

**DOMESTIC DEBT DEVELOPMENTS IN JAMAICA**

**Presentation at the 1<sup>st</sup> Regional**

*Workshop on Developing Government Bond Markets in Latin America*

**June 11-13, 2001**

**Rio de Janeiro, Brazil**

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## **Introduction**

Jamaica, like many other Latin America and Caribbean countries, emerged out of the decade of the 1980s with a heavy external debt burden. The focus in the 1980s was the effective management of the external debt portfolio. The combination of external factors - low export earnings, reduced access to long-term loans on concessionary terms - and internal developments - weak output performance, low revenue intake - saw a number of regional Governments relying on domestic resources to fund their operations. Consequently, by the 1990s, the high levels of external debt and the attendant issues had given way to high and rising levels of domestic debt, high interest rates and fiscal deficits.

This paper looks at key developments in Jamaica's domestic debt market and efforts, in recent years, to strengthen the quality of debt management and to facilitate the development of the domestic capital market.

## **Macroeconomic Policy Framework**

Jamaica accelerated its structural reform programme in the early 1990s with, among other developments, the liberalization of the foreign exchange market, the removal of price controls, reduction in trade barriers and the reform of the tax system. In Jamaica, high levels of inflation and interest rates were major challenges for policy makers in the early 1990s. A re-orientation of macroeconomic policy was essential. The containment of inflation and the maintenance of relative stability in the foreign exchange market became the focus of the macroeconomic stabilization programme introduced in 1991. This was to be achieved through a combination of tight monetary and fiscal policies.

The Government succeeded in reducing inflation to single digit levels and maintaining stability in the foreign exchange market. However, one of the costs of the stabilization has been a marked increase in the level of the domestic debt, beginning in FY1994/95. The stock of domestic debt rose from J\$11.8 billion at the end of FY1990/91 to J\$50.1 billion at the end of FY1994/95. At

the end of FY2000/01, the stock of domestic debt stood at J\$215.1 billion. In addition to deficit financing, the increases in the stock of domestic debt was incurred largely to provide assistance to the central bank - Bank of Jamaica (BOJ) in its liquidity management objectives and to cover BOJ losses. Increases were also due to debt obligations of public sector entities being assumed. The debt problem was exacerbated by the financial sector crisis which emerged in 1996 and the cost to the Government for rehabilitating and restructuring the sector. Effective April 1, 2001, the Government assumed an additional J\$73 billion in domestic debt, representing the remaining contingent liabilities associated with the restructuring of the financial sector.

Jamaica's total public debt/GDP ratio amounted to 116.1% at the end of FY2000/01 compared with 102.6% at the end of FY1994/95. Over the period, domestic debt as a percentage of GDP increased from 30.1% at the end of FY1994/95 to 65.6% at the end of FY2000/01. With the Government's assumption of the remaining liabilities associated with the restructuring of the financial sector, the domestic debt increased to 94.5% of GDP on April 1, 2001. Debt servicing accounts for 62% of budgetary expenditure for the current financial year, with domestic debt servicing costs accounting for 49% of budgeted expenditure.

The substantial debt burden has severely constrained Government's ability to invest in physical and social infrastructure necessary to promote investment and growth. Therefore, since the second half of the 1990s, the major thrust and policy challenge has been the management of the debt dynamics. Emphasis has been placed on the management of domestic debt, the larger and more expensive share of the public debt. This threatens not only the fiscal operations but also the achievement of the macroeconomic objectives.

Cognizant of the importance of reducing the debt to sustainable levels, the authorities took the necessary steps to strengthen its debt management capability and embarked on a path towards the implementation of prudent debt management practices. In addition, steps were taken to facilitate the development of the domestic capital market. Like many other countries in the region, Jamaica's integration into the international capital markets has reinforced the need to focus on domestic capital markets developments.

## **Centralization of Debt Management Functions**

Critical to the formulation and implementation of credible debt management strategy and policies was the need for institutional building and improvements in the Ministry's debt management capability. Since April 1998, there has been a centralization of the debt management functions which, prior to that, were shared by the Ministry of Finance and Planning and the central bank - Bank of Jamaica. The Debt Management Unit (DMU) was formalized within the Ministry with a mandate to raise adequate levels of financing for the budget, at minimum costs; and at the same time, pursue strategies to ensure that the public debt progresses to and is maintained at sustainable levels over the medium term.

There is a clear allocation of responsibility among the three institutions associated with debt management. Responsibility for the core debt management functions - debt policy and strategy formulation and analyses, debt-raising activities, registrar and payment function for government securities and debt recording and monitoring, now fully resides within the DMU of the Ministry. The central bank, in its agency capacity, is responsible for effecting external debt payments, conducting primary market issues and for issuing and redeeming Treasury Bills. The Accountant General Department, which is a department of the Ministry of Finance and Planning, has responsibility for treasury operations including the servicing of the debt.

At the operational level, the centralisation of the core debt management functions within a single unit within the Ministry of Finance and Planning has led to a considerable strengthening of debt strategy implementation. Several factors explain this, foremost of which are increased capacity in debt management expertise, greater clarity of debt management objectives and improved consolidation of debt management information.

## **Co-ordination of Debt Management, Fiscal and Monetary Policies**

The influences of debt management on and by monetary and fiscal policies in a situation of deficit financing, rehabilitation and restructuring of the financial sector are far-reaching, reinforcing the need for strong co-ordination. In Jamaica, the co-ordination of debt management, fiscal and monetary policies is undertaken within the context of a clear and consistent macroeconomic framework designed to lower inflation, achieve economic stability and sustainable growth and development.

The transfer of the debt management function to the Ministry of Finance and Planning has resulted in greater co-ordination of fiscal policy and debt management objectives. It also allows for more clearly defined debt management objectives and for these to be determined independently of monetary policy considerations. However, despite separate objectives, there is a high degree of co-ordination between the fiscal and monetary authorities

At the policy level, there are regular meetings between senior officials of the planning authorities- Ministry of Finance and Planning, the Bank of Jamaica, the Planning Institute of Jamaica and the Statistical Institute of Jamaica - to ensure consistency in Government's economic and financial programme. At the technical level, there are regular meetings where information is shared on Government's cash flow requirements and financing programme, as well as on current monetary conditions and developments within the money and foreign exchange markets. On a weekly basis, there is a meeting within the Ministry between the DMU, Fiscal Policy Management Unit, Cash Management Unit and the Accountant General Department. There is also a weekly meeting between the Ministry and the Bank of Jamaica.

## **Legal and Institutional Framework**

A well-developed legal and institutional framework exists for the execution of debt management. Under Jamaica's Constitution, all loans charged on the Consolidated Fund, including all external and domestic debt payments, represent a statutory charge on the revenue and assets of Jamaica. This provision allows for debt payments to be made without any requirement of Parliamentary

approval and before funds are available for other policies and programmes. In addition, the Constitution and the Financial Administration and Audit (FAA) Act give the Ministry of Finance and Planning overall responsibility for the management of Jamaica's public debt.

The Government's borrowing requirements for each financial year are determined by the Ministry of Finance and Planning and set out in the budget presented to Parliament at the beginning of the financial year.

The authority to borrow is established by statutes. The Loan Act, 1964, and subsequent Amendments, provides the Government with the authority to borrow from the domestic and external markets. The Loan Act establishes quantitative limits on the amount the Government can borrow. Increases in the ceiling have to be obtained through the Parliamentary approval process. Adjustments to the ceiling are done infrequently based on the medium term debt programme.

For domestic borrowings, there are specific Acts which govern the issuance of the various debt instruments. For example, there are the Treasury Bill Act, Local Registered Stock Act, Land Bond Act, Saving Bonds Act.

The borrowing powers of public sector entities are set out in the FAA Act and the legislation governing the corporations. The existing legislation will be supported by the new Public Bodies Management and Accountability Act, currently before the Legislative Committee of Parliament. While the Board of Directors of the entity determines the extent of borrowing, the Ministry responsible for the entity must approve the borrowing plan. However, the approval of the Ministry of Finance and Planning is required before the entities can borrow.

While this has not been the practice, the Government can borrow from the central bank. However, under the Bank of Jamaica Act, advances outstanding to the Government are limited to a maximum of 40% of Government expenditure in that financial year.

## **Debt Management Practices**

### ***Debt Management Strategy***

The reduction of the overall public debt is critical to the attainment of the objectives under the Government's economic programme. As a result, the debt management strategy is an integral part of the medium term macroeconomic programme. Consistent with this, clear objectives have been developed. The strategic objective is to bring the total debt to sustainable levels over the medium term.

Achieving sustainable levels of debt has necessitated the design and implementation of a comprehensive medium-term debt strategy with four broad objectives:

- Satisfying the Government's annual borrowing requirements;
- Reducing borrowing and debt servicing costs;
- Achieving and maintaining a more prudent debt structure;
- Ensuring continued and wider access to markets, both domestic and overseas.

The primary aim is to ensure that overall borrowing is kept within prudent levels and secured on the best terms available. Over the medium term, it is envisaged that debt management strategies will be supported by a continual fall in interest rates, a stable exchange rate environment and a return to fiscal surplus.

### ***Debt Issuance Strategy***

Considerable efforts have been made to increase transparency and accountability in debt management operations in recent years.

Government's debt management strategy is presented to Parliament at the start of the financial year. Since FY1999/2000, this strategy has been published in the form of a Ministry Paper that

has widespread public distribution. The document is also available through the internet on the web-site of the Ministry of Finance and Planning.

Comprehensive information on Jamaica's debt is published on the Ministry's website and routinely updated. In addition to historical debt data, including debt outstanding, debt service payments and debt structure and composition, the web page is also used as a vehicle to announce future debt operations especially as it relates to debt issuance in the domestic market. An issuance calendar has been published.

The rules for participating in primary debt issues, specifically the auction of medium-term government securities, have also been widely disclosed. Notices for future domestic debt issues are published in the print media. Similarly, the results of Government's debt issue are widely reported through the print and electronic media and on the Ministry's website.

## **Development and Maintenance of the Market for Government Securities**

### ***Primary Market***

In October 1999, Jamaica adopted a market-based and transparent mechanism for selling Local Registered Stocks (LRS), the Government's medium and long-term securities. A multiple price auction system was introduced. Previously, the Government set rates on these instruments. This sometimes created price distortions in the domestic market which, at times, manifested itself in Government's financing needs not been met fully from the market issues, necessitating private placements.

A more competitive pricing of medium- and long-term securities has been achieved through the use of the auction system. This has resulted in a significant narrowing of interest differentials between long-term and short-term domestic securities. Since the introduction of the auction system, LRS issues have been significantly oversubscribed. Over time, the price range for bids has narrowed. This policy shift has resulted in Government meeting its financing needs at competitive rates.

Another significant development has been the increased ability of the Government to extend the maturity structure of its debt since the introduction of the auction system. Of the new debt issued in the financial year ending March 31, 2001, some 74% of LRS issued had maturities of 5 years or over. This compared with 44% of new issues of in the previous financial year. A milestone was reached in August 2000, when the first 10-year LRS instrument was successfully auctioned. With improvement in the macroeconomic economic conditions and renewed investor confidence, the first 12-year LRS was successfully auctioned in April 2001. The appetite for longer-term securities has resulted in a positive shift in the maturity profile of the domestic debt.

The conversion of the contingent liabilities associated with the rehabilitation and restructuring of the financial sector into Government securities provides an opportunity for further lengthening of the maturity profile.

To facilitate the development of an orderly and well-functioning domestic securities market, the approach has been to, not only access the market on a regular, but also to inform the market of upcoming issues. Significant progress has been made in informing the market and increasing the predictability of Government's debt operations. In addition to the publication of a calendar of Treasury Bill tenders and issue dates at the start of each fiscal year, announcements have been extended to include the publication of an issuance calendar for LRS. This information dissemination, as well as regular consultations with Primary Dealers, has allowed for greater transparency and predictability in the domestic capital market. Included in this development is widening of the range of investors.

### **Government Securities**

The domestic debt portfolio is comprised of short-term Treasury Bills; fixed and floating rate medium- to long-term LRS; medium-term debentures; fixed-rate foreign currency domestic bonds, indexed bonds; savings and developmental bonds and commercial loans.

Some 69% of the domestic debt portfolio is comprised of floating-rate instruments. However, the 1999 decision to use the auction mechanism to price the Government's primary debt raising

instruments – the LRS - has meant that, over the medium term, an increasing share of the debt will be on a fixed rate basis. This will insulate the portfolio from interest rate shocks and rollover risks.

The principal holders of Government securities are the Bank of Jamaica, commercial banks, insurance companies, pension funds and the money market fund managers. In recent years, Government's debt issuance programme has tried to meet the needs of the market players. A priority has been to introduce new instruments that are more closely tailored to meet the needs of different market segments. In addition to overall capital market development, the benefit to government is a larger pool of resources from which financing can be tapped and on improved terms.

The introduction of new instruments began in 1999 when, on a small-scale, Jamaica offered US dollar indexed bonds to the domestic market. These instruments have proven attractive to those institutional and retail investors uncertain about the future movements in the exchange rate and who are desirous of maintaining the value of their assets. Steps are being taken to reintroduce savings bonds, which because of their structure are attractive to household savers.

### *Secondary Market*

Primary Dealers have played a critical role in securities market building in Jamaica. In 1994, the Bank of Jamaica created a new financial market arrangement involving Primary Dealers. The dealers were to be the medium through which the central bank conducts its open market operations. They were expected to also provide continuous underwriting support for new issues of Government securities thereby providing secondary market liquidity. Though not mandatory, dealers - numbering 15 currently- are required to take up a total of 45% of all primary issues.

Secondary market development is constrained by the absence of exchange trading in securities. The Jamaica Central Securities Depository Limited (JCSD), a subsidiary of the Jamaica Stock Exchange, began operation in 1998. However, the depository currently trades equities only. The early resolution of issues related to ownership, insurance etc. of the JCSD will allow for the

dematerialization of securities which the central securities depository provides. This will increase the efficiency of secondary market trading.

### *Taxation*

While taxes on interest have been levied at a rate of 33.3% for corporates and 25% for individuals, prior to 1999 taxes were withheld only on savings deposits. In 1999, the Government increased the number of financial institutions that were required to withhold taxes on interest as well as the range of financial instruments covered. Withholding tax on interest was increased from 15% in 1999 to 25% in 2000 on all financial instruments. Corporates are liable for the remaining 8.3% when tax returns are made. In addition to the increase in revenue from this source, there has been a reduction in distortions in the domestic market. In an effort to encourage long-term savings by individuals, the Government granted tax-free status to approved Long-term Savings Accounts. These are deposits where the principal amounts are held for at least five (5) years. If the deposits are broken before the minimum 5-year period, then tax is payable at the 25% rate.

### *Technological Developments*

The introduction of new and improved technologies is also contributing to the development of the domestic capital market. One such development is the introduction of a new system that will allow Primary Dealers and other financial institutions to electronically bid for securities. An immediate benefit is the greater efficiency in conducting auctions of government securities. Similarly, upgrades to debt management, monitoring and payment systems are contributing to more comprehensive information being recorded, a greater selection of tools available for debt analysis and speedier processing of debt payments.

### **Going Forward**

While advances are still to be made, Jamaica has made significant progress in developing the domestic capital market. The imperative of the future is to build on these achievements. There are a number of factors that will facilitate the further development of the market. These include:

- The renewed health of the financial sector. Rehabilitation and restructuring efforts have resulted in a consolidation of the sector with fewer institutions with greater critical mass.
- Further improvements in the legislative framework governing the financial sector. A new regulatory authority - the Financial Services Commission (FSC) - was established in April 2001. The FSC is responsible for the efficient regulation and supervision of entities dealing in securities, collective investment funds (e.g. mutual funds and unit trusts), investment advisors, the insurance industry and pension fund.
- Planned reform of the pension system. This will create a larger pool of funds for long-term investment.
- Plans to re-open Government debt issues to create benchmark securities across the yield curve. This will increase the liquidity of the instruments and further extend the maturity profile of the debt.

June 8, 2001