CHAPTER 10. MEDIUM TERM DEBT STRATEGY

10.1 OVERVIEW

10.1.1 Objective

The objective of the Medium Term Debt Strategy 2008–2012 (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.

10.1.2 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 on some measures, the debt portfolio has excessive financial risks, and the Government debt markets are rudimentary.

Currently the Government's credit rating is BB minus for local currency debt, and B plus for foreign-currency debt – these ratings indicate that the rating agencies consider the Government has an inadequate capacity to meet its financial obligations – or an unsustainable level of debt. The Government will have a sustainable level of debt if it continues to retire debt and once the rating agencies consider we have an adequate capacity to meet our financial commitments or assign a rating of BBB minus or better.

The International Monetary Fund (IMF) uses three key indicators to assess debt sustainability, and one indicator shows the Government has an unsustainable level of debt, while the other two indicators show there is a high but sustainable level of Government debt. These two indicators depend in part upon Government Revenue which is exceptionally high and is expected to decline after the commodity boom.

In the past, 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.

Similarly, 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 was 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.

10.1.3 Achievements in 2007

During 2007, 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 from 2004 to 2007

10.1.3.1 Improved Debt Sustainability

- Passed a *Fiscal Responsibility Act* in 2006 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 Treasurer for any borrowings by public bodies.

- In 2006, K100 million of foreign-currency debt was prepaid from funds made available under the second Supplementary Budget.

- At the end of 2006, K430 million of domestic debt was repaid in line with the Budget surplus.

- In 2007, K297 million was allocated under the Supplementary Budget for prepayment of foreign-currency debts.

- In 2007, K250 million was allocated under the Supplementary Budget as partial settlement of the Government's liability to Nambawan Super.

- In 2007, Standard & Poor's raised PNG' s Sovereign Debt Credit Rating to BB- for long-term local currency debt and B+ for long-term foreign-currency debt.

10.1.3.2 Reduced financial risk by improving the composition of debt

- Reduced foreign-currency risk by reducing foreign-currency debt by K369.3 million in 2006.

- 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 39 per cent at the end of 2006, and is projected to reduce to 30 per cent by end of 2007 and lengthened the average maturity of the domestic portfolio from 1 year to 3.4 years.

- Introduced 3, 5, 7, 10, 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 2004.

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

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.

- Signing of an Agency Agreement between the Bank of PNG (Central Bank) and Department of Treasury in April 2007.
- Reduction in auction minimum bid from K1 million to K100,000.
- Improved investors' access to timely and standardized reporting on Government debt portfolio by providing 24 hours reporting of results of Treasury Bills and Inscribed Stock auction.
- Established website links to other Debt Management Offices and organisations.
- Improved coordination between the Bank of PNG and Department of Treasury.
- Better coordination between the Project Steering Committee and Project Team in regard to issues affecting the development of the PNG Debt Market.
- 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.
- Assisted Asian Development Bank (ADB) to assess the viability of issuing Kina-denominated concessional loans in 2008.

10.1.4 The Updated Debt Strategy

The Debt Strategy has been updated for the fiscal results of 2007 and is aligned to the fiscal and macroeconomic forecasts for 2008 in the draft 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.

10.2 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 Treasurer for any new borrowings for public agencies.

The Budget is expected to be in surplus in 2008, with K202.3 million anticipated to be available to repay debt. The combined impact of the 2007 Supplementary Budget and the 2008 Budget is expected to have debt reduced by K497 million and superannuation obligations reduced by K400 million.

The simplest holistic measure of debt sustainability is the Sovereign Credit Rating of PNG, and the Government agreed on a medium-term target of BBB minus for PNG's sovereign credit rating – this is the lowest credit rating that indicates the Government has adequate capacity to meet its financial obligations.

The level of public debt remains relatively high, although some substantial inroads have been made over recent years, with the simple debt to GDP ratio expected to fall to 34 per cent by end of 2007.

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. The IMF also considers the external debt (both private and public) when assessing the debt sustainability of a country (see www.imf.org/external/dsa for more details).

10.3 REDUCING FINANCIAL RISKS

10.3.1 Foreign-currency Risk

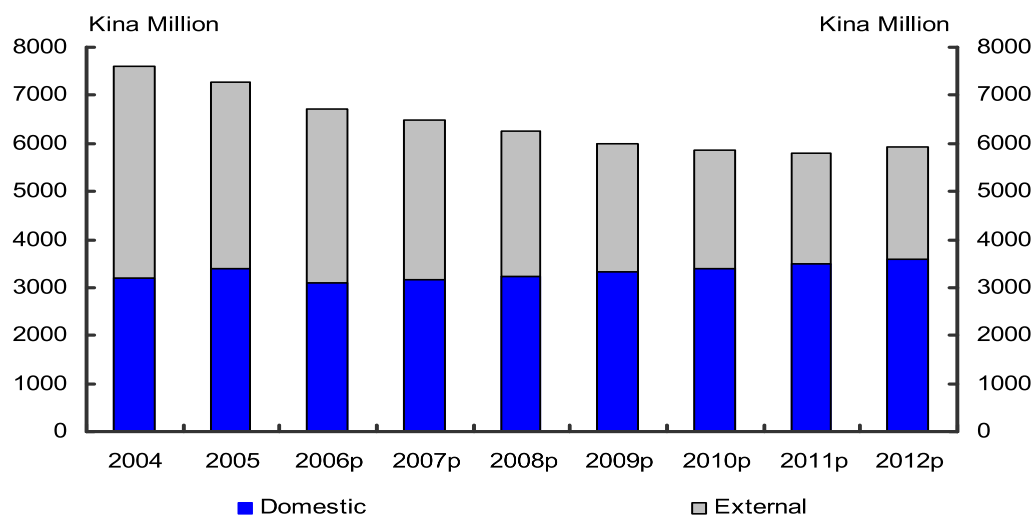
To reduce the excessive foreign-currency risk the Government will gradually repay foreign-currency debt. The Government will fund the repayments through either increased borrowing in Kina or through budget surpluses.

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 minor currencies will be reduced first as the Government has a net-debt exposure to these currencies.

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 or exposure at a faster rate. Finally, the Department of 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 concessional 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 32.

Figure 32: Currency Composition of Government Debt 2004 - 2012 (Kina Millions)

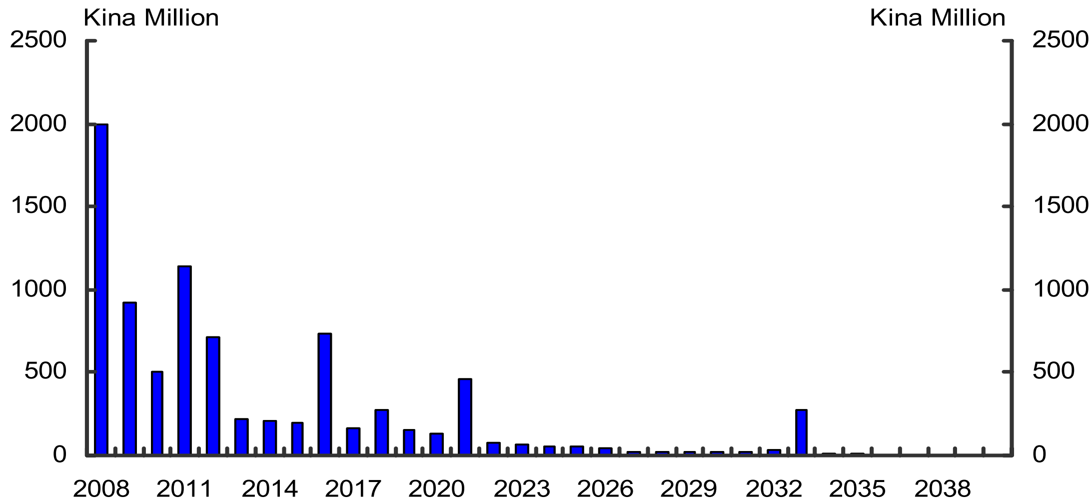


Sources: Department of Treasury

10.3.2 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 2012. Figure 33 shows the maturity profile of the total debt as at the end of 2007.

Figure 33: Maturity Profile of Total Debt as at 31st December 2007 (Kina Millions)



Source: Department of Treasury

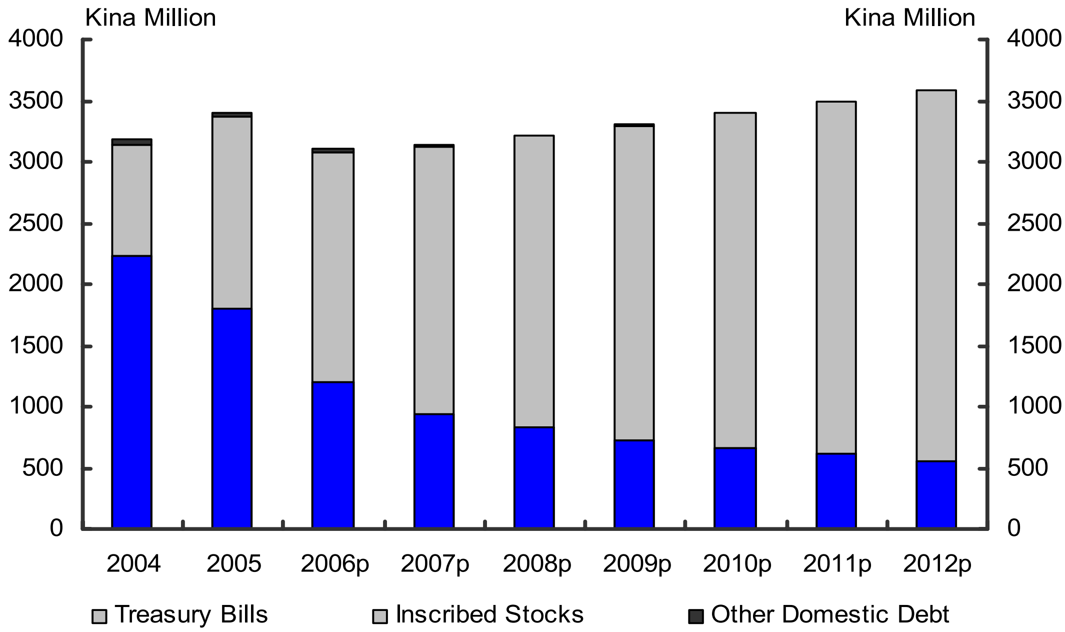
The Department of Treasury reviewed its targets for the use of long-term fixed-rate debt relative to short-term variable-rate debt. On average, emerging market countries have only 10 per cent of their domestic debt in Treasury Bills (IMF's Global Financial Stability Report Chapter III). The Government 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 and 2007.

The Department of 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 anticipated in last year's Debt Strategy due to unexpected higher demand for Inscribed Stock. Figure 34 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. The Department of 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 2012 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 34: Composition of Domestic Debt 2004-2012 (Kina Millions)



Source: Department of Treasury

10.3.3 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 2012 as shown in Table 73 below.

Table 73: Composition of Domestic Debt by Instrument

Instrument Type	Current Structure Per cent	Target Range Per cent
Treasury Bills	**30**	**20-30**
Inscribed Stock / Other	**70**	**70-80**

Source: Department of Treasury

10.3.4 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.

10.4 DEVELOPING GOVERNMENT INSCRIBED STOCK, BILL AND LOAN MARKETS

In 2008, Department of Treasury will continue with emphasis on incremental improvements in processes underpinning the Kina-denominated Inscribed Stock, Bill and Loan markets to a standard that meets investors' and other stakeholders' expectations. This will include such changes as piloting the listing of some Government debts on the Port Moresby Stock Exchange.

At the end of 2008, Department of 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 2009.

Longer-term strategies include:

- Developing a whole-of-government risk management framework and an asset-liability management framework;
- Development of deterministic and stochastic risk measures and limits;
- Development of sophisticated primary and secondary markets in Kina-denominated Inscribed Stock, Bills and Loans; and
- 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.

The Department of Treasury will also continue with incremental improvements in monitoring, reviewing and updating annually the Debt Strategy to reflect international and domestic developments relevant to PNG.