CHAPTER 10. MEDIUM TERM DEBT STRATEGY

10.1 OVERVIEW

10.1.1 Objective and Context

The objective of the Medium Term Debt Strategy 2009–2013 (the Debt Strategy) is to minimize the cost of debt consistent with the Government's tolerance for financial risk. There are three major strategies: reduce debt to sustainable levels; change the composition of the debt portfolio so as to reduce financial risk to prudent levels; and develop the domestic debt market.

The Debt Strategy covers debt issued by the State and secured by a claim against consolidated revenue, and excludes unfunded superannuation, the debt of State Owned Enterprises and other contingent exposures.

Over the last five years, the Government has made excellent progress in implementing the Debt Strategy. However, as outlined later in Section 8.1.3, there are significant changes and new threats which the 2009-2013 Debt Strategy must address.

10.1.2 The Updated Debt Strategy

The Debt Strategy has been updated for the financial and macroeconomic forecasts in the 2009 Budget and Medium Term Fiscal Strategy (2008-2012). There are also several new issues that the updated Debt Strategy will address:

- The impact of the international financial crisis on the Debt Strategy
- The likely increase in debt or contingent liabilities of the State due to the Government's plan to borrow money to invest US$1 billion in the equity of the LNG Joint Venture
- The large amounts of cash kept in Trust Accounts
- The circumvention of budget and debt controls by proponents of public-sector capital expenditure funded by foreign-currency debt
- The over-reliance on domestic investors, as no foreign investors currently own Kina-denominated Government securities
- Treasury's support for introducing an Asset Liability Management framework to better manage the State's financial assets, liabilities and off-balance sheet exposure
- The role and contribution of Petromin and IPBC
- BPNG's reform on the national payments system, and the independent reviews of the PNG's Financial Sector by the IMF and the State's debt strategy in 2009

As noted in previous years, the Government's current debt portfolio is significantly different from the norms of a prudent debt portfolio. This imbalance makes the strategy choices clear: reduce debt to prudent levels, while reducing the reliance on risky debt (foreign-currency, short-term or complex debt) and increasing the reliance on low risk debt (long-term fixed-rate Kina denominated debt and simple debt securities).

There is strong support by the domestic financial institutions, international financial institutions and other investors for the Debt Strategy.

10.2 REDUCING DEBT TO SUSTAINABLE LEVELS

The most widely accepted and used measure of debt sustainability for a State is its sovereign credit rating. The State's foreign-currency debt has a B plus or highly speculative rating, while domestic debt has BB minus or speculative rating. The rating agencies use an economic measure of indebtedness and consider that the State has a contingent liability for a debt issued by State entities. The IMF and World Bank also have a narrower definition of debt sustainability and their indicators show that current levels of debt are almost sustainable.

PNG's debt sustainability can be improved through four major means: the growth in the economy, improvements in public-sector management and governance, the reduction in public debt and other liabilities, and reducing reliance on high–risk, complex debt and increasing reliance on low-risk, simple debt securities.

Two factors will improve debt sustainability and the State's rating: the economy is forecast to continue to grow at a moderate level, and there are plans to improve the governance of public entities.

In particular, Treasury has initiated and will lead a whole-of-government balance sheet committee to clarify the roles and improve coordination of the various State entities responsible for managing the State's financial assets, liabilities and off-balance sheet exposures. Treasury will assist the committee to establish a method to recognise and measure the economic and risk exposures of these entities. Such measures will assist the State to set an overall limit for debt and other financial obligations for all State entities, and then to apportion individual limits for debt and other financial obligations amongst State entities. Another improvement in governance that the Department of Treasury will initiate is to work with other State entities so there are effective and agreed procedures and controls on the evaluation, selection and funding of capital expenditure.

Another significant change that may influence debt sustainability of the State is the Government's decision that IPBC will borrow to fund the Government's US$1 billion investment in the equity of the LNG Joint Venture. The Rating Agencies' and IMF will independently assess the impact of the above changes on the debt sustainability and credit rating of the State.

10.3 REDUCING FINANCIAL RISKS

10.3.1 Introduction

Treasury's own analysis demonstrates that the cost of debt is minimised and risk of debt kept 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 also indicates that complex financial instruments and opaque off-balance sheet structures are inappropriate for PNG due to lack of skills and systems to manage the risks successfully, and risk appetite to absorb losses.

The international financial crisis has provided strong support for Treasury's "keep it simple strategy". The crisis was partly due to large international financial institutions failing in a spectacular way to manage the risks of complex financial instruments and off-balance sheet structures. If these institutions have difficulty in successfully managing such financial structures, there are lessons for others to learn.

In 2008, Treasury continued to hold regular, successful monthly auctions for Inscribed Stocks (bonds) and weekly auctions of Treasury Bills as and when needed. The detailed results of the auctions are quickly displayed on Treasury's website so as to increase investors' information and confidence in the auctions.

Each year, the IMF works with Treasury to develop a set of financial scenarios relevant to PNG. The scenarios demonstrate the main risks to budget projections and relevant constraints and implications for the Debt Strategy. PNG's proposed mix of debt instruments and annual issuance plans are shown to mitigate financial risks, and keep debt costs at comparable levels to other developing countries.

The proposed whole-of-government balance sheet committee will help develop longer-term, coherent strategies for the management of the State's major financial resources and obligations, and provide a valuable forum to critique the Debt Strategy. The Memorandum of Understanding between Treasury and BPNG already provides a forum to critique the Debt Strategy and understand its implications for Monetary Policy, while the internal review process in Treasury ensures the Debt Strategy is aligned to the Fiscal and Development Strategies.

Finally, the success of the Debt Strategy depends on the support of investors, and Treasury will continue its six-monthly visits to all major investors and the publication of annual issuance plan.

10.3.2 Foreign Currency Risk

Foreign-currency debt has the highest risk-adjusted cost of debt for Papua New Guinea, with a similar average economic cost to domestic debt over the last thirty years, while the volatility of the economic cost is nearly four times greater than domestic debt and tends to exacerbate economic cycles.

The Government has three options to reduce the proportion of foreign-currency debt: (i) it can use any budget surplus and windfall revenue to retire foreign-currency debt; (ii) it can borrow domestic funds to retire foreign-currency debt; and (iii) it could use derivatives to hedge the foreign-currency exposure.

The first option uses budget surpluses and 30% of windfall revenues to retire foreign-currency debt and other financial liabilities. All foreign-currency loans have been ranked by their risk and cost to identify loans that should be retired first. This analysis is based on asset-liability management principles, and takes into account any natural hedge provided by the Government's foreign-currency assets and revenues.

The second option is also used to retire additional foreign-currency debt. Domestic funds are borrowed to retire foreign-currency debt (the amount of domestic funding is kept at levels that do not crowd out the private-sector or encourage domestic financial institutions to take excessive levels of public debt). The Government will investigate using Kina-denominated concessional debt from ADB.

The third option is not used as complex instruments are avoided for reasons outlined in previous sections.

New foreign-currency loans will still be considered if the loan is highly concessional and in a low risk currency, and if there is an overall decrease in foreign-currency debt. The criteria for

concessional financing shall be a grant element of 35 per cent or more.[4] This is in line with international debt management practice and as recommended by IMF and World Bank.

The projected decrease in foreign-currency debt, consistent with the MTFS is shown in Figure 28 on the following page.

10.3.3 Interest rate Risk

The Debt Strategy aims to increase the net amount of fixed-rate Inscribed Stocks by K1 billion over the next five years, and decrease Treasury Bills from about K1.1 billion as at the end of 2008 to about K0.7 billion in 2013.

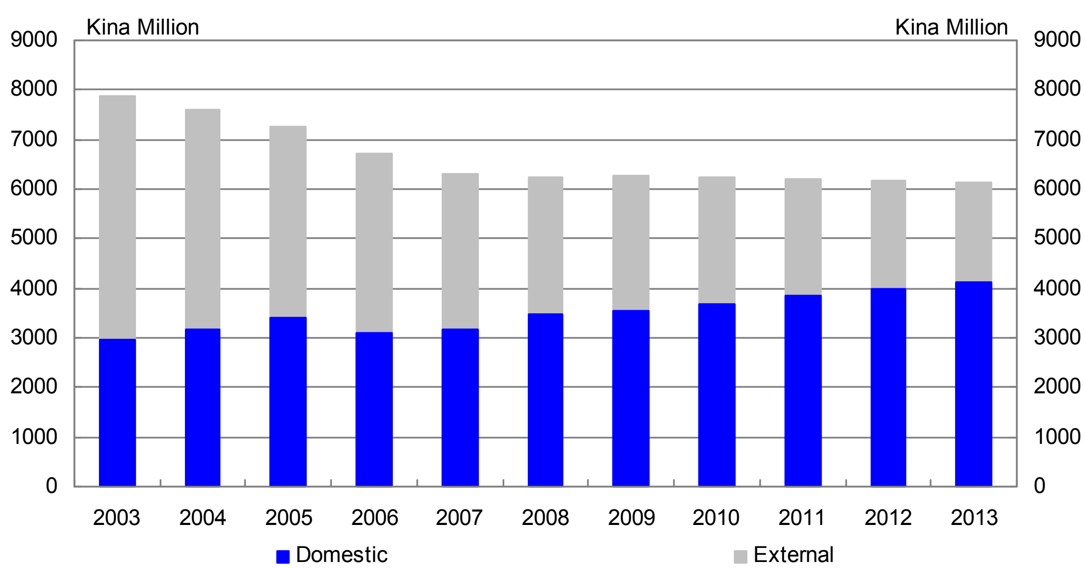
On average, emerging market countries have only 10 per cent of their domestic debt in Treasury Bills (IMF's 2007 Global Financial Stability Report Chapter III). The recent international financial crisis highlights the importance of not depending heavily on short-term debt. The 2009-2013 projections assume Treasury Bills will be between 25% and 10% of domestic debt.

Table 67: Approximate Composition of Domestic Debt by Instrument

Instrument Type	Current Range Per cent	Target Range Per cent
Treasury Bills	32	15-30
Inscribed Stocks / Other	68	70-85

Source: Department of Treasury

Figure 28: Currency Composition of Government Debt 2003-2013 (Kina Millions)



Sources: Department of Treasury

[4] The grant element is the difference between the face value and the market value of a loan expressed as a percentage of the face value of the loan.

10.3.4 Refinancing Risk

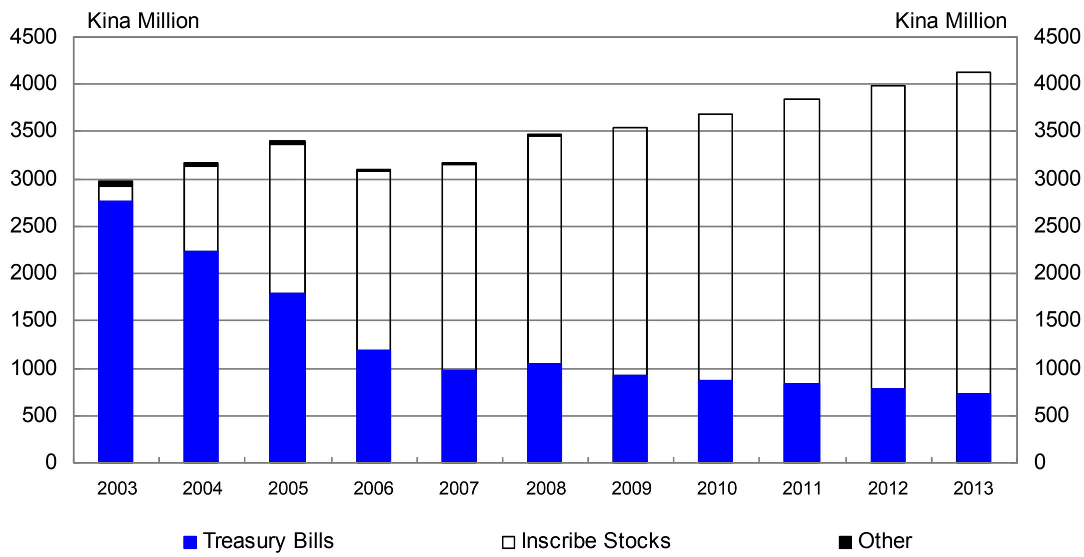
The Debt Strategy will maintain the average maturity at about 5 years for the domestic debt portfolio, and an average maturity at about 8 years for foreign-currency debt.

The Debt Strategy will aim to broaden the number and type of investors, and there will be continued efforts to improve communication with investors and to involve the Minister on presentations to current and potential investors.

The Debt Strategy will consider any recommendations from the Financial Sector Assessment regarding the capacity of the financial sector to safely invest in Government securities without crowding out the private-sector borrowers or increasing the contingent liabilities of the State.

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 Stocks from K2.4 billion at the end of 2008 to K3.4 billion in 2013, while increasing the maximum maturity of Inscribed Stocks from the current maximum of 17 years to 20 years, and limiting the amount of Inscribed Stocks maturing in any one year to K500 million.

Figure 29: Composition of Domestic Debt 2003 – 2013 (Kina Millions)



Source: Department of Treasury

10.3.5 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 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 to continue to improve the effectiveness of CSDRMS and to provide CSDRMS training. Treasury must formulate and regularly test a business continuity plan.

10.4 DEVELOPING GOVERNMENT INSCRIBED STOCKS, BILL AND LOAN MARKETS

There was little progress in developing the domestic market in 2008. In part, this was due to staff turnover. To counter this lack of specialised staff, Treasury has established a Domestic Debt Market Project in partnership with the domestic financial institutions. Two of the staff are from private-sector financial institutions, and half of the steering committee will be senior executives or chief executive officers of local financial institutions.

The Project will make the three most important, feasible improvements identified by stakeholders in 2007: (i) improving coordination between State entities responsible for financial obligations; (ii) providing investors with data that meet the IMF's debt data dissemination standards, and (iii) removing barriers and improving communication so as to broaden the investor base.

10.5 LONGER-TERM IMPROVEMENTS

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. Treasury will consider the recommendations of the IMF's Financial Sector Assessment, and the Debt Management Review by the World Bank or independent consultant. Treasury will survey all stakeholders 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 2010. Longer-term strategies could include:

- Developing a whole-of-government risk management framework based on asset-liability management principles
- Development of stochastic risk measures and limits
- Development of liquid primary and secondary markets in Kina-denominated Inscribed Stocks, Bills and Loans

These longer-term initiatives are not currently feasible given the limited resources and competing priorities of the Government and stakeholders. These improvements are complex and will take many years to implement as they will involve investors and financial institutions, as well as the judiciary, the legal and accounting profession, regulators, utility providers, industry organisations and other public sector entities responsible for managing financial asset, liabilities and exposures.