

COMMENTS ON SESSION IV: MANAGING PUBLIC DEBT

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This was a great session and I found the papers very educational and stimulating. Five of the papers included in the session are country studies and the remaining two papers examine theoretical developments in debt management policies and identify possible points of contradiction between fiscal policy and debt management objectives. The country studies include interesting cases spanning across the spectrum of young transitional (Czech Republic) and mature market (Australia, Italy and Japan) economies, reflecting differences in underlying debt dynamics. I commend all the authors for their thought provoking analysis. My comments will focus primarily on the country studies with examples from the United States and the state of New Jersey. Despite differences, the US experience with public debt management policies, particularly, at the state level may be quite revealing for the countries under consideration.

Wolswijk's survey paper sets the stage for the analysis of individual country studies. I will begin with Cannata *et al.*'s paper on Italy, which outlines a sophisticated approach for stochastic optimal portfolio selection in a post euro environment and presents a model for primary budget balance forecasting. The authors point out that the objective of debt managers is to minimize some measure of expected financing cost in the long run while keeping risks under control, recognizing cost/risk trade-off. The paper highlights the large number of random forces entering the debt official's decision making process rendering optimal debt management a very complex task. The model introduces a useful framework relating to stochastic behavior, however, the long-term horizon facing public debt managers makes their job more challenging. The paper suggests that even though debt managers would look at all the models but ultimately a lot depends on their experience and good judgment!

In the papers on Australia and Japan, two distinct approaches to public debt management policies are outlined. Lebow discusses the monetization of Japanese government debt and raises questions relating to long-term sustainability, particularly, if the macroeconomic fundamentals deteriorate. According to Standard & Poor,¹ a rating agency, Japan is expected to face the world's largest debt burden of 700+ per cent of projected GDP by 2050, reflecting its generous pension promises, the longest life expectancy and one of the lowest fertility rates in the industrialized world. It is interesting to note the home country bias of the Japanese debt structure and the historically low rates of interest.

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The views expressed are those of the author and do not necessarily represent the views of the New Jersey Department of Treasury.

¹ See the *Financial Times*' article dated 4/1/04.

The paper by Fujii, the second on Japan, highlights the possible threats to the Japanese economy when interest rates rise. Fujii examines policy implications based on simulation results using stochastic modeling of the interest rate within a Cost-at-Risk concept. Monte Carlo simulations are conducted to analyze the issue of choice among different maturity structures as an issuing strategy to study underlying risks associated with refinancing when interest rate environment changes. The results show that risks increase under relatively short portfolio strategies. Fujii suggests moving in the direction of financial instruments with greater long-term maturity and recommends that the respective authorities take into account underlying market conditions and trends before developing the issuance plans. The importance of maintaining stable macroeconomic policies to ensure the success of risk management strategies is also emphasized in the paper.

Comley and Turvey's paper examines issues and options with debt management policies in a low debt environment that Australia is experiencing. In contrast to Japan's high debt situation, Australian debt management measures have been driven by the need to adjust to declining levels of net debt, which resulted in a fundamental review of the country's debt management operations. Supporting financial market efficiency and achieving an appropriate balance of cost and risk for the government are the two primary public debt management policy objectives to be attained through physical bond issuance and financial derivatives (or interest rate swaps), respectively. The paper emphasizes the importance of the Treasury futures market and the role of swap market and outlines the new portfolio benchmark, hedging options and liquidity. The futures market is to be supported via issuance targets. The new debt management framework is outlined in a transparent and explicit manner; however, we need to wait through a few budget cycles before evaluating its success.

Matalík and Slavík's paper presents a detailed analysis of the evolution of debt management policies in the Czech Republic and highlights issues unique to transitional economies that are undergoing economic transformation from a centrally planned economy to a modern market-oriented one. Issues surrounding the financing of hidden government debt and privatization revenues are cases in point. The intensive cooperation and coordination between the Ministry of Finance and the Czech National Bank (CNB) is enumerated in detail. It is interesting to note that although the debt strategy is the primary responsibility of the Ministry of Finance, the CNB plays a significant role in the country's public debt management, reflecting a solid form of fiscal and monetary policy coordination in the Czech Republic. Several good debt management operations are outlined relating to: the development of the domestic financial and capital market infrastructure and its liquidity; decreasing the refinancing and interest risks; broadening of the investor base; increasing participation in the foreign capital market through the issuance of euro denominated bonds; and undertaking buy-backs through the new reversed issues of government bonds to lower refinancing risk. Since the innovations and reforms in debt management strategies are fairly recent it will be a while before a progress report is possible.

Nenova and Kaloyanchev's paper examines the effect of contradiction between fiscal policy and debt management objectives. The paper highlights how inconsistencies in a country's macroeconomic policies undermine the credibility and the consequence is a high risk premium on government debt. In emerging market economies there is strong pressure on the government to spend more than their revenues. The situation is exacerbated due to low income and low level of savings and rampant tax evasion. Debt financing and management in emerging market economies have the potential to be effective only under the conditions of a slow rate of debt accumulation and stable risk premium or in the period of risk premium deceleration.

In general all the papers presented in the Public Finance Workshop, and in Session IV in particular, indicate the seriousness of the public debt crisis facing the EU and other industrialized countries. Sound public debt management policies are called for to avoid severe adverse consequences from the rapidly growing budget imbalances. Public debt management issues and options highlighted have a lot in common in the four countries included in this session as well as US. However, there are some interesting differences as well. Let me briefly summarize the US case to illustrate the underlying similarities and differences in public debt policies across country lines.

In 2003, public debt in the US totalled \$6.7 trillion, up 8.7 per cent on a year-over-year basis and accounted for 61 per cent of GDP. However, the percent of net public debt, which excludes intragovernmental debt, accounted for around 36 per cent of GDP for all of last year and had a growth rate close to 10 per cent on a year-over-year basis. The distribution of total public debt by major type of holders was: total privately held (47.9 per cent), Federal Reserve (9.7 per cent) and total intragovernmental (42.4 per cent). For fiscal year 2003, long-term debt outstanding for the state of New Jersey was \$18.8 billion representing an increase of 9 per cent over a year ago and the bulk (85+ per cent) comprising of bonded debt categories including general obligation bonds, revenue bonds and installment obligations.²

In the US, the debt crisis is exacerbated due to entitlements such as on Medicare, which generate uncontrollable costs both at the federal and state levels. Similar experiences, particularly, relating to pension expenditures were indicated in the country studies (e.g., Japan). Over two-fifths of total debt in 2003 was in the intra governmental category due to mandates requiring investments in government account series.

Over the last ten years, the share of privately held debt in total public debt went down from 67 in 1994 to 48 per cent in 2003. The paper by Comley and Turvey presented the Australian experience with declining share of net debt. As the federal budget moved from deficit to surplus, the government's bond position improved, enabling a reduction in the privately held debt in the US. For instance,

² Refer to New Jersey's Comprehensive Financial Report for the fiscal year ending June 30, 2003 for a discussion of New Jersey's debt categories and other info.

when the Social Security Trust fund runs a surplus, the government buys back debt from the public, lowering the share of privately held debt in the US. With its buy back operations, the Treasury has maintained liquidity in the financial markets and reduced the cost of public borrowing. The paper on the Czech Republic had a discussion of similar buy-back options through the reversed issues of government bonds.

In the US, public debt is primarily a function of the budget. The US Treasury Department decides on how much and what type of debt to issue, including length of maturity. The Federal Reserve Bank (or the central bank) plays the role of a fiscal agent and has no significant direct participation in public debt management in the US. Browsing through the country studies I get the impression that even though the central banks engage in standard monetary policy activities, these agencies appear to play a more active role in public debt management policies in these countries. In contrast, public debt management in the US is the primary responsibility of the Treasury Department.

Another difference I noted relates to public debt management goals, particularly, those relating to managing interest risks and associated cost management. The federal government in the US focuses primarily on maintaining liquidity and efficiency in the financial market than maintaining interest rate costs through interest rate swap activities. The Australian paper illustrates this point.

However, it is important to note that public debt management strategies discussed in the papers have more in common with such policies at the US state level. New Jersey for instance, entered into eleven swap agreements during April and May 2003 in association with \$3 billion of future bond transactions involving the New Jersey Economic Development Authority's School Construction Program.³ The swap agreements enable the state to take advantage of the existing historically low fixed interest rates on future debt thereby limiting its interest rate exposure.

One of the major goals of debt management at the state level in the US is to maintain the investment grade of both long- and short-term credit rating of the state and its bond issuing authorities. New Jersey attempts to control the issuance of new general obligation debt by the amount of general obligation debt retirement. The distribution of the debt portfolio is managed by effectively trying to balance the mix of pay-as-you-go appropriations with bonded debt. Another important debt management strategy relates to balancing the implementation of capital improvements with the need to minimize debt.

Other differences relate to the type and length of maturity of public debt. The country studies suggest a preference for relatively long term debt (Australia, Japan, and Czech Republic) whereas in the US issuances with shorter maturities account for a substantial share of total debt. For instance, Treasury bills (under 1 year) and Treasury notes (1-10 years) accounted for over two-fifths of total public held debt in 2003. The US also stopped issuing the 30-year bonds in October of 2001. Also,

³ See the New Jersey CAFR report for FY2003.

inflation indexed notes and bonds account for a very small share, under 3 per cent, of total public debt in 2003.

Another noticeable difference in the debt portfolio among these countries is the relatively large share of debt held by foreign investors, reflecting the attractiveness of US debt instruments. Foreign debt accounted for 21 per cent of total public debt in 2003 and constitutes the single largest component of total privately held debt in the US. Also, its share has been growing steadily and increased substantially from 14.3 per cent of total public debt in 1994. In contrast, this category accounts for a very small percentage of total public debt in the rest of the countries. Some of the country studies did indicate this limitation and have plans to become more active with foreign capital markets.

In conclusion I would like to reflect that fiscal imbalance is a serious problem worldwide and developing optimal debt management strategies is very crucial for sound public finances. Developing efficient capital markets, maintaining sound economic fundamentals through stable macroeconomic policies, issuance of a diversified and flexible debt portfolio along with fiscal discipline, all point in the right direction. The policy makers need to recognize underlying policy trade offs and should strive to adopt transparent debt management rules to build voter confidence. In the US fiscal discipline is superimposed, particularly, at the sub-national level since people vote with their feet as there is free mobility across state lines. Fiscal discipline is likely to become more effective as the degree of mobility improves among EU member countries.

