



**MEDIUM TERM**

**DEBT**

**STRATEGY**

**2005 – 2009**

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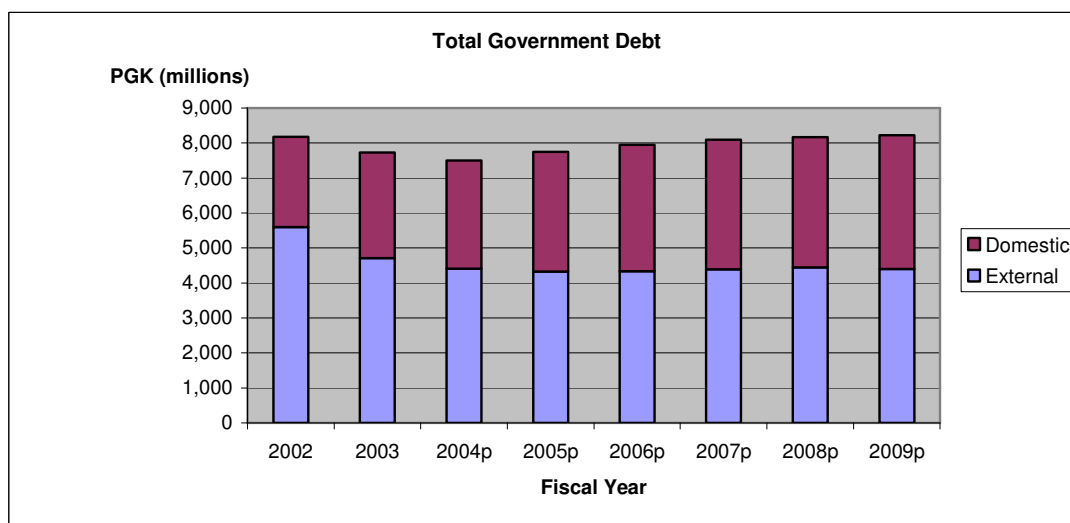
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**Medium Term Debt Strategy  
2005 - 2009**

## 1. Introduction

In line with the Medium Term Fiscal Framework, the overall Medium Term Debt Framework is aimed at reducing the current level of Government debt from 55 percent of GDP in 2004 to 45 percent of GDP by the year 2009. The strategy is formulated on the objective of minimising debt service costs while containing the Government's exposure to risk and having a sustainable level of debt in the medium to long term. It will also ensure the development and maintenance of a well functioning market for domestic government securities.

Part of the strategy is to reduce the percentage share of external or foreign currency debt from the current level of 59 percent of total Government debt to a target range of 40 percent – 45 percent over the medium-term and increase domestic or local currency debt from the current level of 41 percent of total Government debt to a target range of 55 percent – 60 percent over the medium term. The current level of Government debt is around K7.5 billion (K4.4 billion external and K3.1 billion domestic). The actual Government debt levels for 2002 and 2003 together with projected debt levels for 2004 to 2009, classified by domestic and external debt, are shown in the following graph:



## 2. Domestic Debt Strategy

The domestic debt strategy for the medium term is aimed at:

- (i) lengthening the maturity of domestic debt to reduce rollover/refinancing risk,
- (ii) restructuring the debt instrument composition to have it consistent with internationally acceptable structures,
- (iii) ensuring a smooth maturity profile,
- (iv) developing and maintaining a well functioning market for domestic government securities, and
- (v) providing the financial institutions and investors with a pre-announced schedule of Inscribed Stock tenders for the financial year, to be announced at the time of the budget.

## 2.1 Domestic Debt Composition

The strategy will progressively restructure domestic debt over the period 2005 to 2009 in order to meet the proposed structure set out in Table 1.

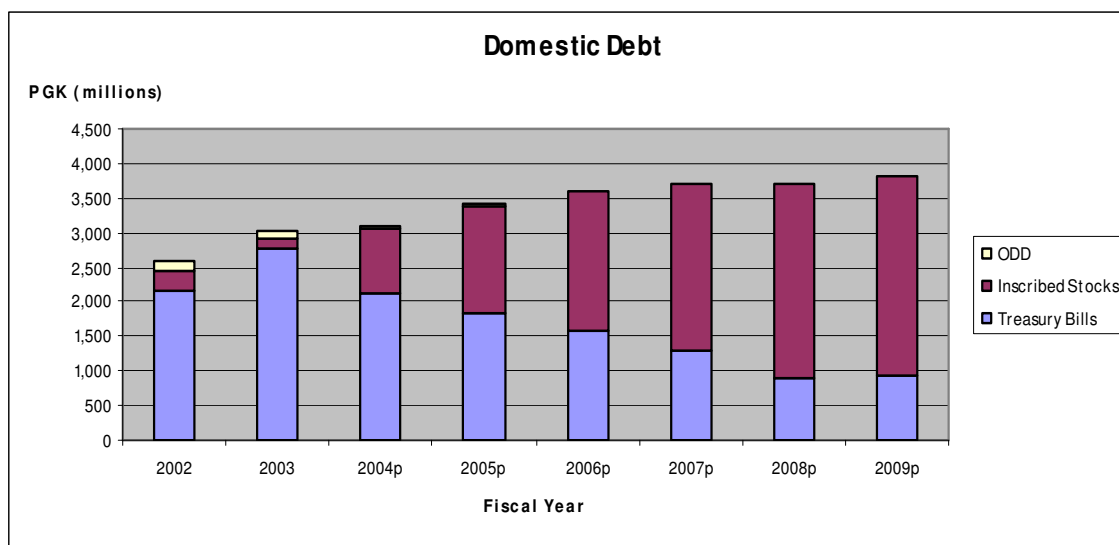
Table1: Composition of Domestic Debt by Instrument

<b>Instrument Type</b>	<b>Current Structure</b>	<b>Proposed Structure</b>
Treasury Bills	84%	25% – 30%
Inscribed Stocks	14%	60% – 75%
Other Domestic Debt	2%	Less than 1%

In order to implement the proposed domestic debt composition in Table 1, the following initiatives are planned:

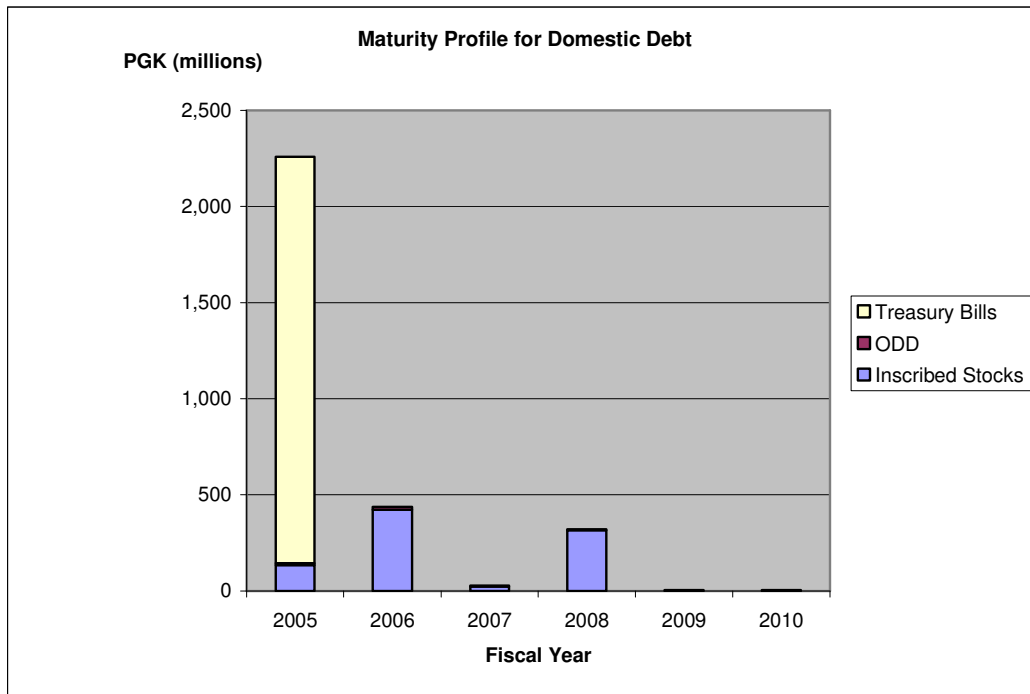
- (i) Development over the medium-term of 4-6 “benchmark” Inscribed Stocks of up to K500 million and progressively extending maturities out to 10 years, which is intended to develop the market for Government securities in order to create greater liquidity and promote secondary market trading.
- (ii) Use of “debt switching” from Treasury Bills into Inscribed Stocks of around K500 million per year for the next 4 years, in order to accelerate the build up of Inscribed Stocks and lengthening of maturities, thereby reducing rollover/refinancing risk to the Government.
- (iii) Review of the existing Treasury Bills tender program, covering the objective and structure of the program; timing, structure and size of the regular weekly tenders of Treasury Bills; and maturities including the scope to introduce 364-day Treasury Bills.
- (iv) The scope to introduce a retail debt instrument for small investors (i.e., a savings bond) will be examined.

The effect of the strategy on the composition of domestic debt over the period 2004 to 2009 is shown in the following graph:



## 2.2 Domestic Debt Maturity Profile

The strategy will ensure that debt issued does not lead to excessive maturities in any one fiscal year and thereby ensure a smooth maturity profile. For example, the strategy will set an upper limit of around K500 million for Inscribed Stocks maturing in any fiscal year. This rebalancing will take several years to achieve due to the large volume of Treasury Bills outstanding and the early stages of development of a profile of Inscribed Stocks across multiple maturities. The maturity profile for domestic debt as at the end of 2004 is set out in the following graph:



## 3. External Debt Strategy

The external debt strategy for the medium term is aimed at:

- (i) restructuring external debt in order to have the currency composition more closely aligned with the country's Foreign Exchange Reserves, thereby reducing the foreign exchange risk,
- (ii) establishing a benchmark for determining the concessionality of a new loan contracted from bilateral and multilateral sources, and
- (iii) ensuring a smooth maturity profile.

### 3.1 Currency Composition of External Debt

The strategy for determining the currency composition of external debt is based on international practices using a government asset-liability management approach. While the foreign exchanges reserves are managed by the Bank of Papua New Guinea, the restructuring of external debt will reduce the overall risk to the Government through hedging the total foreign currency exposure. The current composition of external debt is shown in the following chart:

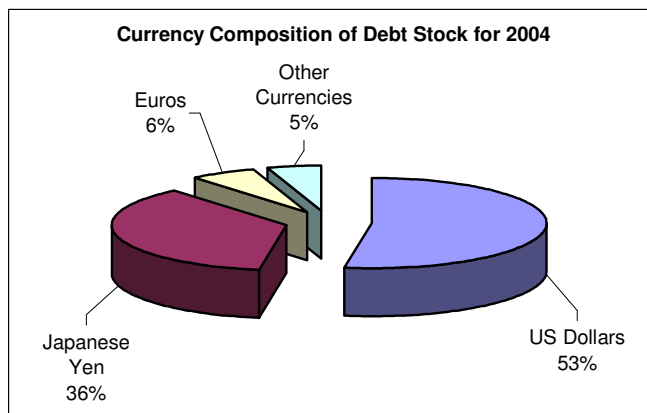
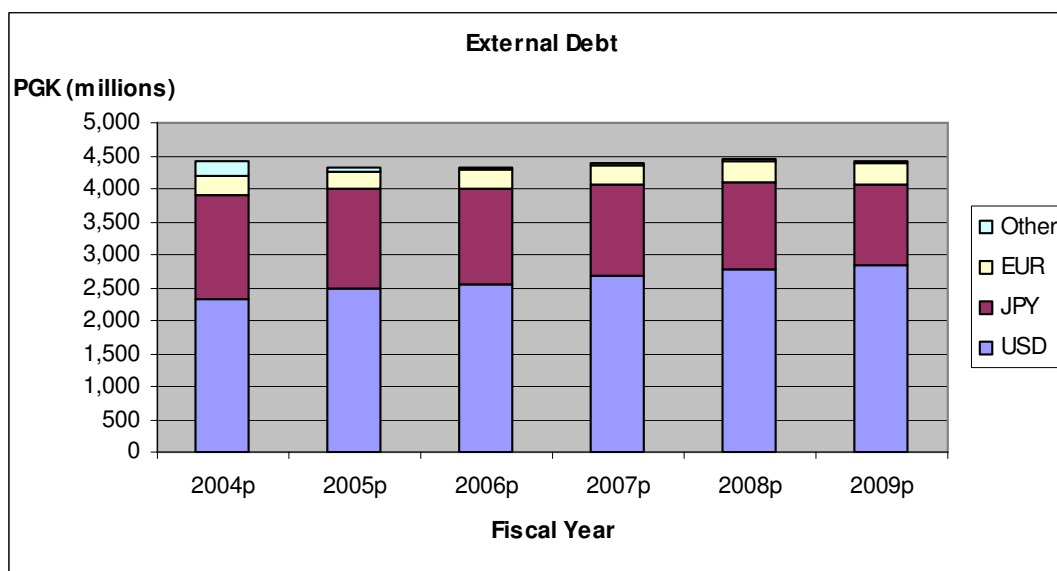


Table 2: Currency Composition of External Debt

Currency	Current	Proposed Range
USD <sup>1</sup>	52.4%	50%-55%
JPY	36.4%	10%-15%
AUD	4.1%	10%-15%
EUR	6.0%	15%-20%
Others	1.0%	0%-5%

The effect of the strategy on the composition of external debt over the period 2004 to 2009 is shown in the following graph:



<sup>1</sup>Includes SDR portion (18.7 %) in US dollars composition as actual debt service payments are billed and paid in US Dollars.

In order to achieve the proposed currency composition, the strategy will involve:

- (i) Switching K40 million per year for the next 5 years using Asian Development Bank (ADB) single-currency pooled loans denominated in Japanese Yen to Euros and Australian dollars.
- (ii) Switching K20 million per year for next 5 years using ADB LIBOR-based loans and World Bank (IBRD) Single Currency/Fixed Spread loans denominated in US dollars to Euros and Australian dollars.
- (iii) Repatriating K50 million per year for the next 5 years through pre-payment of IBRD multi-currency pooled loans or maturing external debt to be financed from the Inscribed Stock tender program.
- (iv) Ensuring the all new borrowing of foreign currency or external loans are consistent within the proposed range in Table 2.

### 3.2. Interest Rate Composition

The setting of the fixed/variable interest rate for external debt is based on international practices. The proposed interest rate composition for fixed rate and variable rate external debt will be 65 percent – 75 percent and 25 percent – 35 percent respectively. Currently, external debt interest rate composition falls within these ranges.

Table 3: Interest Rate Composition

<b>Interest Rate</b>	<b>Current Composition</b>	<b>Proposed Interest Rate Range</b>
Fixed	70%	65% – 75%
Variable	30%	25% – 35%

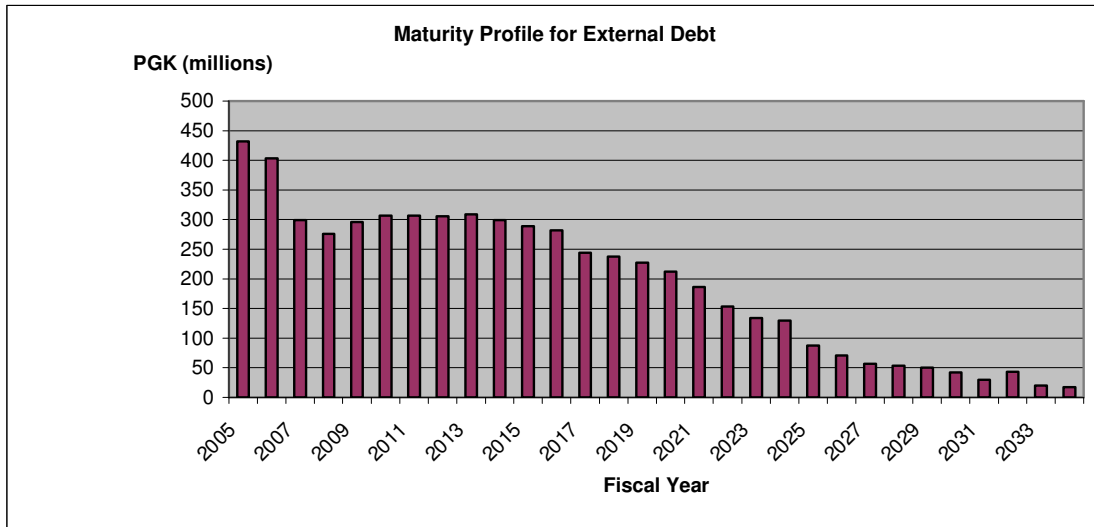
The proposed range will be used to manage interest rate risk and reduce volatility that might lead to increased budget debt service cost and uncertainty in interest rate forecasts. The determination of the interest rate on new borrowing/loan contraction will be consistent with the proposed range in Table 3.

### 3.3 Concessional Borrowing Criteria for New Loan Contraction

In order to secure concessional funding from multilateral and bilateral sources, the condition to which concessionality of a loan is determined should be based on the grant element of a loan other than creditor source. In line with international debt management practice and as recommended by IMF and World Bank, the grant element of 35% or more on a new loan will be used to classify a concessional loan. This will minimise borrowing of non-concessional loans under bilateral and multilateral sources.

### 3.4 External Debt Maturity Profile

The strategy will ensure that debt issued does not lead to excessive maturities in any one fiscal year and thereby ensure a smooth maturity profile. The existing maturity profile meets this criterion due to the long-dated debt issued through multilateral and bilateral sources. The maturity profile of external debt as at the end of 2004, assuming no new loans are taken out and existing loans are fully drawn, is set out in the following graph:



The strategy set out above will be monitored, reviewed and updated annually to factor in developments on debt and related issues relevant to Papua New Guinea and international debt management practices.