The lender's policies do not preclude awarding of contracts to PNG firms and/or awarding of contracts via international competitive bidding.
- (iv) There is a genuine advantage to funding the project from foreign currency loans such as the need to import foreign expertise and/or foreign materials.

In 2011, it is expected that foreign currency debt will increase slightly above the target mix of 40.0 per cent of total debt to 43.0 per cent. This is mainly due to the commencement of capital works on several large-scale infrastructure projects.

10.3.2 Interest Rate Risk

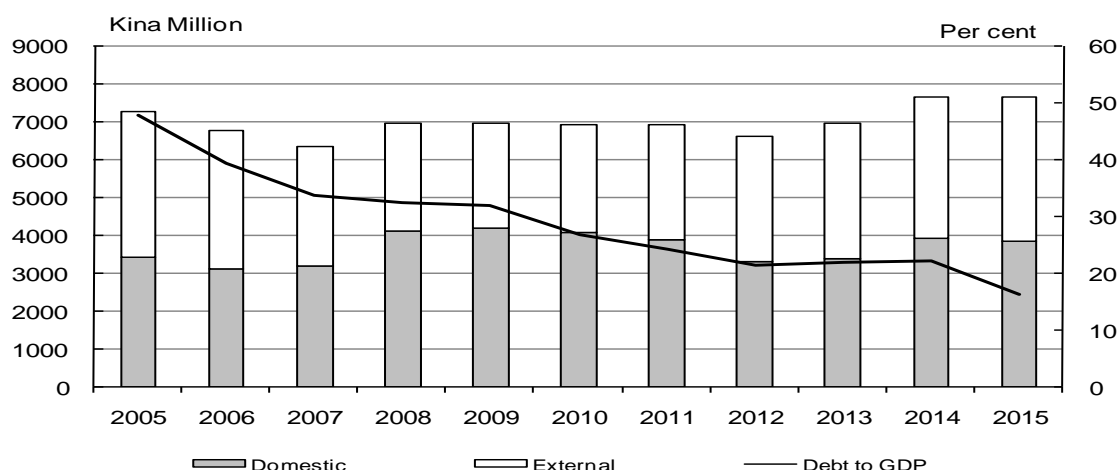
The Debt Strategy aims to increase the net amount of fixed-rate Inscribed Stock by K0.2 billion over the next five years, and decrease Treasury Bills from about K1.5 billion as at the end of 2010 to about K0.5 billion in 2015.

The current level of Treasury Bills is around 36.0 per cent of the domestic portfolio. The Government aims to reduce Treasury Bills to be in the range of 15.0 to 30.0 per cent over the next year.

Table 56: Approximate Composition of Domestic Debt by Instrument

Instrument Type	Current (end 2010) Per cent	Target Range Per cent
Treasury Bills	36	15-30
Inscribed Stock	64	70-85

Source: Department of Treasury

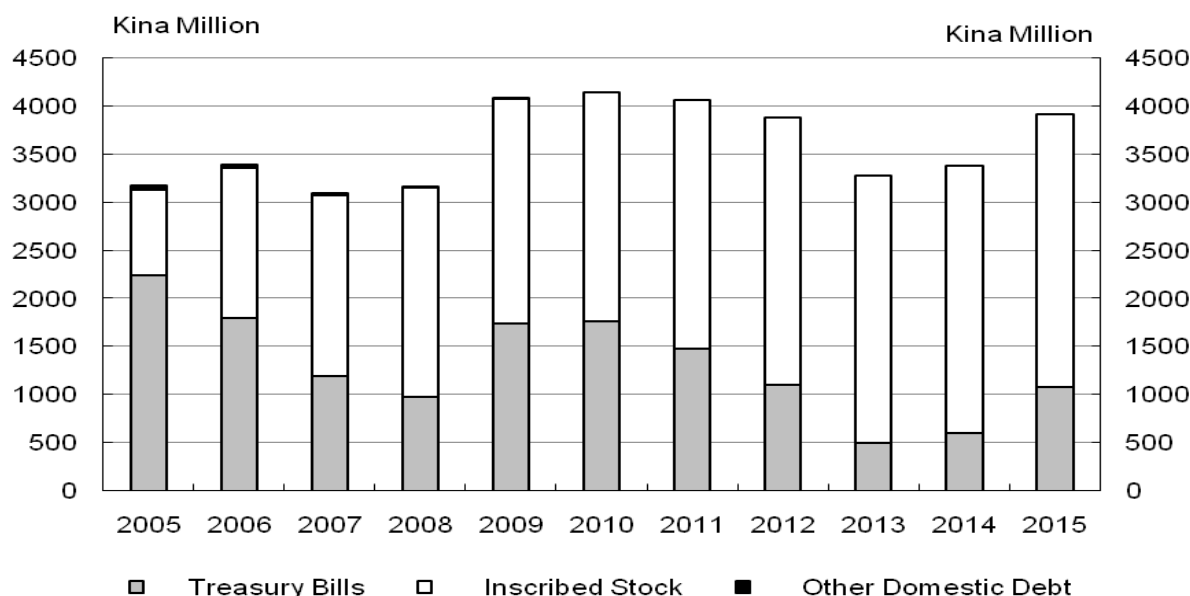
Figure 38: Currency Composition of Government Debt 2004 - 2014 (Kina Millions)

Sources: Department of Treasury

10.3.2 Refinancing Risk

The Debt Strategy will maintain the average maturity at about 5 years for the domestic debt portfolio, and an average maturity at about 8 years for foreign-currency debt.

Treasury has reviewed its targets for the use of long-term fixed-rate debt relative to short-term variable-rate debt, and plans to increase Inscribed Stock from K2.6 billion at the end of 2010 to K2.8 billion in 2015, while maintaining the maximum maturity of Inscribed Stock at 17 years, and limiting the amount of Inscribed Stock maturing in any one year to K500.0 million.

Figure 39: Composition of Domestic Debt 2004 - 2014 (Kina Millions)

Source: Department of Treasury

10.3.3 Operational Risk

Operational risk is defined by the Bank of International Settlements as risk of losses resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

The operational risks facing Treasury include the difficulty in developing and retaining skilled staff, the lack of a business continuity plan, and a heavy dependence on few key personnel operating the Commonwealth Secretariat Debt Recording and Management System (CS-DRMS). Treasury mitigates these operational risks through a capacity development plan, and by working in partnership with the Commonwealth Secretariat and other CSDRMS users.

10.4 LONGER-TERM IMPROVEMENTS

Treasury will also continue with incremental improvements in monitoring, reviewing and updating the Debt Strategy annually to reflect international and domestic developments relevant to PNG. Significant challenges for improving debt sustainability and management of financial risks still remain. These include:

- A small domestic investor base and lack of foreign investors in Kina denominated securities;
- Increases in contingent liabilities such as the IPBC's borrowing to invest in the PNG LNG Joint Venture;
- The impact that the PNG LNG project will have on the size of the economy, the exchange rate and domestic financial markets; and
- Lack of coordinated management of the State's financial assets and liabilities.

The long-term strategies to address these challenges include:

- (i) Development of liquid primary and secondary markets in Kina-denominated Inscribed Stock, Bills and Loans.
- (ii) Developing a Whole-of-Government Balance Sheet Framework (WOGBS) based on asset-liability management principles. Work on the framework commenced in 2009. The WOGBS will enable the Government to manage the volatility of the State's net worth and other contingent exposures. Implementation will be complex and takes time as it will involve participation by other public sector entities responsible for managing financial asset, liabilities and exposures.