Ministry Paper # _22____

DEBT MANAGEMENT STRATEGY FY 2005/06

Ministry of Finance & Planning

April 14, 2005

MINISTRY PAPER NO _______

DEBT MANAGEMENT STRATEGY FY 2005/06

INTRODUCTION

1. Effective and strategic management of Jamaica's public debt has been an important pillar of the Government's fiscal and macro-economic programme. In this regard, the Government's medium-term *Debt Management Strategy* is a critical planning and policy tool. The Strategy is designed to return the public debt to sustainable levels while ensuring that the overall borrowing requirements are met at minimum cost and consistent with a prudent degree of risk.

2. Over the past six (6) years, the Government has made significant progress in strengthening the management of the public debt. The portfolio has been restructured, evidenced by an extension of the maturity profile; an increase in the share of fixed-rate debt in the portfolio, thereby protecting the fiscal operations from unexpected increases in interest rates; diversification of the portfolio in terms of the investor base, instrument type and market sources; and increased transparency and predictability. These developments have allowed for reasonable cost stability under various scenarios in a changing interest and exchange rate and macro-economic environment. They have also contributed to increased confidence among investors, international financial institutions and credit rating agencies.

3. The market environment in FY 2004/05 was much improved over FY 2003/04, both locally and internationally. Jamaica's improved credit story, arising from the improvements in fiscal performance and macroeconomic climate, contributed to the increased investor confidence. In the domestic market, interest rates continued to trend downwards and the foreign exchange market remained stable.

4. International investors demonstrated their increased confidence through their overwhelming demand for Government of Jamaica's eurobonds, enabling the Government to successfully place three (3) Eurobond issues in the international capital markets, thereby completing its external borrowing within the first seven (7) months of the fiscal year. In April

2004, US$125 million was raised through the re-opening of the existing US$300 million 10.625% bonds due in 2017. In July 2004, €200 million 11.0% bonds due 2012 were issued among European investors. The issue was upsized from €100 million. This was followed in October 2004 by the successful placement in the European markets of €150 million 10.5% bonds due 2014.

5. Under the Schedule B Shelf Registration programme with the United States Securities and Exchange Commission, the amount placed on the "Shelf" was replenished to US$700 million, reflecting the Government's medium-term external borrowing programme. Between FY 2001/02, when the "Shelf" was established, and FY 2002/03, US$300 million was drawn down.

6. These achievements were impressive as they took place after the adverse developments in FY 2003/04, which included the lowering of Jamaica's credit ratings by Moody's Investors Service and Standard & Poor's. In December 2004, Standard & Poor's upgraded its outlook on Jamaica's long-term debt from "Negative" to "Stable", citing factors such as improvement in the fiscal performance and external liquidity position; Government's demonstrated commitment to fiscal prudence; and stronger growth prospects. The combination of the positive macro-economic developments locally and strong investor sentiments was reflected in the exceptionally strong performance of Jamaica's eurobonds during the year.

Review of FY 2004/05

7. At the end of March 2005, total public sector debt stood at $759.7 billion. This represented an increase of 9.5% over the stock of $693.9 billion recorded at the end of March 2004. Although the stock of debt increased by 9.5%, the rate of growth was slower than the 15.4% increase recorded for FY 2003/04 over FY 2002/03. The Debt-to-GDP ratio improved from 140.0% for FY 2003/04 to 136.6% for FY 2004/05.

8. The stock of public and publicly guaranteed external debt stood at $310.5 billion (US$5,044.4 million) or 55.8% of GDP. This represented an increase of 12.4% compared with the stock at the end of March 2004. In US$ terms, the external debt rose by 11.4% from US$4,529.0 million at the end of March 2004. The increase primarily reflected:

- The issuance of eurobonds in the international capital markets in excess of gross external amortization; and
- Revaluation and parity changes in respect of some multilateral debts.

9. Central Government domestic debt totaled $449.2 billion or 80.8% of GDP, an increase of 7.6% relative to the $417.6 billion stock recorded at the end of March 2004. The main factors accounting for the increase were:

- The issue of securities to the Bank of Jamaica representing capitalization of accrued interest on BOJ/FINSAC Local Registered Stocks (LRS); and
- The assumption of contingent obligations on behalf of public sector entities and in respect of deferred financing arrangements following the completion of a number of infrastructure development projects; and of obligations relating to Government's support to the UWI and UHWI.

10. The combined effect of higher than programmed external borrowing and reduced budgetary financing requirements, consequent on the lowering of the fiscal deficit, translated into a marked reduction in the rate of the growth of the domestic debt from 14.0% in FY 2003/04 to 7.6% in FY 2004/05.

11. In keeping with the medium-term strategy, the FY 2004/05 D*ebt Management Strategy* sought to:

a) Maintain a prudent debt structure by:

   (i) Maintaining an appropriate mix of fixed-rate and floating-rate debt to further diversify and minimize interest-rate risk; and
   (ii) Extending and smoothing the maturity profile of the debt to better manage refinancing risk

b) Continue to increase the transparency and predictability of debt issuance.

12. The Government made modest progress in executing its Debt Management Strategy in FY 2004/05.

Maintaining a Prudent Debt Structure

Maintain an appropriate mix of fixed-rate and floating-rate debt to further diversify and minimize interest-rate risk

13. In FY 2001/02, the Government emphasized increasing the fixed-rate component of the domestic debt portfolio as a priority area in order to protect the fiscal operations from interest rate volatility. Consistent with international best practice, a medium-term target of 60% of total domestic debt was established. Over the years, the fixed-rate component of the domestic debt portfolio has increased from 7.0% in FY 1999/2000 to 48.4% in FY 2002/03 and 58.6% in FY 2004/05. For the external debt portfolio, the share of fixed-rate debt increased to 76.2% in FY 2004/05, up from 72.3% in FY 2003/04.

Extend and smooth the maturity profile of the debt to better manage refinancing risk

14. The Government had moderate success in extending the maturity profile of the domestic debt in FY 2004/05, despite the lowering of interest rates and stability in the foreign exchange market. Domestic investors displayed a preference for short to medium-term securities over longer-term securities. The market environment was therefore not conducive to implementing plans to "smooth" the domestic amortization profile through the exchange of securities nearing maturity for new instruments with longer maturities.

15. Of total new domestic debt issued in FY 2004/05, 75.7% had maturities of up to 5 years compared with 94.3% in FY 2003/04. Issues with maturities of over 5 years accounted for 24.3% compared with 5.7% in FY 2003/04. Of these, issues with maturities between 5 and 10 years grew significantly from 1.5% in FY 2003/04 to 16.5% in FY 2004/05. Some 7.8% of the new domestic debt was issued with maturities of 10 years and over, compared with 4.2% in FY 2003/04.

16. Of the total domestic debt outstanding at the end of FY 2004/05, 74.4% had maturities of up to 5 years compared with 73.1% at the end of FY 2003/04 and 63.9% at the end of FY 2002/03. Issues with maturities of between 5 and 10 years increased from 14.0% in FY 2003/04 to 15.3% in FY 2004/05. Maturities of 10 years and over accounted for 10.3% of the outstanding domestic debt stock, down from 12.8% at the end of FY 2003/04.

17. In the Euro markets, the Government took advantage of favourable market conditions and strong investor demand and accessed the traditionally longest part of the euro-curve. With the two (2) euro-denominated bonds having 8-year and 10-year maturities, the Government established a liquid euro-denominated yield curve.

Minimize Currency Exposure

18. Significant progress was made in reducing the foreign exchange risk of the domestic debt. At the end of FY 2004/05, US$-Indexed Bonds totaled $37.2 billion (US$599.9 million equivalent) or 8.3%, of the domestic debt portfolio. This compared with $51.5 billion (US$841.5 million equivalent) or 12.3% at the end of FY 2003/04. The stock of US$-denominated bonds stood at $47.5 billion (US$772.4 million) or 10.6% of the domestic debt portfolio at the end of March 2005. This compared with $45.3 billion (US$742.8 million) or 10.9% of the domestic debt stock at the end of March 2004.

Increase Transparency and Predictability

19. An important objective of the Debt Management Strategy continues to be increasing transparency and predictability in the execution of the policies. The Government continued to publish comprehensive domestic and external debt data on the Ministry of Finance and Planning's website on a monthly basis. Information on the Government's debt operations is publicly disclosed by means of monthly schedules of upcoming issues. During the year, the Government began publication of its quarterly borrowing requirements. Information on Government's debt, its strategy, operations and relevant investor information are also available on the Ministry's website.

20. During the year, the Government updated the documentation placed with the United States Securities and Exchange Commission as part of the filing requirement of the Schedule B Registration process.

Market Consultation

21. The Government continued its market-oriented approach during FY 2004/05, actively engaging the local and international financial communities in dialogue through various media such as press conferences, meetings, investor fora and presentations, quarterly conference calls and a road show in major European cities. Formal consultations and discussions between the public and private sectors continued in an effort to explore options for reducing the debt and debt service costs.

Diversification of the Debt Portfolio

22. Jamaica's improving credit profile and scarcity value continued to create opportunities for international investors to diversify their portfolios. In recent years, the Government has invested time and resources in building relationships with domestic and international investors. In FY 2004/05, on the external side, the focus was on the European investors. The two euro-denominated bond issued during the year benefited from this strategy. Distribution of the bonds reached a wide geographic area and included fund managers, banks, insurance companies, retail investors and hedge funds. In the domestic market, frequent issues of short- to medium-term fixed-rate instruments allowed for increased investment by retail investors.

Legal and Regulatory Framework

23. During the fiscal year, a review of the amount of loans raised under the Loan Act vis-à-vis the loan ceiling was undertaken and it was determined that there was sufficient room under the ceiling to satisfy the Government's borrowing programme. The Loan Act 1964, and its subsequent amendments, is the Government's primary borrowing authority. The ceiling under the Act was increased in February 2004.

24. A preliminary review of the legal, regulatory and institutional framework relating to the management of the public debt was also undertaken during the year. The review identified areas for amendments in order to be consistent with the sophistication of the capital markets and with technological advances.

DEBT MANAGEMENT STRATEGY FY 2005/06

25. The management of the public debt in FY 2005/06 will be conducted in the context of Government's fiscal policy of achieving a balanced budget in the fiscal year and surpluses thereafter. Debt management in FY 2005/06 will continue to be guided by the fundamental objective of the Government's medium-term *Debt Management Strategy* of lowering the cost of borrowing, subject to the containment of risks within acceptable levels. Risk management has been an important tool in debt management and given the debt dynamics, will form a critical aspect of the funding policy in FY 2005/06 and beyond.

26. The medium-term objectives of the *Debt Management Strategy are* aimed at:

- Maintaining a prudent debt structure;
- Further diversifying the debt portfolio;
- Using market mechanisms for domestic debt issuance;
- Promoting and building a liquid and efficient market for Government securities; and
- Increasing the transparency and predictability of debt issuance.

27. Within this context, in FY 2005/06 the *Debt Management Strategy* will continue to seek to:

- Maintain an appropriate mix of fixed-rate and floating-rate debt to further diversify and minimize interest-rate risk;
- Extend and smooth the maturity profile of the debt to better manage refinancing risk; and
- Continue to increase the transparency and predictability of debt issuance.

Maintaining a Prudent Debt Structure

28. The size of the debt stock dictates maintenance of a prudent debt structure, making this a priority of the Government of Jamaica. The public debt portfolio is exposed to various risks - interest rate, refinancing (roll-over) and exchange rate risks. The protection of the fiscal operations from unexpected increases in interest rates, volatility in the exchange rates and refinancing risks remains an important aspect of debt management.

Maintaining an Appropriate Mix of Fixed-rate and Floating-rate Debt to Further Diversify and Minimize Interest-rate Risk

29. Significant progress has been made in increasing the share of fixed-rate debt. In FY 2005/06, the Government will continue to issue a mix of fixed-rate and variable-rate instruments in order to further diversify the interest rate risk on the domestic debt portfolio, thereby prudently mitigating the risks to the fiscal budget. The fixed-rate target of 60% of the domestic debt portfolio will be maintained, in keeping with international best practice.

Extending and Smoothing the Maturity Profile to Better Manage Refinancing Risks

30. Achieving and maintaining a stable maturity profile are critical to reducing refinancing risks. The Government will continue its efforts to lengthen the maturity profile of the debt. While attempting to satisfy the investment needs of retail as well as institutional investors locally and internationally, the Government will seek to limit the concentration of debt maturities in the near-term and spread the maturities over the medium to long-term.

Minimizing Exchange Rate Risk

31. The Government has and will continue to take the necessary steps to reduce the foreign currency exposure of the public debt portfolio to internationally acceptable standards. Except under extraordinary circumstances, the Government will continue to restrict the use of US$-Denominated and US$-Indexed instruments in the domestic market in order to reduce the exposure of the domestic debt portfolio over the medium-term. On the external side, the

Government will maintain its policy of borrowing externally to the extent of the gross external amortization in order to maintain favourable external indicators.

Increase Transparency and Predictability

32. The Government has reaped significant benefits from its demonstrated commitment to transparency and predictability in the markets. These guiding principles have helped to reduce borrowing costs, strengthen Government's credibility and enable market participants to plan their investment strategies. The Government remains committed to these principles, notwithstanding the decreasing levels of financing needs.

33. The Government will continue to offer new securities in the domestic market on a regular pre-announced basis. Securities will be issued through market mechanisms (auctions) and offers of fixed priced instruments as well as private placements.

34. While the Government will seek to rely on market mechanisms for the issuance of securities, it will continue to issue securities through private placements. In instances where securities are issued through private placements, the Government will continue to invite proposals from a wide cross section of financial institutions in order to ensure transparency and competitive pricing.

35. During the year, the Government will be reviewing the auction system and intends to implement measures to enhance the functioning of the auction system. Government will be engaging market participants in discussions about ways to improve the system in order to ensure greater competitiveness and fairness.

36. Transparency in the Government's debt operations and borrowing programme will continue to be enhanced by:

- Monthly publications of comprehensive external and domestic debt data;
- Advanced notices of upcoming debt issues;
- Quarterly announcements of Government's borrowing requirements;

- Monthly schedules of market issues; and
- Timely publication of the results of market issues.

37. These, along with the Government's *Debt Management Strategy* and relevant investor information, will continue to be made available in the print media and/or electronically on the Ministry's website (www.mof.gov.jm/dmu). This is consistent with the high level of importance the Government places on the dissemination of accurate, comprehensive and timely information to the domestic and international financial communities.

Calendar of Announcements

38. The Ministry of Finance and Planning will continue to make available to the markets, gross financing requirements for the ensuing quarter at the beginning of each quarter. Monthly schedules of market issues will be announced by the end of the preceding month. The schedule will initially indicate the timing and type of instruments to be placed in the market. Details of the terms and conditions of the instruments will be provided to the market at least four business days prior to the subscription dates.

Market Consultation

39. Continuous dialogue with domestic and international investors has proven beneficial. The Government will continue to hold regular meetings with the domestic and international market makers. In addition, quarterly investors' conference calls will continue as will investors presentations and road shows in North America and Europe.

Legal and Regulatory Framework

40. Over the course of the fiscal year, the Ministry of Finance and Planning, after consultation with the Attorney General's Department, will take the necessary steps to update a number of the statutes that governs debt management. The statutes relating to LRS, Debentures and Treasury Bills will be amended to include, *inter alia*, facilitation of the electronic registration of securities.

Government Borrowing Requirements FY 2005/06

41. Gross issuance in FY 2005/06 is programmed to be moderately lower than in FY 2004/05. The budgetary financing requirement is forecast at $142.7 billion, consistent with gross amortization and in the context of a balanced budget. Of this amount, it is proposed to raise $107.6 billion in the domestic market through various instruments across the yield curve.

42. Funding from official sources is projected at US$43.3 million in FY 2005/06. Over the course of the year, the Government will seek to secure some US$500 million in the international capital markets. The timing, currency mix and structure will depend on relative costs, market conditions and opportunities. Government will continue to secure these funds in a transparent manner and consistent with its medium-term *Debt Management Strategy* objectives.

43. In addition to budgetary financing requirements, non-budgetary debt issuance for the fiscal year is projected at $4.7 billion to cover capitalization of accrued interest on BOJ/FINSAC LRS.

44. The combination of reduced financing requirements in light of a balanced budget and higher levels of economic growth in FY 2005/06 will result in the continued reduction in the Debt-to-GDP ratio.

Omar Davies M.P.

Minister of Finance and Planning

April 14, 2005

APPENDIX I

SIGNIFICANT DEVELOPMENTS IN DEBT MANAGEMENT

- July 1997 – Jamaica's Re-entry into the International Capital Markets
- March 1998 – Initial Sovereign Rating by Moody's Investors Service
- April 1998 – Consolidation and Centralization of Debt Management Functions within the Ministry of Finance and Planning
- April 1, 1998 – Establishment of the Debt Management Unit
- April 1999 – Long-Term Savings Accounts Introduced
- June 1999 – Implementation of 15% Tax on Interest withheld at Source Policy
- July 1999 – US$ Indexed-linked Bonds introduced in the Domestic Market
- October 1999 – Auction System for the Sale of Local Registered Stocks (LRS) introduced
- November 1999 – Initial Sovereign Rating by Standard & Poor's
- April 2000 – First Publication of the *Debt Management Strategy*
- April 2000 – Implementation of 25% Tax on interest withheld at source policy
- March 2001 – Jamaica included as Case Study in IMF/World Bank Publication of *Guideline for Public Debt Management;* Example of country implementing prudent debt management practices consistent with the Guidelines
- April 2001 – First 12-year LRS sold by auction. A total of six 12-year LRS' issued by auction during the fiscal year
- May 2001 – First 10-year Global Eurobonds Issued
- December 2001 – First 20-year Eurobonds Issued
- December 2001 – Schedule B Registration Statement filed with the United States Securities and Exchange Commission (US SEC)
- February 2002 – "Shelf" Registration programme established with the US SEC
- June 2003 – First 15-year LRS sold by auction
- September 2003 – First 30-year LRS sold by auction
- April 2004 – Launch of quarterly investors' conference calls
- November 2004 – Publication of Quarterly Financing Requirements