Keynote Address

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Challenges Faced by Jamaica in Recent Debt Management Initiatives and Lessons for Small, Open Economies Managing High Levels of Sovereign Debt

Ladies and Gentlemen:

Thank you for inviting me to participate in this forum and to speak on the issue of debt management. This is a very important topic for us given my country's history of disappointing growth performance and the recent thrust by the Government of Jamaica to reduce its enormous debt to a sustainable level.

Half-way through a four-year Extended Fund Facility agreement with the IMF, Jamaica's debt is now very clearly on a downward trajectory. Addressing the debt overhang has required institutional reforms and institutional capacity building to underpin the needed structural adjustment. Also, given the heavy debt burden, strong international support was needed. This afternoon, I propose to give a brief and selective survey of Jamaica's experience with debt over the past five years and then describe strategies employed to reduce the debt and some of the lessons that we learned.

The Jamaican Experience

Jamaica's exceptionally high debt overhang represents the most critical challenge to macroeconomic stability and sustainable growth. Accumulated by persistent large fiscal deficits and the crystallisation of explicit and implicit contingent liabilities, the debt burden, which

averaged 141 per cent of GDP over the last five fiscal years, stunted growth, threatened financial stability and exerted dominance over monetary policy.

Over the period, debt service obligations accounted for 71% of tax revenue and 44% of expenditure. This, along with large refinancing needs, led to high risk premiums, which, of course, worsened the fiscal position and added to the debt. Investment was crowded out. Growth was undermined. Real GDP growth averaged only 0.3 per cent per year over the period.

The mountain of debt[1] carries both market and financial risks with the greatest challenge being exchange rate risk as 62% of the portfolio is denominated in foreign currency.

The procyclicality of fiscal policy also deepened the procyclicality problems in the financial sector that are typically associated with private sector credit, contributing to greater vulnerability in the banking sector and creating a large potential contingent liability for the government.[2] Bolstered by the incentive of a high sovereign risk premium, the growing stock of public sector debt was supported by the oversupply of financing by the local banks and securities dealers. Bank of Jamaica's research on the application of countercyclical capital buffers confirms the contribution of the procyclical behaviour of both private sector credit and sovereign bond investment by banks and securities dealers to greater vulnerability in the banking sector with the concomitant threat to the public purse.

Strong institutional reforms and capacity building were therefore required to see off this threat. The government undertook to strengthen capacity in the financial system. A new Banking Services Act brought into effect in 2015 harmonised prudential standards across types of deposit-taking institution and conferred full supervisory autonomy on the central bank

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[1] As at November 2015, Jamaica's debt stock stood at US$17.5 billion with external debt accounting for 59%. Notably, 37% of the public debt is held by the domestic financial sector.

[2] Similar to the procyclical experience that is normally associated with private sector credit, sovereign risk is likely underestimated by the financial sector in economic upturns and overestimated in recessions. That is, in an upturn which is normally associated with higher public revenue, the financial sector would rapidly expand holdings of sovereign bonds, contributing to overpricing and inadequate capital buffers as banks underestimate risk. In the downswing, when sovereign risk increases as public revenues decline, the opposite would tend to occur as banks become overly risk averse.

amongst other things. In addition, the central bank was given overall responsibility for financial system stability in collaboration with a new statutory interagency financial system stability committee.

Jamaica's Debt Strategy: Economic Reform Programme

The Economic Reform Programme that the government embarked on in FY2013/14 was necessary to break the cycle of high debt and low growth. The programme targets debt at 60% of GDP by March 2026 and uses a framework of fiscal rules as an overarching mechanism to help us to ensure that we take all the steps that are necessary to get there. The main debt-related elements of the economic reform programme are the upfront debt restructuring and some debt management initiatives.

Debt Restructuring

On debt restructuring, the comprehensive debt exchange completed in 2013, Jamaica's second in three years, resulted in projected savings of 8.6% of GDP by 2020. Key issues emerging from the exercise include the unsuitability of the 'bail-in' tool for sovereign debt restructuring in small economies and the question whether to restructure the domestic debt or the foreign debt.

Unsuitability of the 'bail-in' tool for sovereign debt restructuring of small economies

In preparing the economic reform programme we considered various strategies that had the potential to reduce the government's debt position. One with great potential was to "bail in" resident creditors by having part of the debt owed written off through deep haircuts. But stress tests on the balance sheets of financial sector firms confirmed that some large securities dealers, which were big holders of GOJ bonds, would likely be forced to close, directly threatening financial stability. These dealers, in a sector that rivals the size of the banking sector, had funded large proprietary positions in long-dated GOJ securities with short-term repos from the general public.

Emergency legislation would be needed to empower the government to compel conversion of the liabilities into equity according to a specific order of priority so that systemically important dealers would stay alive. Lowest in the contemplated order of priority would be retail repo investors with holdings above a certain bail-in threshold that would be high enough to mitigate widespread dislocation.

It soon became clear to us, however, that the bail-in tool would be unsuitable in our small economy with an investor base made up mainly of small and unsophisticated investors. There would be significant contagion effects which could not be eliminated or sufficiently reduced by an appropriate bail-in threshold. Put another way, setting a threshold high enough to avoid widespread losses from investors that should enjoy priority, such as microenterprises, SMEs and private individuals, would not provide enough loss-absorbing capacity to forestall or mitigate failures and contagion.

Debt Restructuring: Domestic v Foreign

In defining the optimal debt restructuring strategy we also considered whether to restructure all the debt or a specific portion of the debt. Sovereigns of small open economies like ours have a strong incentive to discriminate in favour of non-residents when restructuring sovereign debt in order to preserve access to the international market. The incentive is greater when foreign law debt held by the domestic financial sector is originated by institutions overseas.

Jamaica's two debt exchanges (in 2010 and 2013) involved reducing coupons and lengthening the maturity of public debt held by domestic residents only. These exchanges were unlike typical sovereign debt swaps where domestic creditors seek equal treatment regarding burden sharing between local law and foreign law bondholders. The typical rationale provided is that residents face a "double whammy" from the actual debt restructuring and the consequential drag on the domestic economy from the process of adjustment that usually follows.

In the case of Jamaica, however, political economy considerations driven primarily by a financial sector creditor committee influenced the government's decision to focus the

restructuring on only domestically issued debt. Both local law and foreign law sovereign debt instruments were mostly held on the balance sheets of a relatively small group of banks and securities dealers. Their rationale in this case was driven by the practice of overseas investment firms successfully marketing financing for Jamaican global bonds to local financial institutions thus exposing them to highly-leveraged margin and repurchase arrangements. The fear of unravelling these arrangements helps to explain the creditor preference for restructuring domestic debt only.

Debt Management Initiatives

Turning to debt management initiatives, an important component of the reforms was to strengthen the institutional capacity to seal in the benefits of the programme. It was necessary to establish a governance framework for debt management with a solid legal foundation and sound risk management practices. A credible medium-term debt management strategy and policy in keeping with international standards were put in place, a comprehensive statute governing public debt was passed, the Debt Management Branch was restructured and cash management was enhanced by implementing a centralised treasury management system.

Several market-friendly initiatives were also successfully implemented. For example, last (fiscal) year the government bought back from the international market some 12 per cent of the outstanding amount of near-to-maturity, high-coupon global bonds. These successful operations represented a milestone for debt management in Jamaica.

Additionally, in 2015, the Government raised US$2.0 billion in the international capital market and used $1.5 billion of the proceeds to finance the early redemption of over US$3.0 billion of debt owed to Venezuela under the PetroCaribe agreement. The immediate impact of the transaction is a 10 percentage point reduction in the debt to GDP ratio. Total debt service will be lower, and the transaction yielded significant net savings for the government in excess of two per cent of GDP.

Lessons Learnt

Jamaica's voyage out of dangerous waters is not over. We have a lot more work to do. But what have we learnt during the course of this odyssey? I leave the following observations with you:

First, direct action on debt coupled with fiscal consolidation have resulted in a reduction in the debt to GDP ratio to a projected 125% at the end of this fiscal year (March 2016) from 145% three years ago. To seal in the benefits from these initiatives, strong institutional reform and capacity building are required.

Second, it is possible to make appreciable progress towards debt reduction by a well-coordinated strategy to halt the debt creation process. The fiscal reforms at the heart of the programme have set the stage for investors to believe that we have broken with the past. In this respect, the succession of positive quarterly reviews under the EFF has been a valuable endorsement by a credible invigilator.

Third, where the size of public debt plays such a significant role in the prospects for an economy, professional debt management pays dividends. A critical component of the reform process was the strengthening of institutional capacity including establishing a set of governance practices and sound risk management practices. A strong legal framework around debt management that defines goals, authorities and accountabilities opens possibilities for efficient and innovative debt management practices.

Fourth, there needs to be strong political commitment to address the identified policy challenges. The payoff from consistent execution of the reform programme has been slow in coming but the prospects of a strong dividend have been enhanced by the commitment demonstrated by decision-makers.

Fifth, great effort does not always mean great progress. Jamaica has taken a full course of the prescribed medication but the malady is far from cured. There is yet room for bold steps and renewed support from multilateral institutions for the case to be made that following the DC star leads to the Promised Land. In this respect, Jamaica is leading the way in exploring ways in which new modalities for international support can make a palpable and lasting difference to the prospects for vulnerable, middle-income, highly-indebted countries like ours.

Thank You.