BANK OF JAMAICA

XXXI MEETING OF THE LATIN AMERICAN NETWORK OF CENTRAL BANKS AND FINANCE MINISTRIES

Inter-American Development Bank
Washington, DC

23 April 2010

'Recent Debt Management Initiatives in Jamaica'

Brian Wynter
Governor, Bank of Jamaica

Ladies and Gentlemen:

For the greater part of the last two decades Jamaica has been caught in a vicious cycle of low growth and unsustainable fiscal and debt dynamics. In the last decade real GDP growth averaged **1.0 per cent per annum,** while the public debt stock remained **above 100.0 per cent** of Gross Domestic Product. Not only was the stock of debt high by world standards, but approximately **40.0 per cent** of the domestic debt was maturing in less than **24 months** thus presenting significantly high levels of roll-over risk and leaving the Government vulnerable to sudden adverse shifts in market sentiment. As a direct result, interest payments as a ratio of GDP had tripled over the last 5 years, with interest payments accounting for **23.5 per cent** of GDP at end-2009 and reflecting an average of **60.0 per cent** of Government revenues annually. These high and rising levels of debt service costs *inhibited* investment in infrastructure and other essential services, *generated* excessive high real and nominal interest rates and *catalyzed* recurring fiscal slippages.

The Strategic Plan

By the last quarter of 2009, it was becoming increasingly clear that Jamaica needed a comprehensive policy change that would address the fundamental challenges affecting the economy and not just the symptoms of those challenges. What was needed was a paradigm shift that would *propel* Jamaica out of the vicious cycle to a virtuous cycle of lower debt servicing costs, lower roll-over risks, less volatility in domestic prices and sustained growth. It was also becoming apparent that the scale of the solution would have to match the depth of the challenges facing the country.

In structuring the transaction, consideration had to be given to the liquidity impact of alternative proposals as this would have a direct impact on the conduct of monetary policy. If bonds were called[1], for example, what would investors do with the unanticipated cash flows? What would be the impact on the foreign exchange market or the balance of payments? How would financial intermediaries respond to the strategy and adjust their portfolios in the context of domestic and global macro-economic uncertainties? In the final analysis, proposals such as targeting high coupon debt, and calling those, for example, would simply not suffice to deal decisively with a problem now decades old. Consequently, a multi-pronged and multi-stakeholder approach would be required to hammer out a strategic plan to enable Jamaica to emerge from its precarious position with minimal impact on the stability of the financial sector and the economy as a whole. The stakeholders that would have to be brought to the table would include the private sector, the banking sector, households and the civil service.

It is important to stress that the strategy for implementing the JDX was developed after extensive consultations with participants across all market segments to reflect, to the extent practical, the specific constraints or preferences of each specific stakeholder. Furthermore, great care went into ensuring that the transaction treated all creditors in a manner that was fair and equitable. In fact, in structuring and executing this complex initiative the single *most important success factor* was to get all major stakeholders to agree on what success would look like.

[1] Domestic bonds issued by the Government of Jamaica all permitted the government to call the bonds at par with two months' notice.

The broad consensus that emerged was:

1) The transaction had to be large. The domestic debt re-profiling exercise was to be a comprehensive transaction that would address <u>all</u> of the Government's domestic publicly traded debt, amounting to J**$700.0 billion** or **65.0 per cent** of GDP.

2) For the transaction to be successful, we would have to **target 100% participation** of domestic bondholders with the aim of having an equitable sharing of the cost.

3) The transaction would have to achieve significant extension in the debt maturity profile while lowering the interest costs of the GOJ.

4) Finally, and perhaps most importantly to Jamaicans, the transaction would have to maintain the constitutionally mandated obligation of the GOJ to honour its debt obligations. Jamaica boasts a long, proud and well-respected tradition of always honouring its debt obligations. The debt re-profiling exercise was not to be an exception to that tradition. This mandate could be met if and only if:

> i) the transaction was structured as a **par-for-par** exchange of old GOJ bonds for new GOJ bonds; and
>
> ii) the transaction was **100 per cent** voluntary with no investor forced into selling the bonds.

Structuring the JDX Transaction

Care was taken to ensure that the transaction was clear, simple and transparent. This, in my opinion, was also a critical success factor. Under the JDX, domestic holders of Government debt had the right but not the obligation to select from a menu of fixed, floating, and inflation-linked securities, subject to a set of allocation rules.

A critical deliverable for the central bank was the stability and resilience of the financial system during and after the transaction. This was critical given that the financial system held **65.0 per**

cent of the domestic debt. The portfolios of the financial system were carefully stress-tested to evaluate the susceptibility to market risks. In particular, what configuration of debt exchange instruments would lead to marked-to-market losses which could potentially impair the capital base of the financial sector?

It was successfully argued that to the extent that this could not be achieved, a fund would be needed that would provide emergency liquidity to institutions which had participated in the transaction. Against this background, a Financial System Support Fund ("FSSF") of approximately **US$950.0 million** was contemplated, to be funded by resources from the IMF, the World Bank and the Inter-American Development Bank ("IDB"). The FSSF would be accessible to participating financial institutions in the event of, for example, a margin call on funds borrowed from overseas institutions arising directly from the debt exchange, a liquidity run on an institution, or problems arising from liquidity mismatches emanating from the transaction.

Finally, in terms of structuring the transaction, the authorities saw the JDX as a prime opportunity to deepen and strengthen the development of the domestic capital market by leveraging the central bank's recent investment in a central securities depository as well as the recently implemented real-time gross settlement system. The transaction was customized to allow for the *dematerialization* of 350 separate paper-based registered bond issues with low levels of liquidity to be replaced by **24** significantly more liquid book-entry securities. The new securities were placed along the maturity spectrum to facilitate the development of a domestic yield curve. The resulting yield curve is now reported on daily by Bloomberg and has already much enhanced the price discovery process in domestic trading.

Evaluating the Performance of the Jamaica Debt Exchange: Is the JDX a game-changer?

By any criteria, the JDX has been a resounding success. We have been fortunate and our strenuous preparations have been well-rewarded. The transaction, which opened on 14 January 2010, closed with a participation rate of **99.2 per cent** on 24 February.

Domestic bondholders, acting in their collective self-interest, rallied around this effort to tackle an increasingly unsustainable debt burden. By the close of the transaction, the debt profile was significantly altered. The weighted average maturity of the domestic debt after the JDX increased by 4.5 years to **9 years**, a level which had not been achieved in all the years leading up to the JDX. The fixed rate and newly introduced CPI-linked portion of the domestic debt increased to **41.0 per cent** from **34.0 per cent**. The average coupon on outstanding domestic debt declined by an average of **650 bps** to **12.5 per cent**, rates comparable to domestic borrowing costs in the period immediately prior to the financial crisis in the United States and Europe. The estimated interest cost savings for the Government is JA**$41.0 billion** annualised.

In response, multi-lateral agencies endorsed the reform agenda with financing of **USD$2.4 billion** over the next two years. This level of support from the IMF, the IDB, and the World Bank helped to build confidence not only for the JDX but also for the medium-term economic programme of Jamaica. Rating agencies, as many of you may know, have signalled the game-changing nature of these efforts as they upgraded the ratings on Jamaica's sovereign bonds from Selective Default (**SD**) to grades that are higher than pre-JDX. Spreads on GOJ global bonds have narrowed significantly post-JDX and the new bonds which were issued as part of the exchange are trading above par. Additionally, anecdotal information suggests renewed interest in GOJ global bonds by international investors who, prior to the JDX transaction, had offloaded their holdings to domestic bondholders. This could be described as perhaps the acid-test of the success of the JDX. Finally, and perhaps, most importantly, we have seen significant improvements in the level of volatility in our key macro-economic indicators. Bank of Jamaica's macro-prudential index, which synthesises all the macroeconomic variables into a single indicator, has declined towards pre-Lehman Brothers collapse levels. This is primarily as a result of the marked reduction in the volatility of the exchange rate and the inflation rate as well as our significantly reduced exposure to currency risk.

The main lessons, I think, critical to the success of any debt re-profiling exercise are:

(i) a broad consensus on the need for immediate and fundamental change and that all stakeholders have to share in the burden of that particular transformation;

(ii) a stakeholder approach to the broad design of the transaction;

(iii) the transaction itself must be simple, clear, equitable and transparent;

(iv) the proper identification of risks and risk mitigation strategies to address those risks;

(v) careful attention to the design of all elements of the transaction in order to reinforce collective action decisions by participants; and

(vi) finally, the transaction must be underpinned by a broader programme of reforms that investors can buy into. The JDX was not conceptualised nor communicated simply as a financial transaction but rather as an integral part of Jamaica's strategic economic programme. This economic programme included significant fiscal reforms and supporting policies aimed at the virtual elimination of the fiscal deficit in four years as well as institutionalising principles of prudent fiscal management.

The net result of the JDX is a present that is markedly different from the recent past and a promise of an even more attractive future.

Thank you.

POWERPOINT PRESENTATION

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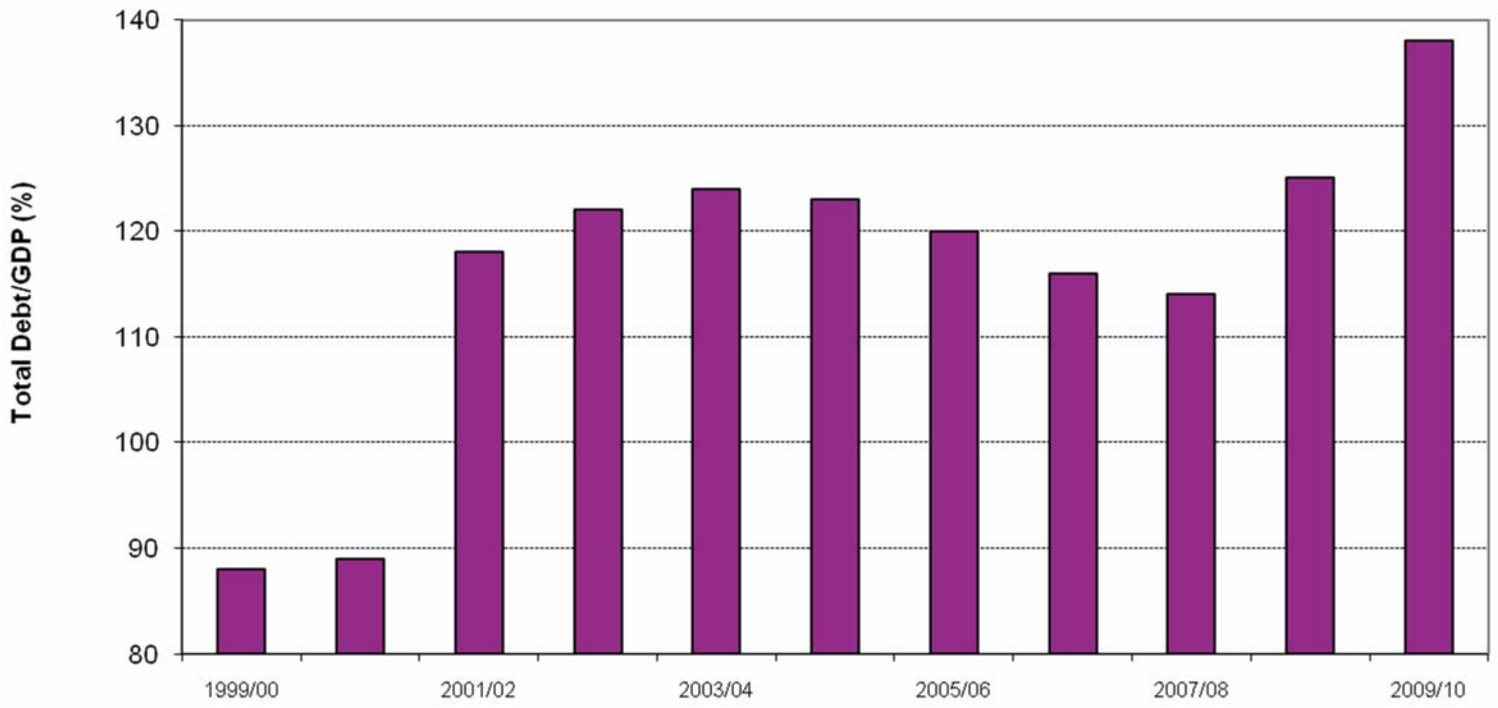
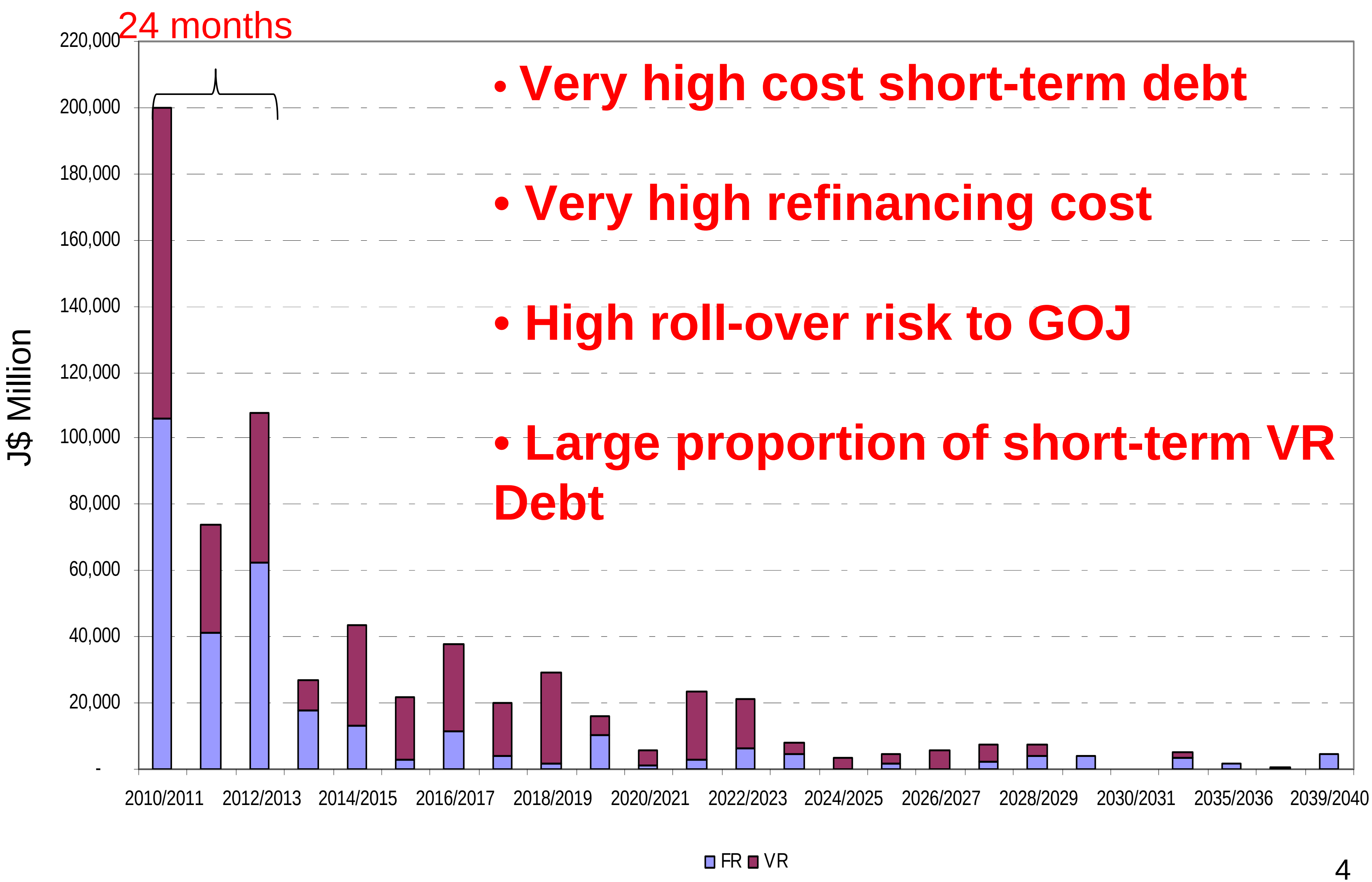
Global and Macroeconomic Context for the Debt Management Initiative

High Levels of Debt

Debt / GDP

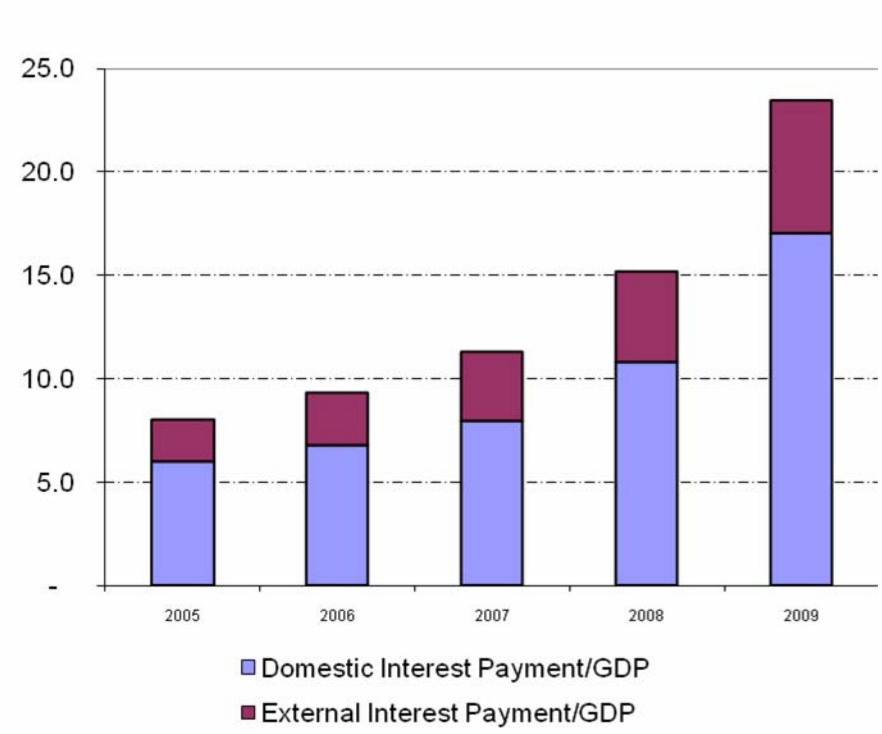


Structure of Domestic Debt Before JDX

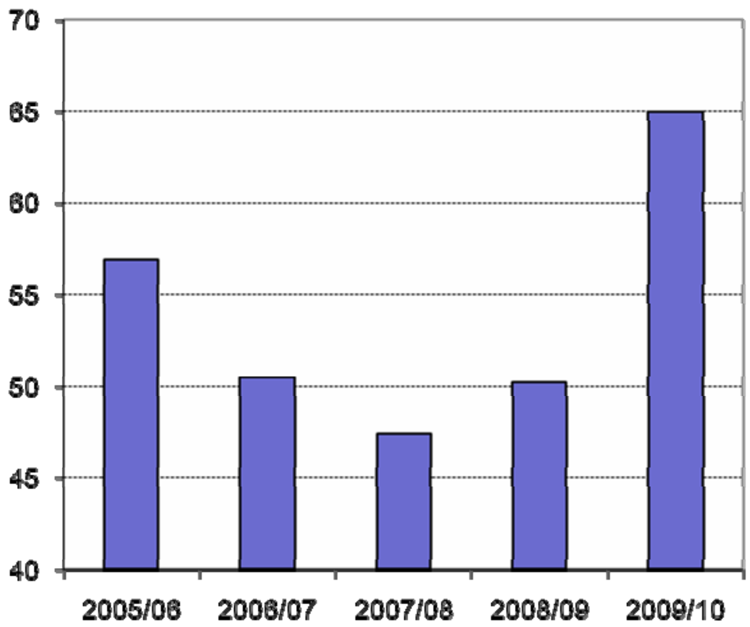


Rising Debt-Service Burden

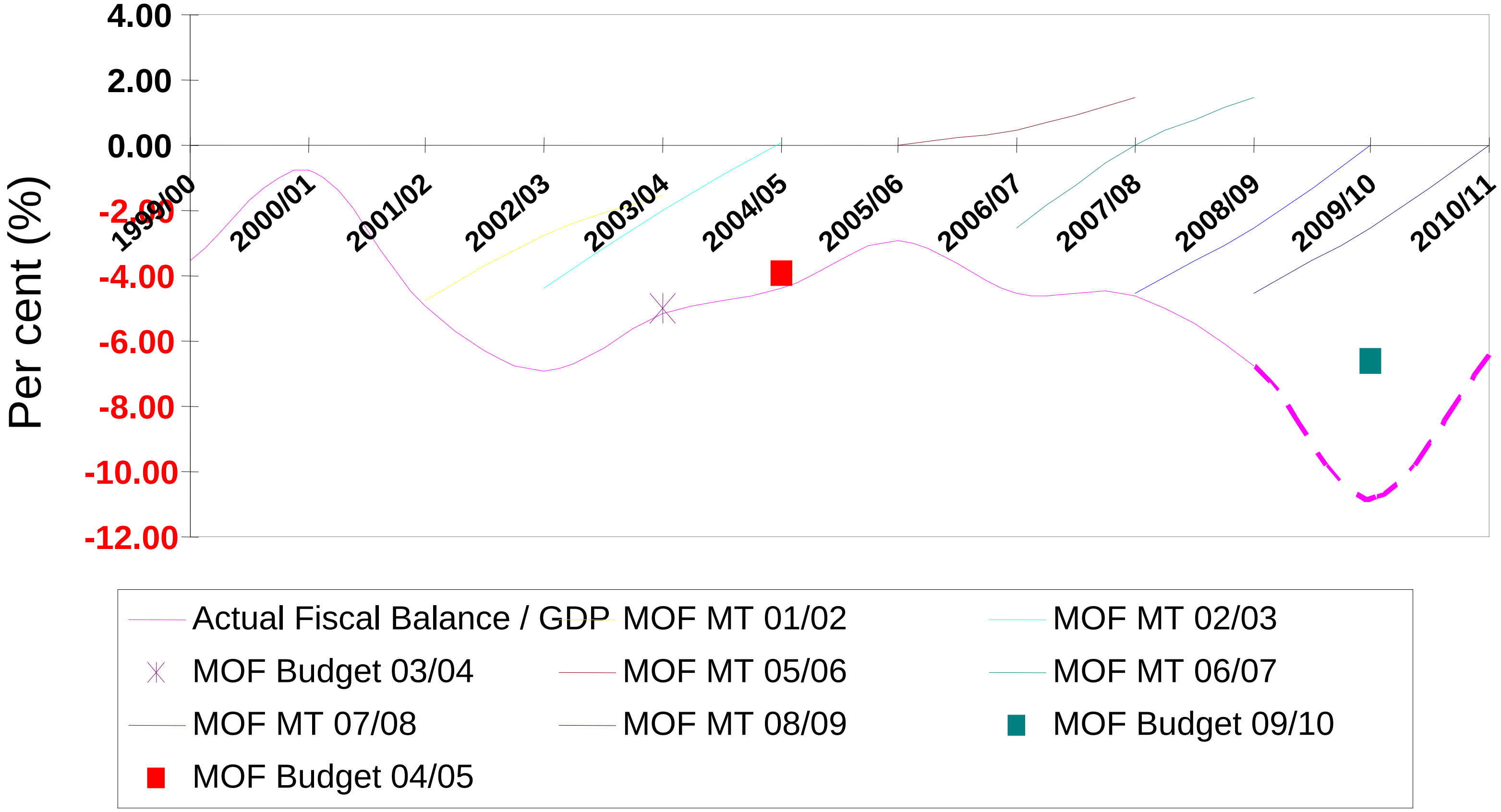
Interest as % of GDP



Interest as % of Tax Revenues



Persistent Fiscal Deficit Deviation From Projections



Assessment and Challenges

- **Economic growth below potential**
- **Debt/GDP ratio high and rising**
- **Interest cost crowding out public investment & services**
- **Excessive nominal and real local interest rates**
- **High sensitivity to global economic and financial market shocks**
- **Recurring fiscal slippage and rigid expenditures**

- Strategic plan
- Stakeholders
- Extensive consultation
- Fair and equitable treatment
- Defining success

Defining Success

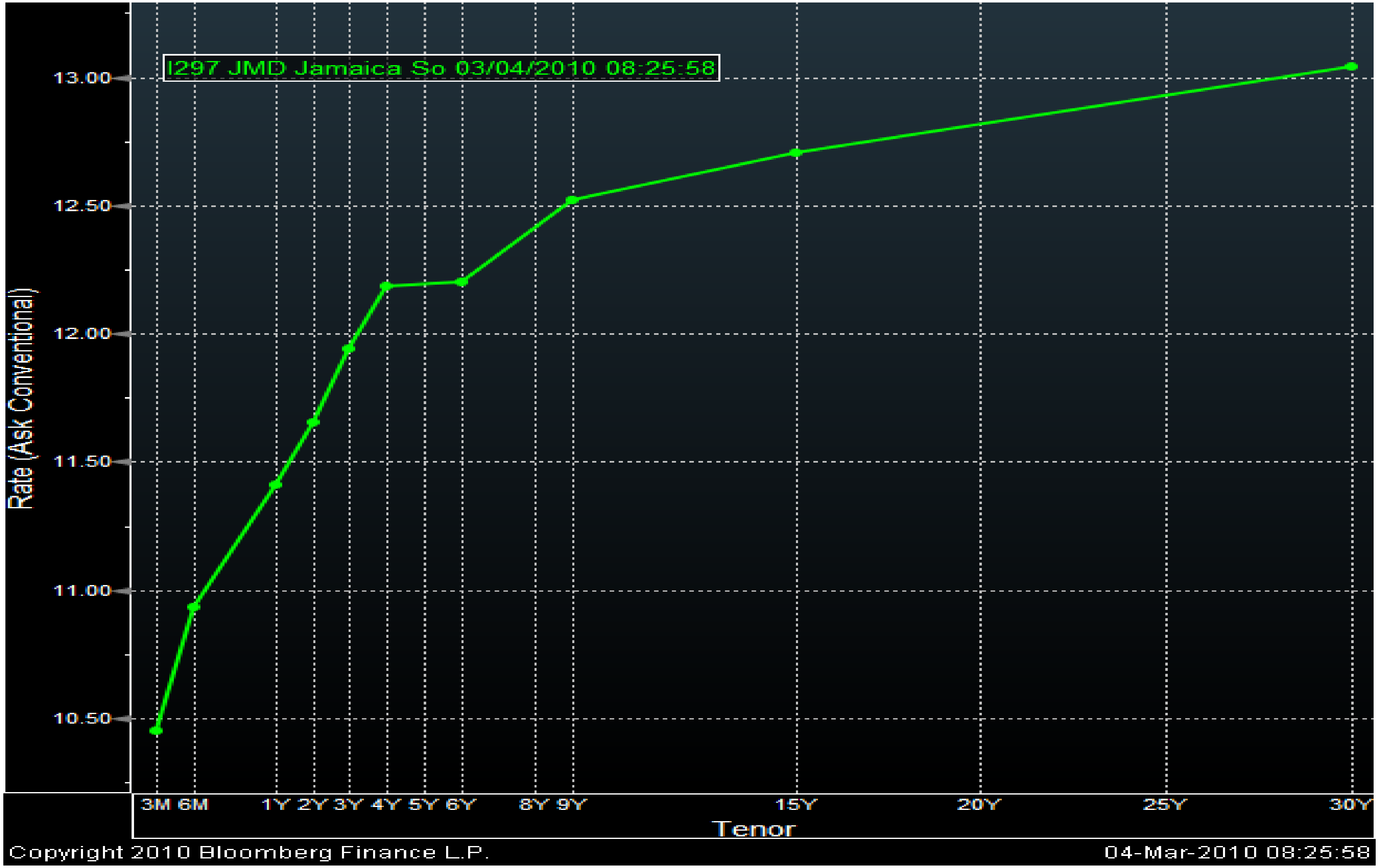
- Target 100.0 per cent of Domestic Debt
- Target 100.0 per cent Participation
- Lengthen Maturity Profile and Lower Interest Cost
- Maintain constitutional obligation to honour debt
  - Par-for-par exchange of bonds
  - Voluntary exchange

Structuring the JDX Transaction

- Clear, simple and transparent
- Maintain stability and resilience of financial sector
  - Stress-tests
  - FSSF
- Strengthen domestic capital market
  - Dematerialisation
  - Liquid benchmark bonds

Bloomberg

Yield curve I297



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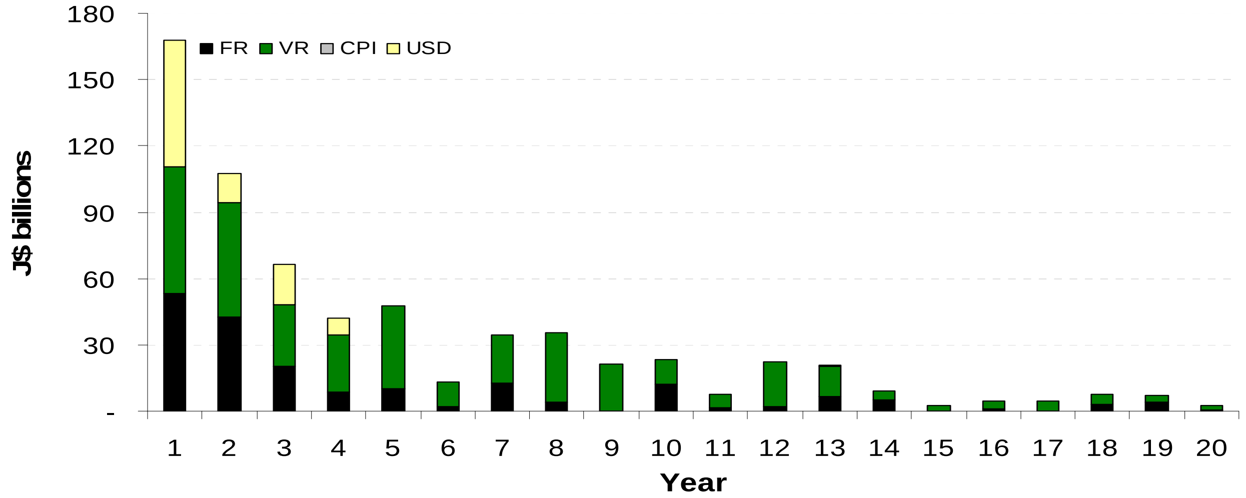
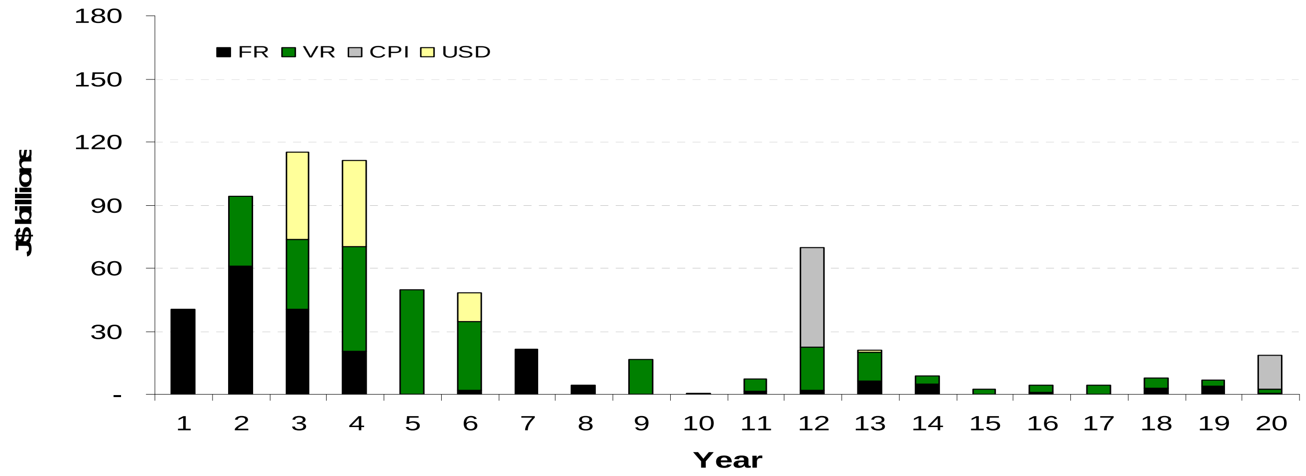
Was the JDX a game changer?

Maturity Profile Impact of Transaction

Before:



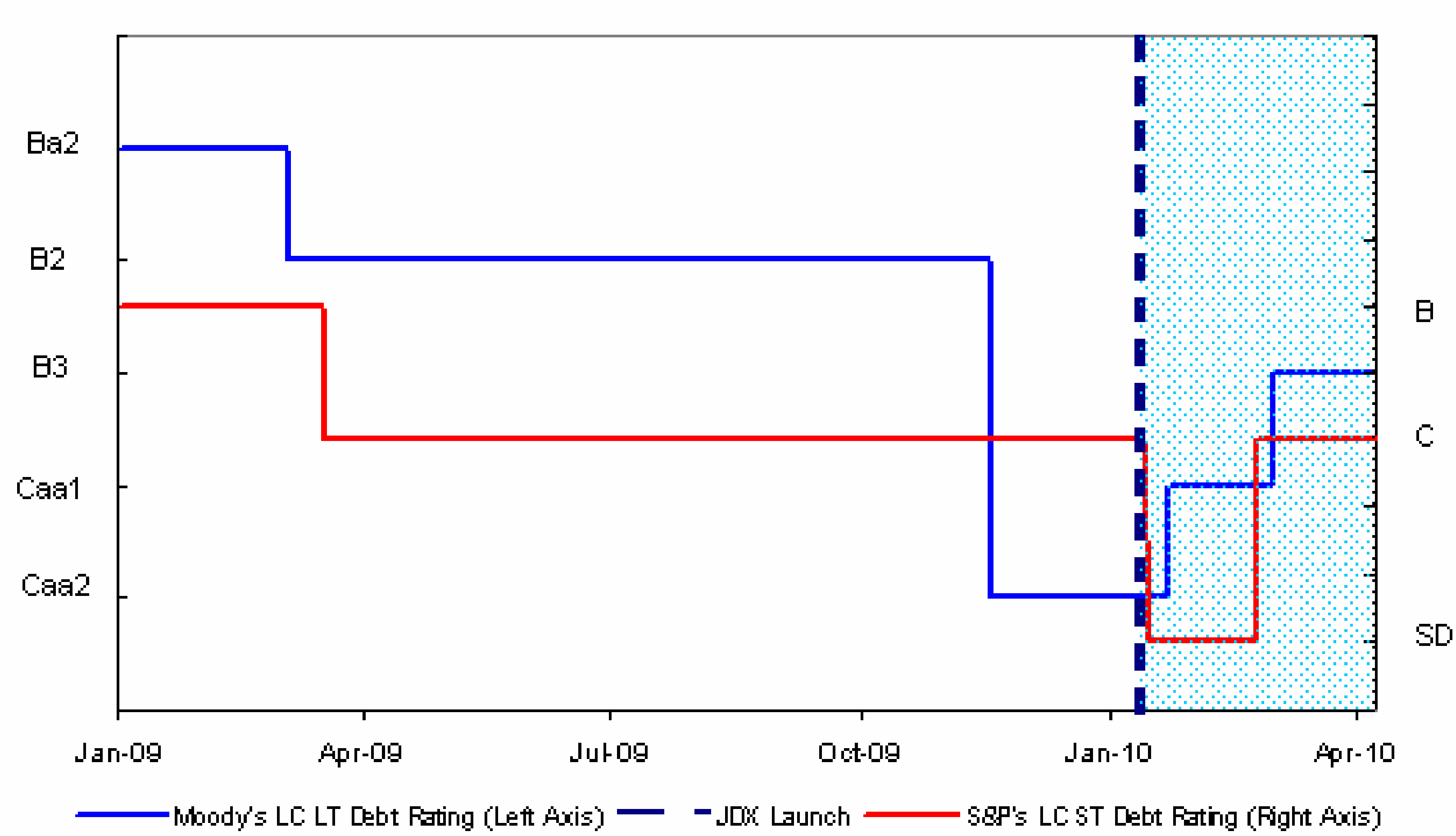
After:



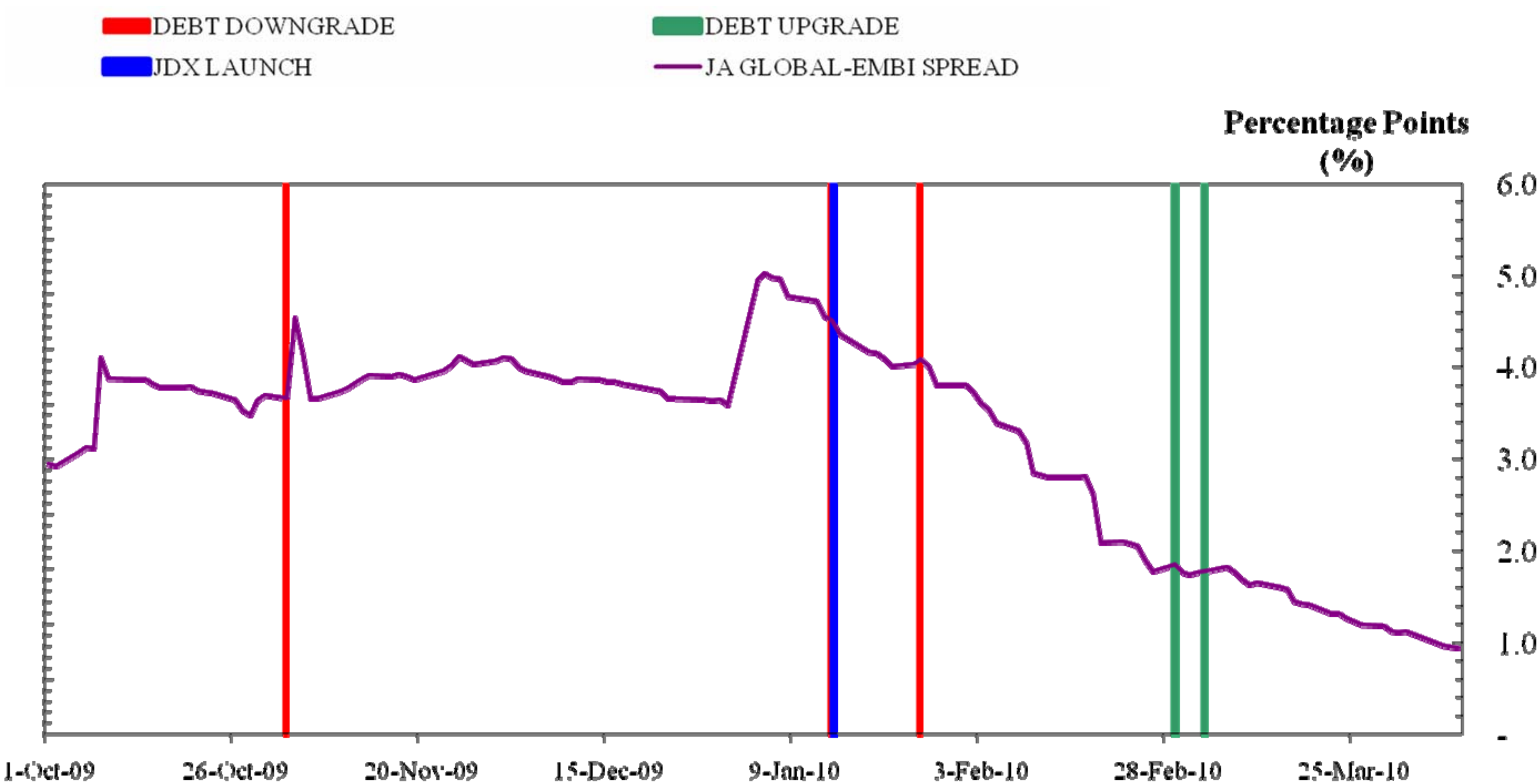
Debt Profile

	Pre-JDX	Post-JDX	Difference
Simple Average Age of Debt (Years)	6.5	8.0	1.5
Weighted Average Age of Debt (Years)	4.5	8.9	4.4
Variable Rate Portion (%)	53.9	47.7	- 6.2
Fixed Rate Portion (%)	33.9	38.1	4.2
US$ Portion (%)	12.2	11.0	-1.1
CPI Indexed (%)	-	3.2	3.2

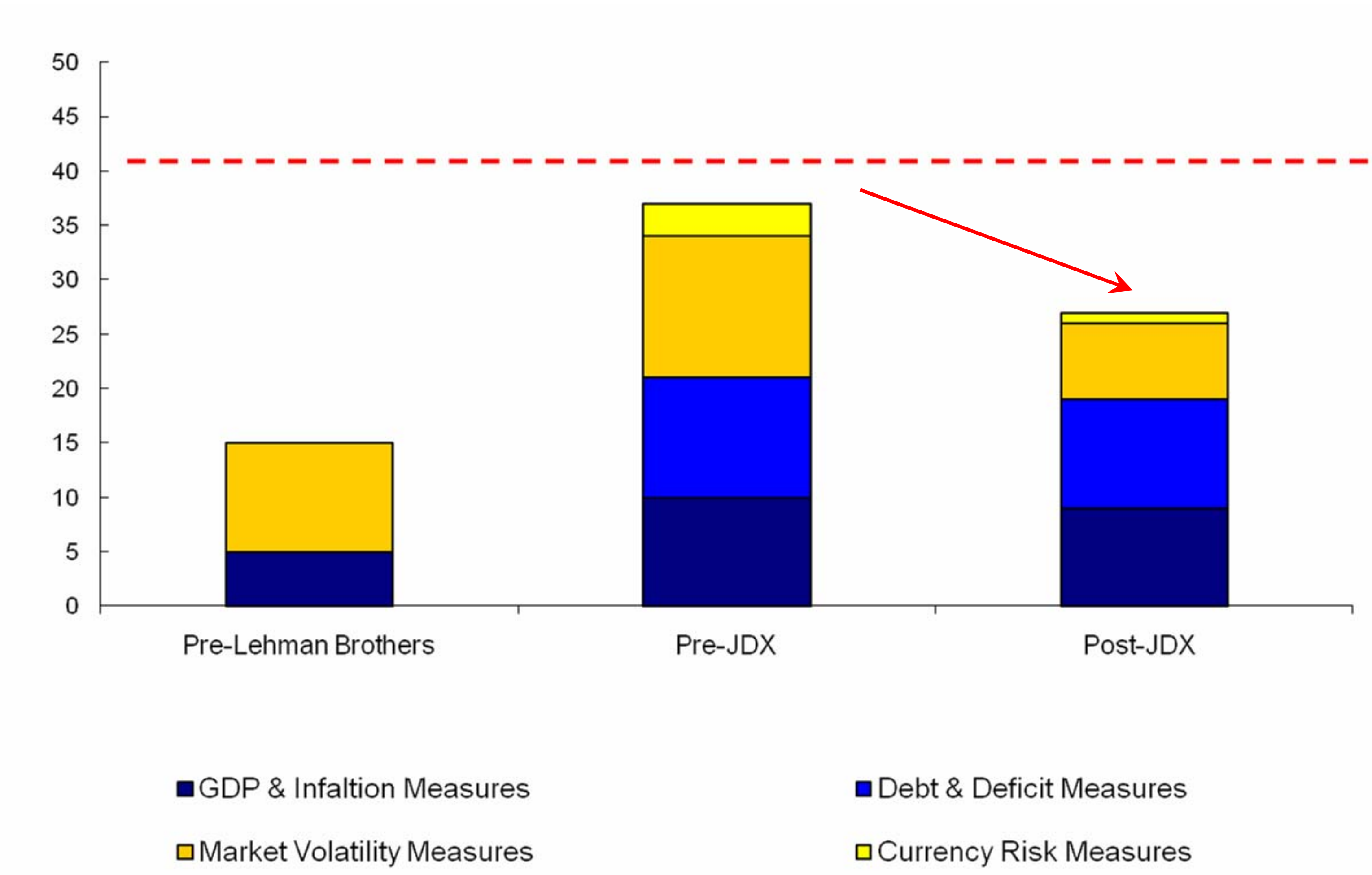
Credit Rating Upgrades Post-JDX



Narrowing Credit Spreads Post-JDX



Improvement in Macro-Prudential Index



Main Lessons Learnt

The success reflected:-

- A broad consensus on the importance of the transaction
- A stakeholder approach to the broad design of the transaction
- Transaction must be simple, clear, equitable and transparent
- Risk identification and mitigation is paramount
- Design should reinforce collective action
- Transaction backed by broader economic and legislative reforms

Economic Programme

Objective

- Decrease public debt ratio
- Institutionalize Fiscal discipline and accountability
- Raise real GDP growth rate

Pillars

- Fiscal consolidation strategy
- Comprehensive domestic debt management strategy
- Reforms to strengthen the financial system

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