What is Debt Management and why is it important?

Macroeconomic Working Group

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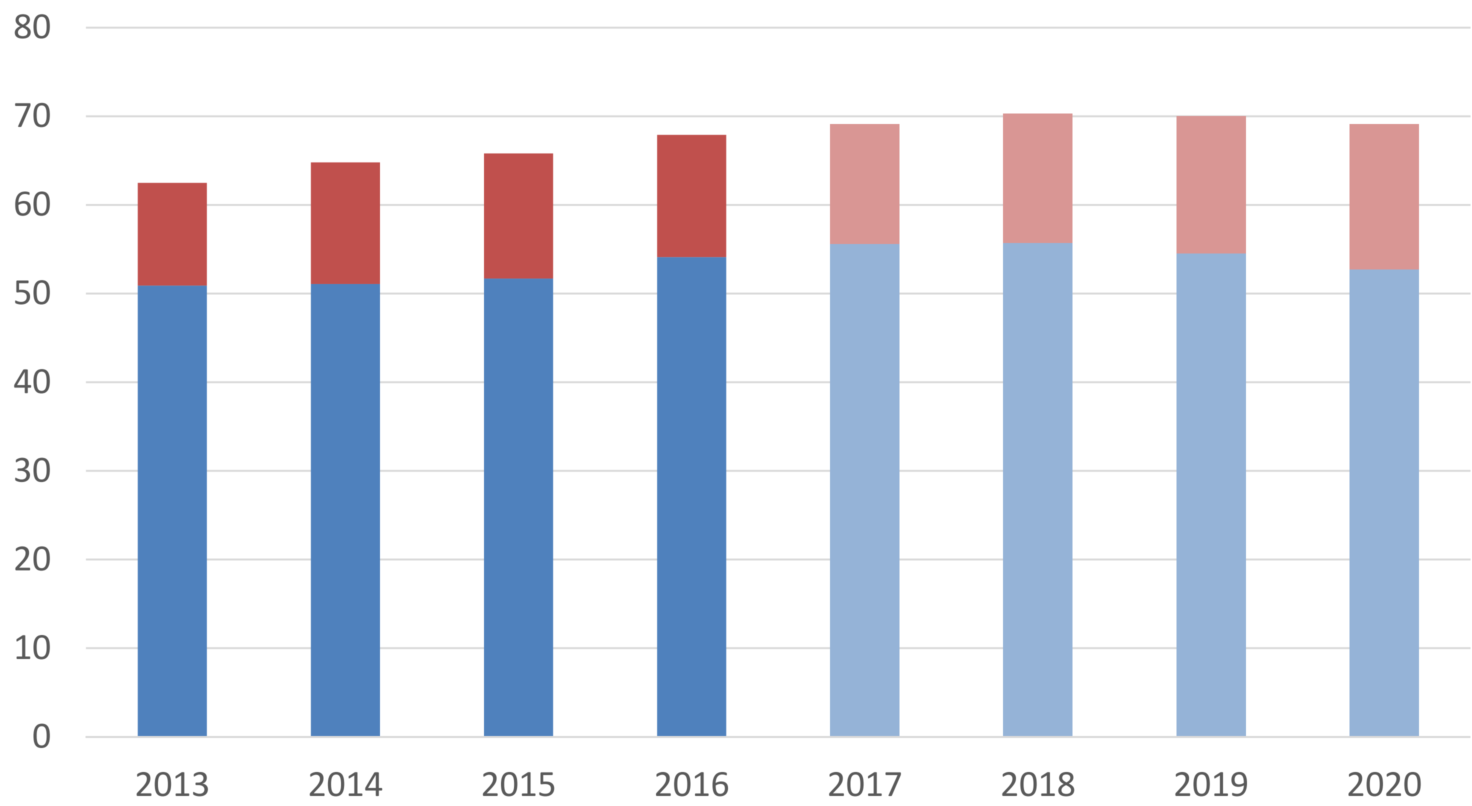
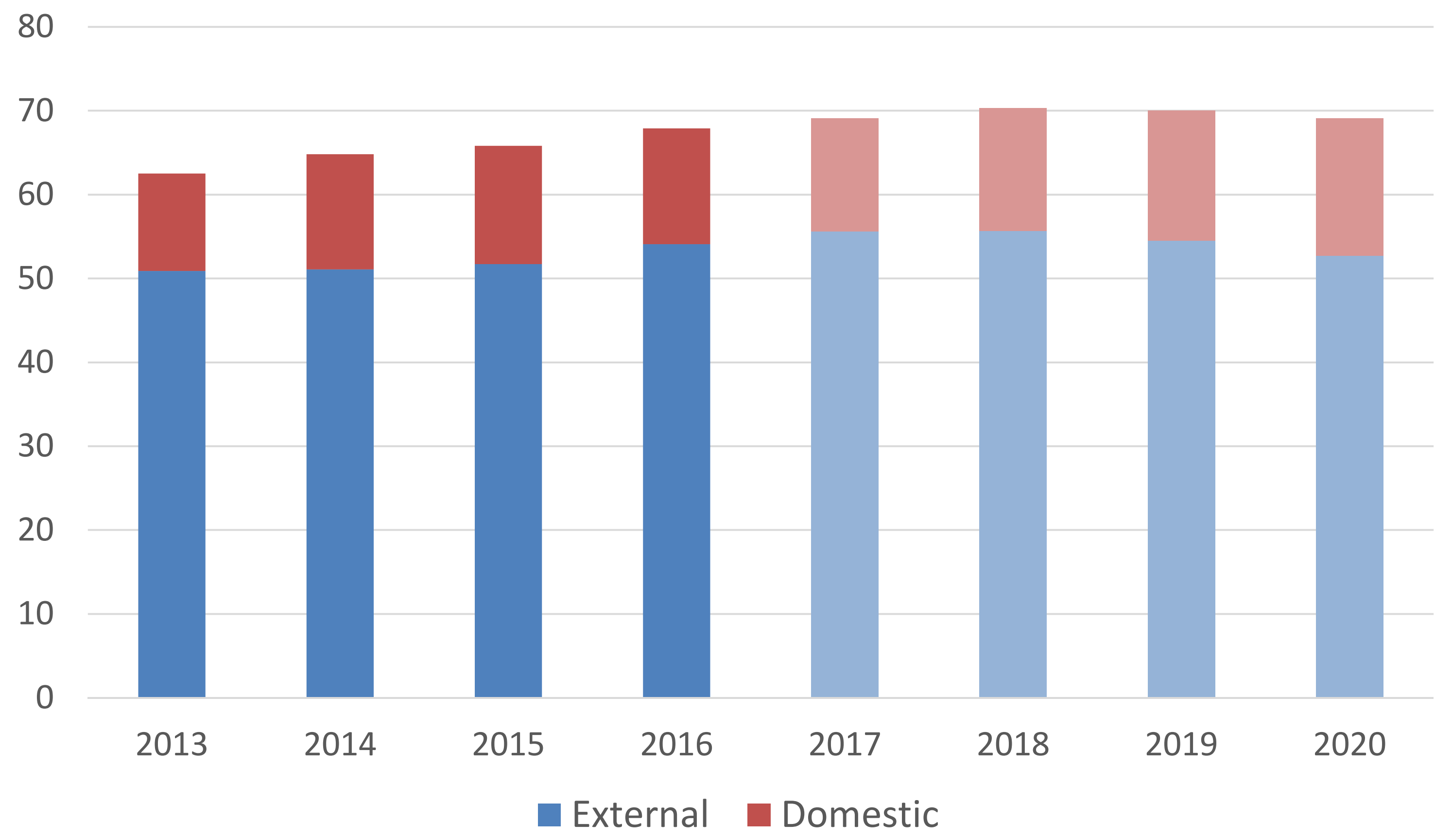
Vientiane, Lao PDR

What is this?



Lao PDR, public debt/GDP

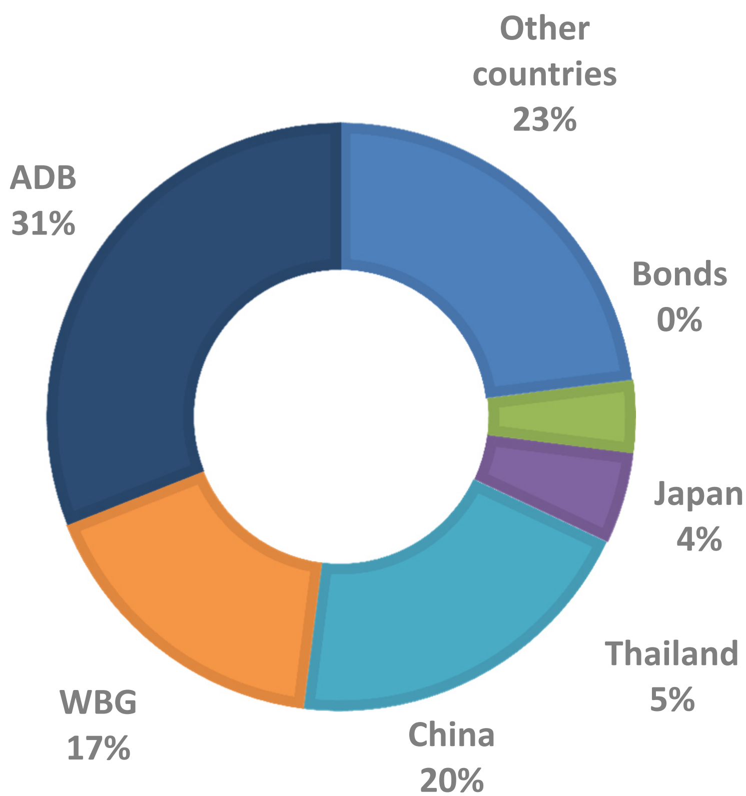


More background

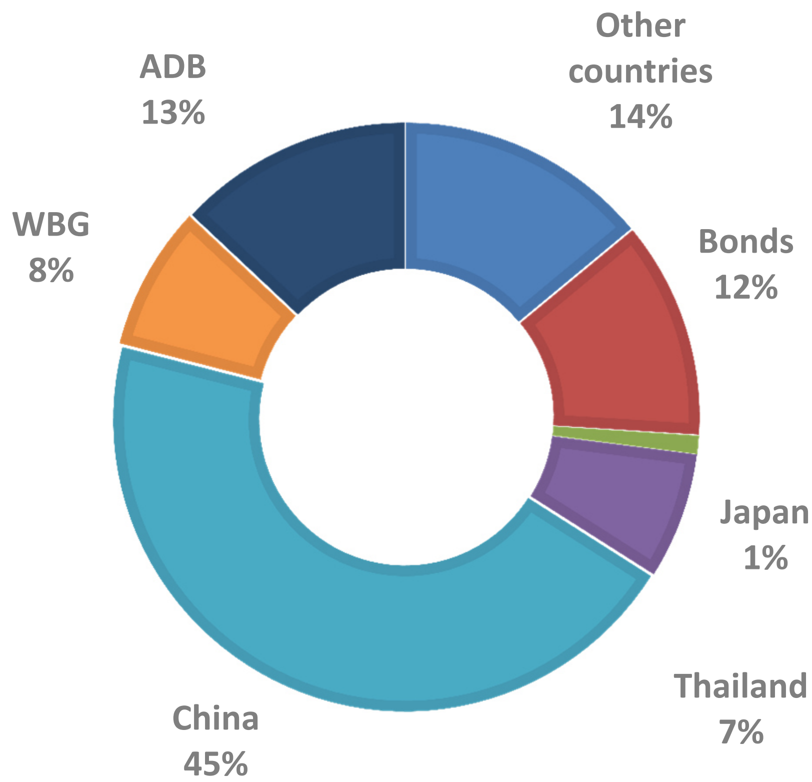
- Debt level is relatively high :
  - **Risk to the debt size is high**
  - **Risk to interest cost and the budget, relatively low** due to high share of debt with very low interest rate
- IMF Article IV, February 2017: "Lao P.D.R.'s **risk of external debt distress is reclassified from moderate to high**, suggesting the urgent need to tighten fiscal policy, strengthen public financial management, and **develop a comprehensive medium-term debt management strategy**"
- Access to concessional funding will gradually reduce – implication is **higher cost**, but **more financial choices**

Structure of public debt

2010



2015



Agenda

1. The macro context
2. Objectives and the debt management strategy
3. Cost and risk
4. What is the role of debt manager, and how should debt management be organized

The macro context

Policy objectives and instruments

	Objective	**Instrument**
Debt Management	To minimize cost, subject to a prudent level of risk	Composition of the debt portfolio
	Contingent liabilities	
Fiscal Policy	Improve resource allocation and achieve distributive objectives	Composition of spending and taxation. **Levels** of deficits and debt
Monetary Policy	Price stability	Interest rates, exchange rate or money aggregates

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Basic budget arithmetic

Revenues

- <u>Primary Expenditures</u>

Primary balance

- <u>Interest payments on debt</u>

= **Fiscal balance**

- <u>Repayment of debt</u>

= **Funding needs**

- A risky debt structure implies risk to the budget, high debt implies higher cost
- **Debt management is about monitoring and managing risk exposure!**

Objectives and strategy

What are the objectives of public debt management?

1. Finance the government and meet servicing obligations
2. Minimize cost <u>but</u> subject to containing risks over the medium/long term
3. Promote development of domestic debt market (optional)

- **Objectives ideally formulated in debt management law, and change infrequently**
- Scope for debt management?
  - Directly contracted debt (domestic and external)
  - Sometimes also on-lending and guarantees

The strategy translate the objectives into a specific plan

DM strategy is a rolling medium-term plan that:

- **Specify the way the objectives and priorities for debt management will be met**
  - Express the characteristics of the desired debt portfolio
- **What are the desired financial characteristics of the debt portfolio?**
  - Share of domestic versus external
  - Currency mix of external debt
  - Share of fixed versus floating interest rate debt
  - Maturity profile
  - Share of nominal versus inflation-indexed (or other index)

Should the strategy be a public document?

- **Yes**
- But, it is possible to have a formal strategy document that is not published
- **There are good reasons for transparency**
  - **Effectiveness**: goals are understood and authorities are seen to make a credible commitment to meet them
  - **Accountability**: debt portfolio poses significant risks and the public requires assurance that they are being well managed
  - **Certainty for investors**: Disclosure of the borrowing program increases investors' certainty and lowers government's borrowing cost in the long-run

Cost and risk

Cost and risk

How should "costs and risks" be defined for a debt portfolio?

- **Cost** – interest payments on debt (measured in local currency)
- **Risk** – the negative effects that could arise from an undesirable outcome

Cost and risk trade-off

- Short-term debt is typically cheaper, but refinancing risk and exposure to higher rates
- FX debt tends to have lower costs, but FX risk

For a government debt manager an undesirable outcome is an increase in the cost of debt servicing

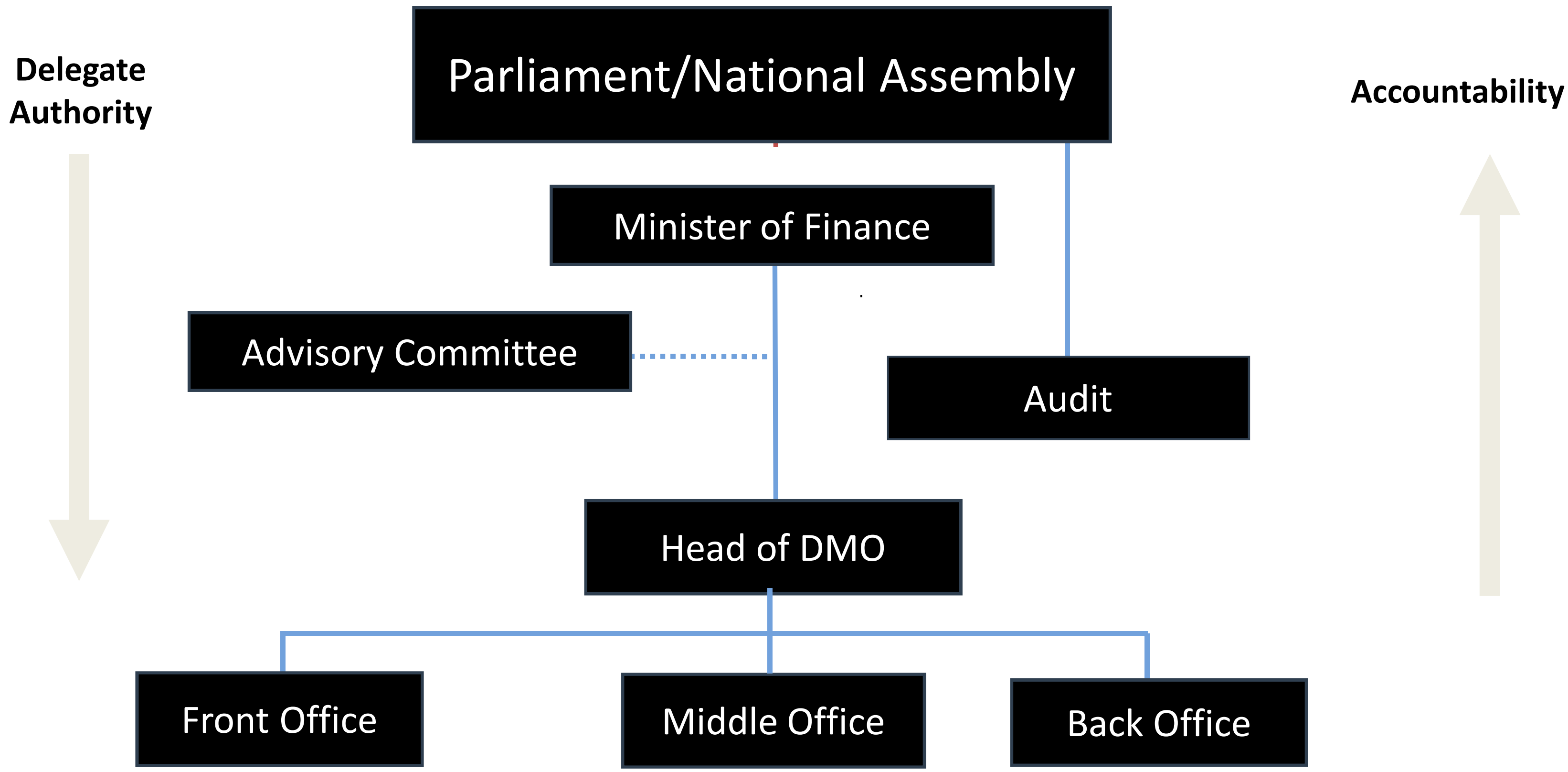
Risk exposure indicators

Key role of the debt manager is to monitor and manage risk – the exposure indicators facilitates this role

- **Refinancing risk**
  - Redemption profile
  - Share of debt maturing in 1 year
  - Average Time to Refinancing
- **Interest rate risk**
  - Share of debt with re-fixing within 1 year (fixed rate debt maturing and all variable interest rate debt
  - Average Time to Refixing (ATR)
- **Currency risk**
  - Currency composition

The role of the debt manager and the organization of debt management

Delegation and accountability to implement a strategy



- Delegations in laws: power to borrow, transact
- Accountability: reporting and oversight, external audit
- Operational risk: large transactions, strong control environment required

Role of a debt management office

- For effective strategy development and coherent implementation it is important that there is one central debt manager
- **Key that financial decisions are taken by debt management office**
  - **Development of DM strategy**
  - **Implementation of DM strategy, including loans, domestic and international bond issues, on-lending, guarantees, etc.**

Summary

- Debt management separate from fiscal and monetary policy
- The debt portfolio can have substantial negative budget implications
- DM objectives in DM law – changed infrequently
- DM strategy a rolling medium-term plan
- Cost-risk trade-off is central to debt management
- A unified debt management office facilitates effective debt management