CHAPTER 8. MEDIUM TERM DEBT STRATEGY

8.1 OVERVIEW

8.1.1 Objective

The objective of the Medium Term Debt Strategy 2007–2011 (the Debt Strategy) is to minimize the cost of debt consistent with the Government's tolerance for financial risk. This objective supports the Medium Term Fiscal Strategy (MTFS) and Medium Term Development Strategy (MTDS).

There are three major strategies to support the objective: reducing debt to sustainable levels, reducing financial risk to prudent levels, and developing the Government Inscribed Stock, Bill and Loan markets.

8.1.2 Why management of the Government Debt is important

Management of the Government's debt is important because the Government has an unsustainable level of debt, the debt portfolio has excessive financial risks, and the Government debt markets are rudimentary.

The present value of Government debt as a proportion of GDP is 42 per cent, above the sustainable level of 30 per cent of GDP recommended by the International Monetary Fund (IMF).

The excessive interest-rate risk caused domestic interest expense as a percentage of domestic debt to increase to over 12 per cent per annum in 1989, 1990, 1991, 1992, 1995, 2002 and 2003, with a peak of 22 per cent in 2003.

The excessive foreign-currency risk caused the total of external interest expense plus currency depreciation losses expressed as a percentage of external debt to increase to over 20 per cent per annum in 1990, 1994, 1995, 1997, 1998, 1999 and 2001, with a peak of 50 per cent in 1994.

Such high volatility is due to excessive levels of foreign-currency debt and Treasury Bills, and a lack of fixed-rate long-term Kina-denominated debt.

PNG has a rudimentary primary market for Treasury Bills and Inscribed Stock, with weekly competitive auctions of Treasury Bills and Central Bank Bills, and monthly competitive auctions of Inscribed Stock. However, there is almost no secondary market, and no effective repo market. Furthermore, the foreign-currency market is relatively illiquid, and there are no currency swaps available or other sophisticated financial instruments that can be used to hedge financial risks. Nearly all of the Government's external loans are illiquid with different terms and conditions, making it relatively expensive to administer and hedge these loans.

8.1.3 Achievements in 2006

During 2006 the Government implemented the debt strategy which helped to improve debt sustainability, reduce financial risk of the debt portfolio, and develop the Inscribed Stock, Bill and Loan markets. Debt sustainability is largely determined by the fiscal strategy.

Major achievements in 2006 include:

- Improved Debt Sustainability

    - Passed a *Fiscal Responsibility Act* with a commitment to firstly, not raise the overall level of debt during each Government's term, and to secondly, obtain prior approval of the Minister for Treasury for any borrowings by public bodies.

    - The Supplementary Budget set the net financing for 2006 at nil.

- Reduced financial risk by improving the composition of debt

    - Reduced foreign-currency risk by reducing foreign-currency debt by K209 million.

    - Reduced interest-rate risk and refinancing risk by increasing Inscribed Stock by a net of K309 million, and reducing Treasury Bills and other domestic loans by a net of K100 million. This decreased the proportion of the domestic debt that has a variable-rate from 55 per cent at the end of 2005 to a projected 49 percent at the end of 2006, and lengthened the average maturity of the domestic portfolio from 1 year to 2.5 years.

    - Introduced 12 and 15 year Inscribed Stock consistent with lengthening the maturity to meet the growing investors' preference to have longer dated stocks. Such long-term debt was not viable before 2006.

- Development of Government's Inscribed Stock, Bill and Loan Markets

    - Simplified Inscribed Stock auctions by allowing investors to purchase Inscribed Stock with either cash or by switching from Treasury Bills or Inscribed Stock with residual maturity of less than 6 months. Previously separate auctions were held for cash purchases and switches.

    - Finalized an Agency Agreement with Bank of Papua New Guinea (BPNG) to formalise the debt management services they provide to Treasury.

    - Surveyed stakeholders to assess the gap between the management of the Government's debt and leading international practice, so as to identify the most important, feasible improvements to the management of government debt.

    - Established a joint private-public sector Steering Committee to oversee a Project Team responsible for implementing the most important, feasible improvements to the management of government debt.

    - Assisted Asian Development Bank (ADB) to assess the viability of issuing Kina-denominated concessional loans in 2007.

8.1.4 The Updated Debt Strategy

The Debt Strategy has been updated for the fiscal results of 2006 and is aligned to the fiscal and macroeconomic forecasts for 2007 in the MTFS and the Budget.

The Government's current debt portfolio is so significantly different from the norms of a prudent debt portfolio that the strategy to reduce financial risk is clear: reduce excessive net foreign-currency debt, lengthen the maturity of the domestic portfolio, reduce the proportion of variable-rate debt and develop the domestic market.

However, the priorities of the Debt Strategy have been updated to reflect the three most important, feasible improvements identified by stakeholders:

- Better coordination between Treasury, BPNG and the Independent Public Business Corporation (IPBC).
- More frequent, timely and standardised reporting on the Government's debt portfolio.
- Continued emphasis on incremental improvements in processes underpinning the Kina-denominated Inscribed Stock, Bill and Loan markets.

8.2 REDUCING DEBT TO SUSTAINABLE LEVELS

The Government will be bound by the principles of the Fiscal Responsibility Act with a commitment to firstly, not raise the overall level of debt during its term, and to secondly, obtain the prior approval of the Minister for Treasury for any new borrowings for public-agencies.

The Net Financing requirement for 2007 is K35 million. This together with the projected growth in GDP and Government Revenue will see all debt sustainability indicators improve.

One important measure of debt sustainability is the Sovereign Credit Rating of PNG, and the Government agreed on a medium-term target of BB for PNG's foreign-currency sovereign credit rating and BBB for domestic-currency sovereign rating.

Most of the IMF's debt sustainability measures indicate that PNG has high, although sustainable, levels of debt. The IMF's debt sustainability indicators compare debt stock and debt service relative to measures of repayment capacity.

The quality of a country's policies and institutions has a major influence on its debt sustainability thresholds. The World Bank's Country Policy and Institutional Assessment classify PNG as a poor performer. If the World Bank assessed PNG as a strong performer then we would have higher debt thresholds and hence have sustainable debt levels.

Table 63 shows the IMF's indicators for the sustainability of government debt.

Table 63: Sustainability of the Government's Debt

Sustainability Indicators	IMF Threshold Per cent	Forecast PNG 2007 Per cent	Comment
PV of Government Debt / GDP	30	42	Unsustainable
PV of Government Debt / Government Revenue	200	180	High but sustainable
Government Debt Service / Government Revenue	25	20	High but sustainable

Source: IMF and Department of Treasury

8.3 REDUCING FINANCIAL RISKS

8.3.1 Foreign-currency Risk

To reduce the excessive foreign-currency risk the Government will repay gradually foreign-currency debt. The Government will fund the repayments through either increased borrowing in Kina or through budget surpluses.

All foreign-currency loans have already been ranked by their risk and cost to identify loans that should be either pre-paid or refinanced or hedged. This analysis was based on asset-liability management principles, and took into account any natural hedge provided by the Government's foreign-currency assets and revenues, including BPNG's reserves. Thus foreign-currency exposures to Japanese Yen and other minor currencies will be reduced first as the Government has a net-debt exposure to these currencies. The analysis of the foreign-currencies is shown in Table 64 below.

Table 64: Gross and Net Foreign-currency Debt in 2006

	Gross Debt Kina Million	(Reserve Asset) Kina Million	Net Debt/(Asset) Kina Million
Yen	1,317	(194)	1,123
Others	31	-	31
Sub-Total	1,349	(194)	1,155
US Dollars	1,716	(1,745)	(29)
Euro	524	(767)	(243)
Australian Dollars	9	(969)	(960)
Pound Sterling	88	(194)	(106)
Sub-Total	2,337	(3,675)	(1,339)
			-
Grand Total	3,685	(3,878)	(368)

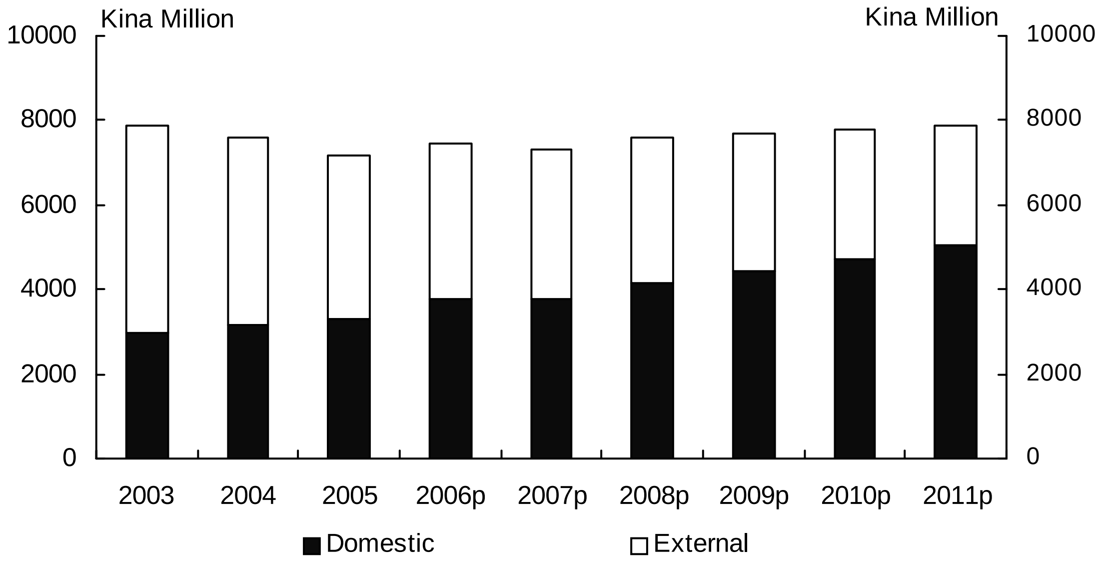
Source: Department of Treasury and BPNG

It is possible that the foreign-currency loans may decrease at a quicker rate than is budgeted. The Government will investigate using Kina-denominated concessional debt from ADB and hedging instruments from the World Bank and ADB to reduce foreign-currency debt at a faster rate. Finally, Treasury will request the Government to use any unbudgeted, budget surpluses to repay foreign-currency debt.

New foreign-currency loans will still be considered if the loan is highly concessionary and in a low risk currency. The criteria for concessional financing shall be a grant element of 35 per cent or more. This is in line with international debt management practice and as recommended by IMF and World Bank. Overall, the repayment of existing foreign-currency debt will exceed any new foreign-currency loans and therefore, there will be net amortization. The Kina equivalent amount of foreign-currency debt will reflect exchange rate changes.

The projected decrease in foreign-currency debt, consistent with the MTFS is shown in Figure 28 below:

Figure 28: Currency Composition of Government Debt 2003-2011 (Kina Millions)

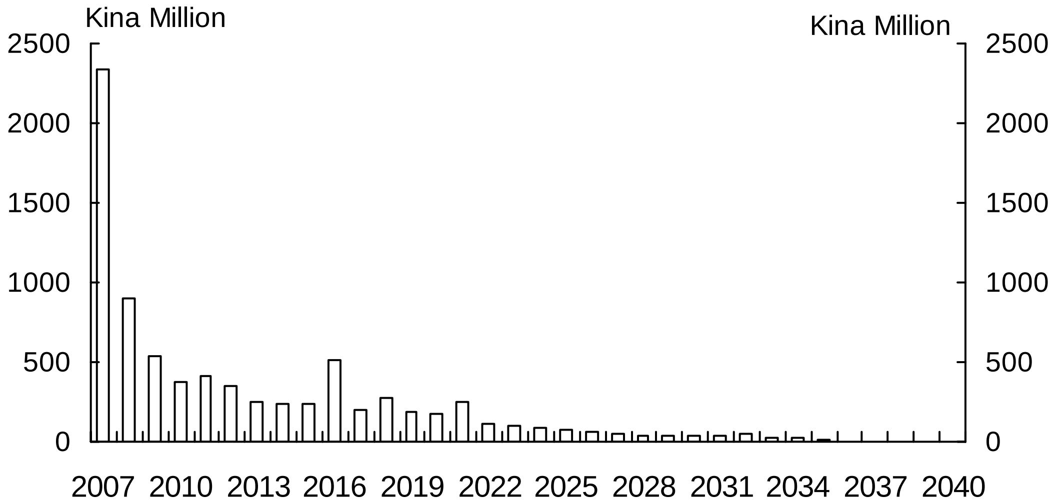


Sources: Department of Treasury

8.3.2 Refinancing Risk

The Debt Strategy will continue to increase the average maturity of the domestic debt portfolio from the current average of about 1 year to about 4 years in 2011. Figure 29 shows the maturity profile of the total debt as at the end of 2006.

Figure 29: Maturity Profile of Total Debt as at 31st December 2006 (Kina Millions)



Source: Department of Treasury

Treasury reviewed its targets for the use of long-term fixed-rate debt relative to short-term variable-rate debt. On average, emerging market countries have only 10 per cent of their domestic debt in Treasury Bills (IMF's Global Financial Stability Report Chapter III). The Government has lowered the target for the proportion of Treasury Bills from 30 - 40 per cent, to 20 - 30 per cent. This is an appropriate trade-off relative to industry norms between the additional cost of borrowing long-term fixed-rate debt, and the benefits of stable debt

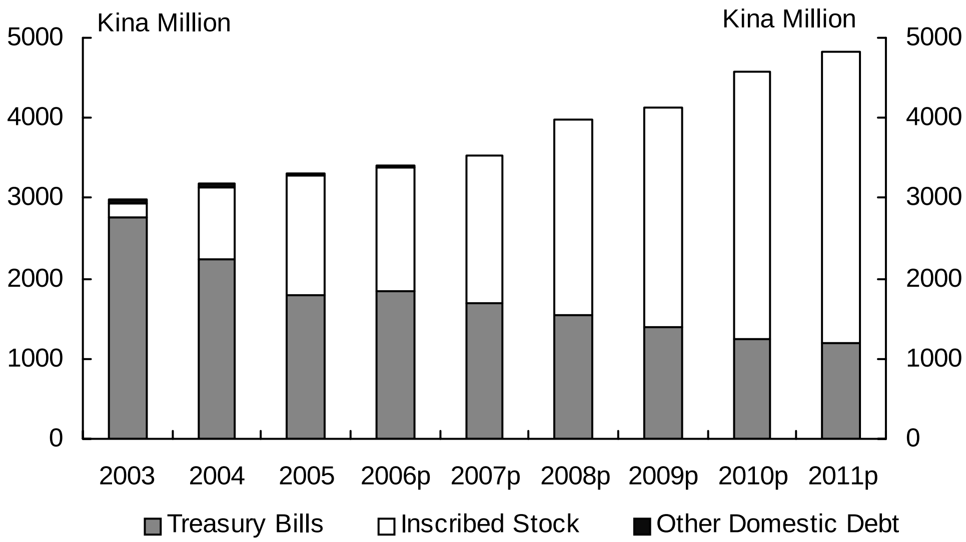
servicing cost and low refinancing risk. A further consideration in changing the Government's target was BPNG successfully issuing a large volume of Central Bank Bills during 2006.

Treasury will achieve this target by increasing the net amount of Inscribed Stock by about K300 million a year over the next five years. This is a quicker rate than last year's Debt Strategy due to unexpected higher demand for Inscribed Stock. Figure 30 shows the change in composition of the domestic debt portfolio.

The Inscribed Stock will have maturities between 3 to 15 years, with a limit of K400 million for Inscribed Stock principal maturing in any year. Previously the annual limit for Inscribed Stock maturing in any year was K500 million and the maximum maturity was 10 years. The limit has now been reduced to K400 million as the Government can spread its Inscribed Stock maturities over 15 years rather than 10 years. Treasury will reduce the net amount of Treasury Bills by about K200 million a year over the next five years. The targeted rebalancing will take until 2010 to 2011 to achieve due to the large volume of Treasury Bills outstanding.

The external debt portfolio has an acceptably low refinancing risk with an average maturity of 10 years.

Figure 30: Composition of Domestic Debt 2003-2011 (Kina Millions)



Source: Department of Treasury

8.3.3 Interest Rate Risk

In the past, nearly all of the Government's domestic debt had, in effect, a variable interest rate. This exposed the Government to huge swings in debt servicing costs. As previously noted the Debt Strategy aims to increase the net amount of fixed-rate Inscribed Stock by about K300 million a year over the next five years, and decrease the net amount of variable-rate Treasury Bills by about K200 million a year over the next five years. This will result in about 80 per cent of the domestic debt being fixed-rate, and 20 per cent variable-rate by 2011 as shown in Table 65 below.

Table 65: Composition of Domestic Debt by Instrument

Instrument Type	Current Structure	Target Range
Treasury Bills	49	20-30
Inscribed Stock / Other	51	70-80

Source: Department of Treasury

8.3.4 Early Repayment Risk

Some foreign-currency loans have large penalties for early repayment, while some fixed-rate loans can have market values far in excess of the principal of the loan if market interest rates have fallen substantially since the loans were contracted. Thus, there is a substantial risk that the early repayment of foreign-currency debt may be highly expensive.

The Government will request International Financial Institutions to waive prepayment penalties and give PNG substantial discounts for the early repayment of debt. Such discounts are in the best interests of the Government and the International Financial Institutions as they will provide an incentive to reduce overall debt to a more sustainable level and reduce the risk of default. If the International Financial Institutions agree with the Government's request, then the Government will consider repaying foreign-currency loans at a faster rate and conversely repay Treasury Bills at a slower rate.

8.4 DEVELOPING GOVERNMENT INSCRIBED STOCK, BILL AND LOAN MARKETS

In 2006 Treasury surveyed all stakeholders (investors, domestic financial institutions, representatives of International Financial Institutions, and officials from BPNG, IPBC, and Departments of Treasury and Finance) to assess the gap between the management of the Government's debt and leading international practice. Based on the survey results Treasury identified the consensus view of the three most important, feasible improvements to develop the market for Government Inscribed Stock, Treasury Bills and Loans:

1. Better coordination between Treasury, BPNG and IPBC to a standard recommended in the World Bank's and IMF's Debt Guidelines for Public Debt Management.

2. More frequent, timely and standardised reporting on the Government's debt portfolio that complies with the IMF's Special Data Dissemination Standards.

3. Continuing emphasis on incremental improvements in processes underpinning the Kina-denominated Inscribed Stock, Bill and Loan markets to a standard that meets investor's and other stakeholder's expectations. This will include such changes as piloting the listing of some Government debts on the Port Moresby Stock Exchange.

Treasury has established a Project Team comprising both Treasury and BPNG officials to implement these three improvements, and a Steering Committee comprising representatives from the private sector, the IPBC (representing public agencies and State Owned Enterprises), BPNG and Treasury will oversee the progress. In addition, the Project Team will formally report and seek feedback every six-months from existing investors and stakeholders, and will continue to hold seminars to encourage additional investors to invest in Government Securities.

At the end of 2007 Treasury will survey all stakeholders again to re-assess the gap between the management of the Government's debt and leading international practice, and identify the most important, feasible improvements for 2008.

Longer-term strategies still include developing a whole-of-government risk management framework and an asset-liability management framework, the development of deterministic and stochastic risk measures and limits, the development of sophisticated primary and secondary markets in Kina-denominated Inscribed Stock, Bills and Loans, and the use of more sophisticated hedging instruments to improve the composition of the debt portfolio. These longer-term strategies, while important are not currently feasible given the limited resources and competing priorities of the Government.

These longer-term strategies involve not only investors and financial institutions, but also the judiciary, the legal and accounting profession, regulators, utility providers, industry codes of conduct and qualifications. These improvements are complex and will take many years to implement.

Treasury will monitor, review and update annually the Debt Strategy to reflect international and domestic developments relevant to PNG.