DEPARTMENT OF TREASURY

FINANCIAL MANAGEMENT DIVISION

UPDATED MEDIUM TERM DEBT STRATEGY (2018-2022) AND 2018 ANNUAL DEBT FINANCING PLAN

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1.0 MEDIUM TERM DEBT STRATEGY (2018 – 2022)

Towards the end of 2018, the Government of the Independent State of Papua New Guinea through the Treasurer presented the National Government's 2018 National Budget. As part of the 2018 Budget, an updated and new Medium Term Debt Strategy 2018-2022 (MTdS) was formulated based on updated economic conditions and events, with core objective remaining the same and the core existing strategies were reaffirmed and strengthened. This replaces the previous MTdS 2013 – 2017.

Update on MTdS 2013 - 2017

The MTdS 2013-2017 was aimed at maintaining debt and financial risks at sustainable levels while minimising the cost of debt but with revenue lower than anticipated in recent years, the Government was forced to run higher than programmed Budget deficits. The increased debt and associated debt service placed significant pressure on the Budget as well as financing demands. This impacted adversely on the implementation of the MTdS.

To finance these deficits, Government increased the debt stock from K8,478.0 million in 2012 to K21,944.0 million in 2016 and to K23,820.0 million in 2017. The main source of the increased borrowing has been the domestic market – with an increase in Treasury Bills and Inscribed Stock of 184 per cent between 2012 and 2017, from K6,118.3 million to K17,349.4 million.

As a result, debt to GDP ratio exceeded the Fiscal Responsibility Act (FRA) 30 per cent limit in 2016 and 2017, and financial risk has increased as the duration of the domestic debt portfolio has declined and as the stock of Treasury Bills continued to increase in proportion to total Government securities on issue. In 2017, the proportion of Treasury Bills and Inscribed Stock to total Government domestic securities on issue was 53.9 per cent and 46.1 per cent respectively, well short of the 30-70 per cent respective targets in the Strategy and foreign currency debt as a proportion of total central Government debt was 27.2 per cent which was well below the target of 40 per cent set in the MTdS 2013-17.

The 2016 IMF Debt Sustainability Analysis concluded that the risk of debt distress in PNG remains low based on an assessment of public and publicly guaranteed external debt. However, factoring in public domestic and private external debt, the overall risk of debt distress remains with the substantial private sector debt of large mining companies tending to be secured through holding offshore foreign currency accounts and therefore limits debt risk in PNG.

In the 2016 Article IV report, the IMF concluded that the ratio of central Government debt to GDP was low, but that liquidity risks remain high but a failure to consolidate the fiscal position, including through obtaining more cost effective and longer-term financing, would worsen debt dynamics.

The trend over the past three years signals that there is reduced appetite for the Government securities, particularly longer dated Treasury Bonds. In 2017 the significant unplanned increase in the issuance of shorter term treasury bills resulting from the fiscal overhang at the end of 2016 and the need to offset the failure to obtain the planned amount of external commercial financing in 2017 have meant that financial risk (both rollover and interest rate risk) from the domestic market has increased significantly.

The persistent foreign exchange imbalance, which tends to tie up banking sector liquidity, has resulted in substantial constraints being placed on additional issuance over 2018. This, coupled with constraints on the level of the Government securities that can be held on banks' balance sheets because of exposure limits and asset-liability mismatches, implies that these difficulties are likely to extend into 2018.

Importantly, despite these trends, the Government remains committed to lowering the deficit and debt to GDP ratio over the medium term. The Government amended the FRA in 2017 allowing the debt to GDP ratio to move within a band of 30-35 per cent, but that the authorities will target a debt to GDP ratio of 30.0 per cent by the end of the projection period in 2022.

In addition, the Government is required to target a zero average annual non-resource primary balance over the medium term (assumed to be somewhat longer than the projection period). The latter target will tend to be more binding on fiscal expansion should resource developments increase significantly above the baseline assumptions and as such, under the baseline assumptions the 30.0 per cent debt to GDP target is the main anchor on fiscal excesses.

Medium Term Debt Strategy 2018 – 2022

The new MTdS 2018 – 2022 overall objective is to: "*raise the required amount of Budget financing and manage the debt portfolio to achieve prudent risk and cost minimisation objectives, and develop and maintain an efficient market for Government securities and diversification of funding sources".*

The MTdS operationalizes this objective in order to achieve the desired composition of the Government's debt portfolio which captures the Government's strategy with regard to the cost-risk trade-offs. The major strategies to support the debt management objective comprise:

- maintaining debt at sustainable levels. The FRA target band of debt to GDP of 30-35 per cent and the 30.0 per cent target by 2022 will constrain debt to sustainable levels, although the band only applies to central Government debt and does not include arrears, SOE borrowings or contingent liabilities;

- maintaining financial risk at prudent levels. The reduction in the domestic debt target relative to foreign debt is a trade-off between domestic liquidity and interest rate risk against foreign exchange risk, and the lengthening of the average time to maturity is a trade-off between cost and refinancing risk;

- developing and efficiently managing the domestic debt market involves broadening and deepening the market in domestic securities and improving the market infrastructure; and

- developing and managing the offshore commercial market, including the inaugural sovereign bond issuance that will diversify funding sources, provide an alternative market based financing instrument, ease domestic liquidity and foreign exchange constraints and provide PNG a sovereign reference price. This will allow international investors to take a position in PNG which will also facilitate non-resident purchases of domestic bonds through a market based assessment of interest differentials.

Managing Portfolio Risk and Developing the Bond Market 2018 – 2022

In implementing the debt and financing strategy, the Government will be managing a number of risks including exchange rate risk, liquidity risk, interest rate risk, refinancing risk and others. These risks will be reduced through:

- managing the currency composition of external debt, especially as it increases as a proportion of debt, to ensure the composition is aligned with export receipts and foreign exchange reserves;

- continuing the through-the-year practice of accumulating funds in the dedicated debt account to pay debt service and redemptions when falling due and to cover issuance shortfalls;

- Smoothing out the maturity and repayment profile of the domestic debt service schedule, within the projected financing envelopes, through debt switches and buybacks and establishing a reduced number of more liquid benchmark issues. To facilitate this measure, the Loans Securities Act 1960 and the T-Bills Act 1974 will need to be amended to clearly state the authority for Treasury to actively manage Government debt.

- The publication of a more detailed and timely borrowing plan;

- lengthening the duration of the domestic portfolio to reduce refinancing risk through the development of the domestic bond market and targeting compositional changes between shorter term treasury bills and longer-term treasury bonds;

- addressing a number of preconditions for the development of the domestic bond market including: improving the efficiency of the primary market (the current manual and cumbersome processes will need to be changed to attract non-resident investors and encourage secondary trading); promoting money market and interbank transactions through repurchase agreements; developing automated clearing, settlement and custody facilities; establishing a bond market code of conduct with effective oversight by BPNG; promoting the establishment of pools of liquidity to allow small investors access to the market; improved coordination between monetary, fiscal and regulatory authorities and market participants; and developing and maintaining a centralised source for bond market information and data. These preconditions will underpin the goals of expanding the existing highly concentrated investor base and promoting a more liquid and efficient secondary market;

- addressing the concerns by non-residents that seek to invest in domestic securities, namely through rectifying the current foreign exchange imbalance and restrictions on access to foreign currency at redemption or repurchase, implementing access and disposal arrangements through improved market infrastructure for automated clearing, settlement and depository functions, and facilitating secondary market liquidity; and

- documenting and monitoring debts of state-owned enterprises and contingent liabilities and providing advice on management and exposure levels, with the more significant being the domestic commercial loans taken out by Kumul Consolidated Holdings (KCH) to finance the Motukea Port relocation, Eda Kopa Solwara 1 Project and the NCD Roads Project. Records relating to these liabilities are available in Statement I of the annual Public Accounts Statement.

Table 1: Percentage of Foreign Currency Debt to Total Central Government Debt

Target	2016 Actual	2017 Revised	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.
Up to 40%	25.10%	27.17%	31.3%	35.3%	37.5%	37.6%	37.4%

Source: Department of Treasury

Table 2: Percentage of Treasury Bills to Treasury Bonds under the Domestic Debt Portfolio

Target	2016 Actual	2017 Est	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.
50%	52.70%	53.94%	53.0%	51.8%	51.3%	49.6%	47.2%

Source: Department of Treasury.

Table 3: Average Maturity of the Domestic Debt Portfolio

Target	2016 Actual	2017 Est	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.
5 Years	4.4	4.2	4.5	4.6	4.7	4.8	4.8

Source: Department of Treasury.

To undertake the measures presented in the MTdS 2018-22, the Government will establish a high-level debt development and management committee comprising Treasury and BPNG senior staff.

2.0 2018 GOVERNMENT DEBT FINANCING PLAN

Set out below is an outline of the indicative debt issuance plan for 2018. It provides more up-to-date details compared to those shown in Chapter 8 (Financing and Debt Management Strategy) and Appendix 3 of Volume 1 of the 2018 National Budget document . This information is available on the website: http://www.treasury.gov.pg/html/national_budget/2018.html

Summary of Repayments and New Issuance during 2018 (Kina million)

Financing Source	**Estimated Balance 31 Dec 17**	**Estimated Repayment 2018**	**Estimate Borrowing 2018**	**Projected Balance 31 Dec 18**	**Net Change 2018**
Treasury Bills	9,358.3	9,358.3	9,388.5	9,388.5	30.2
Treasury Bonds (Inscribed Stock)	7,991.1	656.4	1,000.0	8,334.7	343.6
Domestic Debt	**17, 349.4**	**10,014.7**	**10,388.5**	**17,723.2**	**373.8**
International Agencies	5,081.2	300.3	1233.9	6,014.8	933.6
Commercial	1,389.8	0.0	39.8	1,429.6	39.8
Sovereign Bond	0.0	0.0	640.0	640.0	640.0
External Debt	**6,471.0**	**300.3**	**1,913.7**	**8, 084.4**	**1,613.4**
Total Debt	**23, 820.4**	**10,315.0**	**12,302.2**	**25,807.6**	**1,987.2**
Debt to GDP	**32.1 %**				**32.2 %**

Budget Deficit K1,987.2 million
Financing Source: (a) Debt Financing K1987.2 million (b) Asset Sales K0 million

Treasury Bills

Treasury Bills will continue to be auctioned on Wednesdays, and settled two days later on the Friday. Department of Treasury determines the amount of Treasury Bills required to ensure there are sufficient cash balances in the Government's bank account so as to pay the Government's expenses that are due. Bank of Papua New Guinea in its role as the debt management issuing agent of the Department of Treasury will announce to investors by close of business on Tuesdays the amount and term of Treasury Bills to be sold. The Government will continue to issue mainly 6 month, 9 month and 12 month Treasury Bills, but will also consider the investor demand for shorter term investment preferences by issuing under 91, 63 and 28 days in co-ordination with Bank of Papua New Guinea who are issuing the Central Bank Bills under the short-term.

Treasury Bonds (Inscribed Stock)

All Treasury Bond will be auctioned on the third Tuesday of each month and settled three days later on the Friday. The amounts issued each month will issue ranging from K70 million to K110 million each month starting in April 2018. The higher amounts tendered are on the months of Treasury Bonds when coupon payments and maturity are due while the lower amounts tendered are on the non-coupon payment and maturity months. A quarterly review will be conducted on performance of tender results and a revised amount depending on underlying investor demand and cash needs will be updated and conveyed to investors at least two weeks before the first tender of each quarter. The Bank of Papua New Guinea, in its role as the debt management issuing agent of the Department of Treasury, will announce to investors during the first two business days of each month the amount of each Treasury Bonds series to be auctioned (each series has a specific maturity and coupon). Refer to the issuance calendar below for more information.

2018 Domestic Issuance Calendar – Treasury Bonds (Inscribed Stock)

Issue Date	Amount on Offer	Maturities & Coupon Rates
Tue, 17 Apr 2018	K180 million	To be announced at start of month
Tue, 15 May 2018	K120 million	To be announced at start of month
Tue, 19 June 2018	K70 million	To be announced at start of month
Tue, 17 July 2018	K70 million	To be announced at start of month
Tue, 21 Aug 2018	K100 million	To be announced at start of month
Tue, 18 Sep 2018	K100 million	To be announced at start of month
Tue, 16 Oct 2018	K100 million	To be announced at start of month
Tue, 20 Nov 2018	K200 million	To be announced at start of month
Tue, 18 Dec 2018	K60 million	To be announced at start of month
Total Issuance	**K1000 million**	

Updates of the debt issuance plan

The above issuance plan is based on projections in the 2018 Budget, and if there are any changes, they will be made as part of a Supplementary Budget in 2018. The plan is subject to change and investors will be notified accordingly if changes are made.

By the beginning of each quarter Treasury will announce:

- The amount of Treasury Bills that mature over the next three months and the likely amount of Treasury Bills to be offered at tender; and
- The series (maturity and coupon) of Treasury Bonds to be auctioned over the next three months.

Additional information

Further information on the historical results of auctions is available on the Public Debt folder of the Department of Treasury's website: www.treasury.gov.pg. If you have any questions please contact the Securities Execution Branch on telephone numbers: 313 3675, 313 3739 or 313 3547 or fax 313 3761.

GIBSON GOTAHA
Acting First Assistant Secretary
Financial Management Division