



Domestic and External Debt Management: Perspectives from Pacific Islands Nations

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Outline

- Debt situations in Pacific Island economies
 - Drawing from the experiences mainly from 7 Pacific Island countries (Cook Islands, Fiji Islands, Papua New Guinea, Samoa, Solomon Islands, Tonga, and Vanuatu)
- Management issues associated with external debt, domestic debt, short term debt, private sector debt, contingent liabilities, on-lending, sub-national debt
- Debt management & domestic debt market development
- Debt restructuring as part of debt management
- Interaction of debt management with key macroeconomic policies (fiscal, monetary, exchange rate, etc)
- Institutional issues in debt management



Double sword nature of debt finance

- External capital served as important source for financing development
 - Experience of newly industrialising economies (NIEs) of Asia and Latin America
- High public debt, particularly external debt, acted as obstacles to development in a large number of countries
 - Third World Debt Crisis of 1980s
 - Continuation of debt problems in several low & middle income countries of Africa and Asia since 1980s
 - Crisis in Mexico (1994), East Asia (1997), Brazil (1998), Russia (1998), Turkey (2001) and Argentina (2001)



High public debt, external as well as domestic, can act as obstacles to development

- Weakens the government's ability to achieve macroeconomic stability (inflation, interest rate & exchange rate targets)
- Creates adverse incentives associated with future taxes
- High debt servicing halts social and developmental progress
- Rescheduling/default erode the sanctity of credit contracts
- Need to channel debt for development, productive utilization of borrowed resources



Special characteristics of the Pacific Islanders

- Pacific Island economies are small (high debt/GDP ratio)
- Characterized by low savings rates and underdeveloped domestic securities markets
- Highly sensitive to the general conditions in world economy
- Have significant commodity concentration in their exports, as well as significant bilateral trade imbalances
- Exhibited considerable fluctuations in their economic growth in recent years, with declining trends in a few
- Exacerbated in most cases by natural disasters
- Fluctuations in migrant remittances & inward tourism flows
- Depended to a large extent on the financial flows from bilateral and multilateral donors
- Lacking access to private sources of international borrowing



Debt management complexity depends to a large extent on the economic characteristics of the country, the size and structure of domestic securities market facilitating government financing, resilience of the economy to absorb shocks, as well as track record of international borrowings



Issues in external debt management :

- Public debt of Pacific Island states comprise primarily of external debt, with the exception of Fiji and PNG
- Maintaining the level of external debt consistent with the trends in balance of payments and its sustainability
 - Undertake regular debt sustainability analysis (DSA)
- Government should ensure new borrowings, within its risk and cost preferences
- Maintain an optimum composition of external and domestic debt in the public debt portfolio
 - Develop domestic debt markets to facilitate future financing of budget



External Debt Sustainability Thresholds

WB/IMF assesses the debt sustainability in relation to indicative country-specific debt burden thresholds by relating to the quality of policies and institutions

Assessment of Institutional Strength and Quality of Polices

Indicative Thresholds(%)	<u>Poor</u>	<u>Medium</u>	<u>Strong</u>
NPV of debt/GDP	30	45	60
NPV of debt/exports	100	200	300
NPV of debt/revenue*	200	275	350
Debt service/exports	15	25	35
Debt service/revenue	20	30	40

*Excluding Grants

Based on a paper “Debt Sustainability in Low-Income Countries: Proposal for an Operational Framework and Policy Implications”, the IMF and the World Bank, February 3, 2004.



External Debt Ratios of Selected Pacific Countries Average for the years 2002–04

	Total external debt (EDT) to exports of G&S (XGS)	Present value (PV) of EDT as % of XGS	EDT as % of gross national income (GNI)	PV as % of GNI	Total debt service as % of XGS	Interest service as % of XGS
Fiji	16	16	9	9	1	0
PNG	87	80	72	66	19	3
Samoa	451	400	177	158	17	13
Solomon Islands	169	129	76	58	16	6
Tonga	125	90	46	33	4	1
Vanuatu	81	64	44	35	2	1

Source: Global Development Finance, 2006



Benefits of Creditor Diversification

- Borrowing country should access alternative sources of external finance: bilateral, multilateral, private, bond & bank based arrangements, etc
 - Scouting for lenders with complete terms and conditions, rather than on concentrating on restricted choices;
 - Over concentration on one/two major lenders is expected to affect the future changes in the lender behavior;
- Diversity in creditors is expected to bring diversity in the deployment of such funds sector-wise
- Possible to explore credits with more innovative structures



Prepare public sector access to global capital markets

- Preparing public sector enterprises for external borrowings, for their investments & expansion
 - Well within legal framework and country ceiling for such borrowings
 - Phasing out external commercial borrowings with government guarantee
 - Clearly defining who bears the foreign exchange risk
 - Monitoring their end-use and repayments



Criticality of Private sector external debt

- Excessive borrowings by private sector would have significant balance of payments implications
 - The stock of public debt would significantly accelerated following the financial crisis or exchange rate collapse in post crisis Asia
 - Created severe non-performing loan (NPL) problems, resulting in bank failures, disrupting of the financial sector
 - Fiscal costs due to bail out, following a bank failure or the cost of corporate restructuring after a major currency crises
- Consider the external liabilities of the private corporate sector as well as financial intermediaries (commercial banks, DFIs, NBFCs)
- Financial institution's external borrowings for on-lending should be monitored by the central bank, for macro prudential regulations
- Need to record and monitor private sector debt while gauging the country's overall external exposure



Importance of Sovereign credit ratings in external borrowings

- External capital flows respond changes in credit ratings (by S&P and Moody's, etc)
- Global risks assessment has been exacerbated by country risk revisions
- Private capital flows have been sensitive to changes in credit ratings, and are influenced to a large extent by macroeconomic situation, debt and reserve level and political stability
- In April 2004, the Fitch Ratings upgraded the long-term foreign currency rating of Papua New Guinea to B+, which has been stable since then
- Cook Island's long term foreign exchange rating was upgraded to BB+ in December 2005
- Fiji's foreign exchange rating was down graded to B, following the military coup in December 2007



Debt management & debt market development

- Domestic debt management issues in general are no longer considered merely as part of the budgetary exercises
- High level of government debt along with inconsistent fiscal monetary policies can raise market interest rates (thereby future debt costs) through raising risk-premium in the structure of long term debt
- Debt management with narrow focus on debt market development can constrain long run sustainability of domestic financing & its roll over
 - Fragmented domestic debt markets with too many instruments as well as contractual feature, affecting liquidity & depth of debt market
 - Bunching of debt maturity creates rollover risk, constrain the length of the yield curve and liquidity
 - Overlaps of debt management and monetary policy objectives, often central bank and treasury issuing similar securities, thereby fragmenting the market



Recent shift towards domestic debt markets

- Recent shift towards domestic debt in some countries are in response to the increased risks perceptions of external debt, as several countries are resorting gradually to higher domestic borrowing
 - PNG has been issuing medium term Inscribed Stocks since external debt difficulties in 2003
 - Fiji's cautious policy of external borrowings has landed in a situation of high domestic debt
 - Tonga has been resorting to roll over of domestic debt, mostly due to fiscal pressures that are due to higher debt service burden
 - Solomon Islands might begin issuing bonds after Honiara Club restrictions are eased
 - Vanuatu intends to issue domestic bonds to finance budget deficit
- Building of Government securities markets should be an important aspect of debt management



Domestic Debt Market Development: Issues

- Creation of liquid debt market: benchmark bonds, re-opening, exchange offers
- Efficient selling techniques for securities: auctions
- Widening of the investor base
- Secondary markets trade: ensuring liquidity
- Repos & money market instruments
- Efficient trading and settlement infrastructure
- Provision of adequate investor protection
- Strengthening of institutions and intermediaries
- Rationalization of regulatory framework



Foreign Issuers in Local Market

- Recent efforts by ADB to issue local currency bond issuance in China, India, Malaysia
- Such issuances have shown great interest by local investors



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- Such issuances have shown great interest by local investors
- Local bond proceeds can fund projects as well as other long-term **local** investment needs, thereby reducing the need for external financing



Contingent Liabilities

- (Unfunded) contingent liabilities carry significant fiscal risks, can impact on future debt obligations of Government
 - Explicit contingent liabilities may include sovereign guarantee of borrowings by statutory bodies, exchange rate and interest rate risk guarantees, etc
 - Implicit contingent liabilities may include contractual or legal obligations conditional upon certain events such as ensuring systemic solvency of the banking system.
- Implicit contingent liabilities are more difficult to assess than their explicit counterparts, due to the **potential moral hazard issues involved**.
- Contingent liabilities can have far greater implications in the presence of **poor governance and regulatory regimes**



Government On-Lending

- Government loans that have an equivalent on-lending arrangement with parastatals & other state owned entities might become future liabilities of Government
- Clear demarcation of policy as to when to on-lend vs when to extend guarantees against their own borrowings, and when borrowings on their own be encouraged
- Need to have a **master on-lending agreement** ensuring transparency, and determining the terms and conditions compatible with the underlying loan itself
- Typically **bankruptcy laws** don't extend to public utilities sector and public service providers, therefore difficult to deal with defaults



Implications of short term debt

- Short-term debt classification as per new IMF/WB Debt Guide
 - Value of outstanding short-term external debt (original maturity basis), plus;
 - Value of outstanding long-term external debt due to be paid in one year or less (remaining maturity).
- Short-term external capital flows are volatile, reversible, and can create liquidity crisis
- Make analysis of various forms of short term external debt (short term trade credits, foreign currency deposits, non-residents flows, portfolio investments), considering their vulnerability factors
- Short term domestic debt (treasury bills, other borrowings) can create significant rollover problems and implications on money markets



Sub-national debt

- Trends towards decentralization have necessitated borrowings by sub-national entities such as provinces, local governments, and local utility providers
- Sub-national borrowings have implicit government guarantee, thereby carrying significant fiscal risk and eventually taking over of the obligations by the national government
- Sub-national borrowings can complicate the exact nature of liabilities as these can have more **complex structure** involving credit enhancements, guarantees, securitization of receivables, linkage with federal transfers as well as political interference



Sub-national debt management

- Leveraging the internal resources of the local governments with market borrowings for local infrastructure creation is desirable
- However, there is need to monitor the level of sub-national debt, within government debt management functions
- Need to put in place appropriate regulations of for such sub-national debt, with clearly defined borrowing powers, nature of guarantee mechanisms and potential for government contingent liability, guarantee fees, ensuring the debt management practices, bankruptcy regulations with defined and enforceable debt contracts
- Promoting market based credit discipline of the local governments, with fair disclosure and accounting, and better management practices



Debt restructuring

- Undertake regular debt portfolio review
 - domestic as well as external debt
- Evaluate trade offs in new borrowings
- Identify opportunities to reduce the cost of debt service
 - Prepay high cost debt by taking advantage of favorable borrowing conditions
- Identify opportunities for debt restructuring (Debt refinancing, debt buyback, debt conversions)
 - Calculate costs and benefits of restructuring
- Use the world's best practices such as debt conversion schemes
 - debt-for-equity swaps, debt-for-environment swaps, debt repayment against export deliveries, debt-for-investment scheme (in specific projects)



Debt management & Fiscal Policy

- Government debt build up typically originates from **sustained fiscal deficits**
- However debt build up cannot continue indefinitely without a **fiscal crisis**, as a high level of debt-to-GDP ratio can threaten fiscal sustainability, **requiring correction**
- Fiscal deficit becomes unsustainable in the presence of an **ever-increasing debt-to-GDP ratio**
- Additional borrowings (domestic or foreign) in the presence of a debt-to-GDP ratio only **postpones the crises**
- Stabilization requires **running primary surplus**
 - The higher is the **initial stock of public debt stock**, the more difficult it becomes to run primary surplus
- Government should have an **integrated strategy for managing debt & fiscal sustainability**



Debt Management & Monetary Policy

- Debt management should focus on financing with costs/risk trade-offs, while monetary policy should aim at achieving price stability, supporting debt market development for government financing
- Government borrowing programs should be determined by the fiscal policies as well as debt market developments, while monetary policy is carried out independently from debt management
 - It is necessary to ensure that debt managers are not opportunistically transacting on the basis of privileged or inside information about market liquidity
 - Cost minimization should not be viewed as a mandate to reduce market interest rates nor resort to low cost credit from the central bank, as the later can be inflationary
- Central bank to move towards market based instruments for conducting monetary policy rather than direct controls
- Government not to adopt issuance strategy that would affect interest expectations in the market



Debt Management & Monetary Policy

- Choice of instruments for monetary policy and for government financing can have important implications liquidity and interest rates
- Central banks typically undertake monetary policy operations using government debt instruments (i) conducts outright sale of government securities, (ii) issues its own securities (T Bills primarily), or (iii) uses repurchase/reverse agreements with government securities
 - Such actions can affect interbank rate & liquidity, and thereby raising budget costs
 - Higher costs to central banks can be due to the costs of interventions, which are passed on to Government through lower profits for the former
- Another instance of trade-off is when central bank prefer Government to raise foreign currency loans as this might increase reserve levels, but Government would perceive external borrowing adding an extra risk to its balance sheet



Exchange Rate Policy

- Pegged exchange rate regimes were susceptible to overvaluation, policy inconsistencies and speculative attacks
 - East Asia experience of the bail-out costs of the private sector following a currency crisis or the costs of foreign exchange market intervention and loss of reserves
- Maintaining undervalued exchange rates often lead to high costs of debt service
- Overvalued exchange rates support higher imports and current account imbalances
- Objectives should be to balance between two goals:
 - Maintain price competitiveness of exports/ imports and prevent a rise in the cost of external debt servicing
 - Need to have real exchange rate targets



Reserves Adequacy

- Countries need to maintain adequate foreign exchange reserves:
 - reserve adequacy for short term liquidity management (import cover) as well as potential for debt servicing
 - reserve holdings for exchange market interventions
 - reserve adequacy in relation to stock of short-term debt and portfolio flows
 - Reserves ensuring credibility in international markets
- Some countries have built reserves by raising external borrowings/bond financings
 - Need to examine the opportunity cost of holding reserves through borrowings



Strengthening Institutional Arrangement

- Clarity in the legal authority to borrow
- Setting borrowing limit/ceiling, preferably annual
- Defining the boundary of operations between MOF and Central Bank
- Setting up of debt office and its operational framework
- Establishing of debt management committee
- Ensuring coordination among the various functionaries of government
- Framing debt management guidelines and manuals



Role of Central Bank and Ministry of Finance

- Define roles for Central Bank and Ministry of Finance by having an effective agency agreement in place
- MOF acts as the key player in developing the government debt market, as the issuer of government debt instruments
 - advising central bank to undertake government borrowing program with focus on debt market development
- Central bank acts as the fiscal agent, executes auctions, carries out back-office operations, promote money market instruments, ensuring stability in liquidity conditions, and improving trading and settlement infrastructure
- Agree co-ordination structures, sharing of information (e.g. cash flow forecasts) and create understandings to avoid competing market interventions and signalling

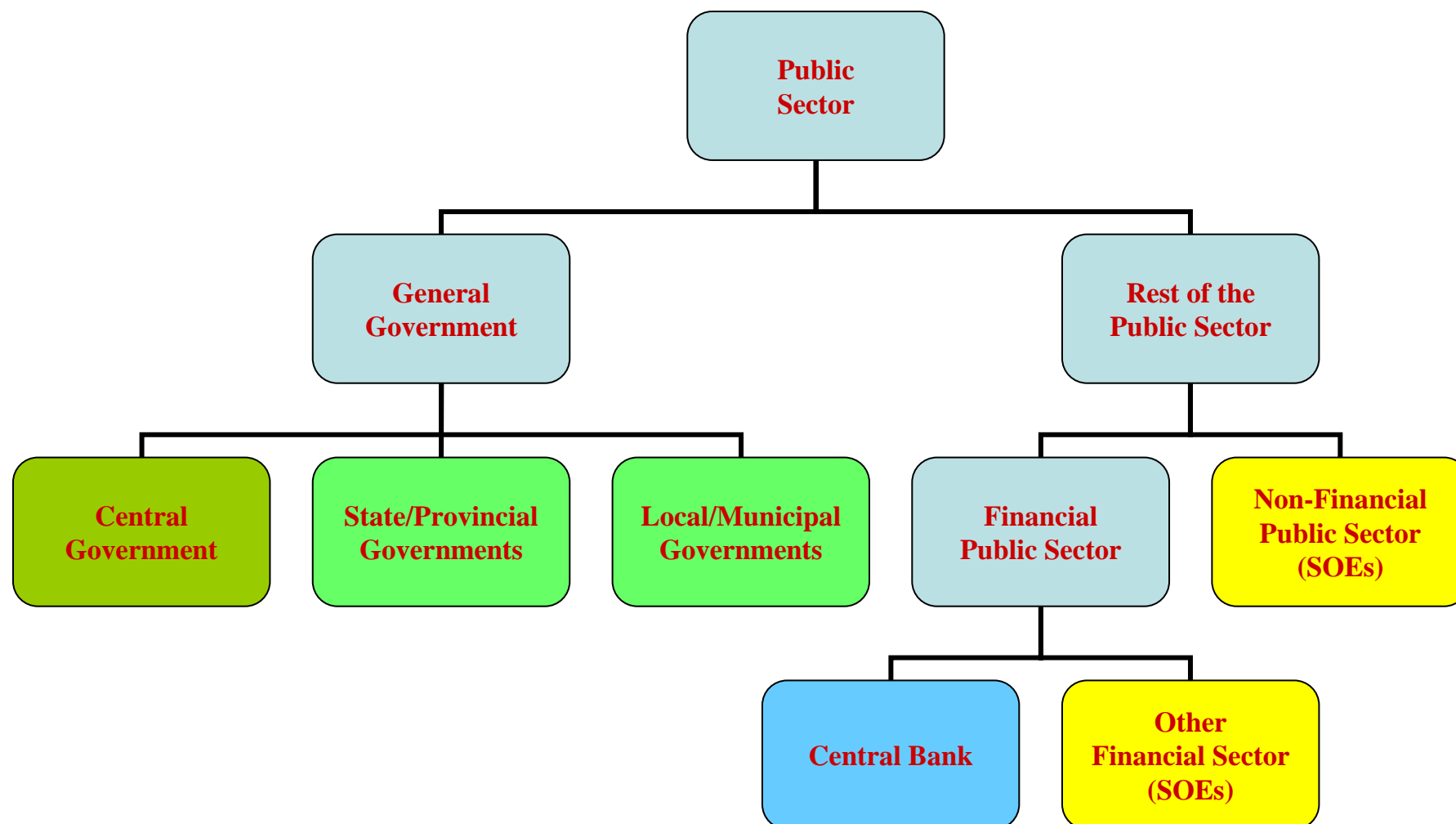


Integrated approach to debt management

- Maintaining sustainable debt level in relation to key macro variables
- Diversifying borrowing sources
- Determining appropriate maturities of debt portfolio
- Determining an optimum mix of domestic and external debt in the debt portfolio
- Developing government securities markets
- Coordinating debt management with macroeconomic policy
- Strengthening institutional structure of debt management



Consider a comprehensive measure of public debt to include external, domestic, contingent liabilities, on-lending, short term debt, other liabilities (arrears)





Debt Data Capture

- Recording of debt, analysing debt portfolio and making policy analysis
- Ensure reliable and comprehensive data availability
- Compatible with emerging multilateral debt standards
 - External Debt Statistics: Guide for Compilers and Users (2003)
- Interface with the with government financial management information systems



Commonwealth Secretariat

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Questions?