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# PUBLIC FINANCE AND REGULATION

## PUBLIC DEBT MANAGEMENT

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**Abstract:** The paper generally describes the segment of public debt management or especially the structure of public debt. It focuses on different kinds of risks which present potential danger for the public debt explosion. It intends to explain the government goal for borrowing money at lowest rate and sustain the fiscal stability. Also, it explains some practical issues regarding this topic for Republic of Macedonia for the period from 2009-2011. In the process of research were implemented several qualitative methods.

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## Introduction

Based on the experiences from the debt crises of the 1980s and 1990s, the last 20 years in public debt management has changed significantly in many countries. The presentation of the operational dimension of fiscal and monetary policy, it became a custom activity with goals of portfolio management in terms of cost and risk. The size of the public debt is mainly due to fiscal policy and deficits, while the public debt management affects the structure of the public debt, and through him on the level of exposure to macroeconomic and market risks. Public Debt Management aims to design and implement a strategy for the management of public debt in a way that will provide time withdrawals of funds for budget execution. At the same time, public debt management should achieve goals related to establishing a balance between the risks and costs of long-term portfolio, and other targets set by the state. In other words, government policies should ensure economic growth and growth of debt that will result in long-term fiscal sustainability. States, from a macroeconomic point of view, should endeavor to ensure that the level and rate of growth of their public debt is fundamentally sustainable and will be serviced in different circumstances between achieving these cost and risk objectives. Managers of government debt share the concerns of fiscal and monetary policy counselors that the public sector debt remains on a sustainable path and that the credantial strategy is aimed at reducing excessive levels of public debt. Debt managers should ensure that fiscal authorities are aware of the impact of state funding needs and levels of debt on the cost of borrowing. Examples of indicators that covers the issue of sustainable debt includes indication of servicing the public debt, indicators of public debt to GDP and to tax revenues.[1] Poorly structured debt in terms of maturity, currency or interest rate composition and large and unfunded contingent liabilities represent important factors in imposing or propagation of economic crises in many countries throughout history. For example, regardless of the exchange rate regime or whether it is involved in domestic debt and foreign currency, crises often are result from excessive focus of the states for possible cost savings followed by large amounts of short-term or floating debt. That led the state budgets in situation of serious exposure to changes in financial market conditions, including changes in the creditworthiness of countries, when the debt had to be delayed. Debt in foreign currency also has its specific risks and excessive leverage can lead to pressure on the exchange rate or monetary policy, especially if investors are not decisive for refinancing of government debt denominated in foreign currency. By reducing the risk management in which government debt portfolio will become a source of instability for the private sector, prudent management of government debt, followed by sound policies in the management of contingent liabilities, can make countries less exposed to damage and financial risk.

## Public debt management

Debt portfolio is usually the largest financial portfolio in the country. It often contains complex and risky financial structures and can generate a significant risk to the balance of payments of the country and financial stability. As noted by the Working Group on capital flows of the Financial Stability Forum, "recent experience marked the need for states to limit the accumulated liquidity risk and other risks that make their economies vulnerable to external shocks." Therefore, quality risk management by the state is an essential part of risk management by other sectors of the economy, "because the individual entities within the private sector, typically, are faced with enormous problems when inadequate risk management performance generates vulnerability to liquidity crises" (Financial Stability Forum, 2000, p.2).

Quality debt structures help countries to reduce their exposure to interest rate, currency and other risks. Many countries seek to support these structures by establishing, where possible, portfolio guidance related to the desired currency composition, duration and maturity structure of the debt to control the future composition of the portfolio.

The importance of sound debt management practices, and the need for efficient and functional capital market has come to the fore with the emergence of several crises of market debt. Although, perhaps policy management of

[1] Excessive levels of debt resulting in higher interest rates can have opposite effects on real output. See, for example: Alesina, A., M. de Broeck, Prati, A., Tabellini, G., 1992. "Default risk on government debt in OECD Countries," in Economic Policy: A European Forum, pp.427-63

public debt were not the only or main cause of these crises, the maturity structure, interest rates and currency composition of the debt portfolio of the state, along with significant commitments in respect of contingent liabilities, contributed to the serious consideration of crises. Even in situations of a quality setting for macroeconomic policy, risk management practices in the debt increases the vulnerability of the economy to economic and financial shocks. Sometimes, these risks can be neutralized by relatively direct measures, such as: extending the term of maturity of indebtedness and the payment of higher costs of servicing the debt (assuming the curve of rate of return on an upward slope) by adjusting the amount, date of maturity and composition of foreign exchange reserves by looking at the criteria and state contracts in respect of contingent liabilities.

Usually risky debt structures are the result of inadequate economic policies - fiscal, monetary and exchange rate - but the "feedback" effects are moving in both directions. However, there are limits in terms of what they can offer the sound policies in the management of public debt. Healthy management debt policies are not substitute for quality management with fiscal and monetary policy. If macroeconomic settings are poor, prudent public debt management will not be sufficient to prevent the particular crisis. Experience supports this argument, for example, that the developed domestic debt markets can be a substitute for bank financing when the source dries up, helping the economies to cope with financial shocks (and vice versa).[2]

When it comes to effective debt management should consider Strategy for Public Debt Management and Strategy for Risk Management. The most significant risk is one that is determined by the structure of the public debt. To achieve effective public debt management is essential need for continuous monitoring and periodic evaluation of the risks that may have a significant impact on the structure of the debt portfolio. Such risks worth mentioning are: market risk, refinancing risk, liquidity risk, credit risk, settlement risk, and operational risk.

The risk who includes changes in prices affecting the cost of servicing the debt is known as *market risk*. This refers to changes in interest rates, changes in inflation rates, exchange rates, prices of some raw materials - the cost of servicing government debt. Changes in interest rates, including debt in domestic and foreign currencies, affect the cost of servicing the new debt at the time when refinancing of the debt is made with fixed rate and variable rate on the rate reset date. Hence, debt with a short maturity (short-term or variable rate) are considered more risky than long-term debt with fixed rate (also excessive concentration of long-term instruments with fixed rate debt can be risky in terms of uncertain future financial needs). Debt denominated in or indexed to foreign currencies also adds uncertainty to the cost of servicing the debt measured in domestic currency, as a result of movements in exchange rates.

[2] See, for example, Chairman Alan Greenspan speech before World Bank Group and the International Monetary Fund, Program of Seminars, Washington, D.C., September 27, 1999

*Refinancing risk* is the risk that debt by at maturity will have to refinance ie "rall over" at a high interest rate or will not be refinanced in general. Debt managers should refinance the mature debt at low costs. The normal way to reduce the risk of refinancing is through a prolonged period of maturity, which in turn may be in conflict with the purpose of financing the debt with low cost, which is characteristic of short-term instruments. Therefore, the primary task is balancing the refinancing risk aimed at reducing the cost of borrowing for the relevant projections for annual refinancing needs and the maturity structure of debt.

*Liquidity risk* refers to the situation when the amount of liquid assets reduces, because of unanticipated cash flows and / or due to problems in finding free cash, where for short term, through borrowing of money, budgetary costs will be realized.

The *credit risk* refers to two types of risks. State credit risk is a key determinant of the cost of government borrowing. Another risk, facing the Government, generally refers to the risk that the investor (lender), whose bid in the auction was accepted by the Government, will not perform his obligation to pay the amount of the bill accepted by the Government (risk business partner) .

Under the *settlement risk* refers to losses due to the inability of the state to settle for a number of reasons, but not because of his solvency or default.

*Operational risk* includes various types of risks such as errors in the execution of transactions, the lack of internal control, legal risk, security risk, and others.

States should endeavor to minimize the expected cost of servicing the debt and costs of holding liquid assets and subject them to an acceptable level of risk for a period of 5 years. Minimizing costs while simultaneously ignoring the risks should not be the goal of the manager. Transactions that appear to reduce the cost of servicing the debt, often contain significant risks for the country and may limit their capacity to repay creditors.

Developed countries, which typically have a deep and liquid market for their securities, often focus on market risk using stress tests, through the use of sophisticated portfolio models, can measure this kind of risk. In contrast, developing countries that have limited access to foreign capital markets and have relatively underdeveloped domestic debt markets, should pay close attention to the risk of refinancing. This objective is particularly relevant for countries where market constraints such as short-term debt, debt with variable interest rate and foreign currency debt may be, at least in the short term, the only viable alternatives to monetary financing.

These risks and goals should be clearly incorporated into functional strategy for debt management which defines strategic objectives and program financing budget expenditures. After office debt management will deliver a win-win strategy with the proposed objectives, the Minister shall decide on them according to the prefered level of risk and those goals are automatically transformed into strategic goals. Following the decision of the Minister of Finance, Office of Debt Management becomes responsible entity in the implementation and realization of such goals.

The publication of the strategy for public debt management strengthens the transparency and responsibility of the office of public debt management.

## Public debt management in Macedonia

After previously elaborated general conception of public debt management is necessary to make a brief review of the policy and strategy for the management of the public debt of the Republic of Macedonia, which in large part is trying to neutralize the impact of the numerous risks through continuous servicing of debt obligations.

Under the Public Debt Law, public debt of the Republic of Macedonia is a sovereign debt and the debt of public enterprises and companies that are fully or predominantly owned by the state, municipalities in Skopje and Skopje and the National Bank of the Republic of Macedonia. What should be emphasized is the harmonization of the public debt law with GFS methodology for calculating public debt in which as public debt is considered and the debt of the National Bank. This adjustment of the Public Debt is used for statistical purposes to obtain an indicator that can be compared with the ratios of public debt to other national economies.[3]

From the Strategy with Macedonia's public debt can be concluded that the relationship between total public debt to GDP and public debt/GDP ratio at the end of 2009 was 27.1% and 24.3%, which are conditions that are below the targets set in strategy for the period 2009-2011, and according to which the total public debt should not exceed 40% of GDP and public debt 30%. Also, the ratio of guaranteed debt is lower than the set target of 10% which for 2009 was 2.6%. While debt in local currency had decreasing trend of 9% at the end of December 2008 to 1.7% at the end of 2009. Conversely, the debt issued in foreign currency clause, issued and paid in denars, but indexed to the euro currency, increased. The need to increase reserves to maintain the fixed exchange rate regime led to a decision to increase the share of the euro in the currency structure of total 77.1% an increase of 11.3%. That is within the target of the strategy can be said also about the net debt ratio based on total public debt, that refers to disbursements based on total debt net of repayments at the end of 2009 who was 211.7 million euros. An amount that is below the planned limit of 370 million euro.

According to the Public Debt Strategy 2009-2011, Macedonia will try to get to the source with fixed interest rates, but in this period of 3 years to maintain the current interest rate structure, primarily for two reasons: first, new borrowing in international financial institutions were made under variable interest rate, and second, underdeveloped market of domestic securities who doesn’t have potential. As for the currency structure is proposed to dominate debt denominated in euros, because current strategy of targeting the exchange rate and debt denominated in local currency. Regardless of this, it is planned to increase the debt in other currencies, but the focus is placed on the euro, which

[3] Official Gazette of Macedonia, No.62/2005 and 88/2008

should reach 70% of total public debt +/- 5% deviation, and rate with 13% of the total public debt or deviation of +/- 3%.

The objectives of management of the public debt of the Republic of Macedonia under the public debt law are as follows:

1. Taking measures and activities by the Ministry of Finance to provide funding for the state with the lowest possible cost, in the medium and long term and sustainable level of risk, and
2. Taking measures and activities by the Ministry of Finance to develop and maintain effective domestic financial markets.

As for trends in public debt in the period from 1 January to 31 December 2009, it increased to 258.7 million euros, or 3.3% relative to GDP, at the end of the year amounted to 2,128.8 million euros or 32.1% of GDP. These movements are tracked based on the National Methodology and the International Monetary Fund. Government debt increased by 210.2 million euros at the end of 2009 reached a figure of 1,597.2 million euros. Besides insignificant increase by 2.7 percentage points relative to GDP, ie from 21.3% to 24.1%, the conclusion remains that the public debt of the Republic of Macedonia remained well below the reference level of the Maastricht criteria, according to which the general debt Government must not exceed 60% of GDP.

Such a state of public debt in Macedonia 'is caused by the need to extend the performance of numerous capital projects related to education, social sphere such as social housing, agriculture, investment in health, road infrastructure, rail traffic and the energy sector. Also, in 2009 the broadcast is typically the second Eurobond in the international capital market totaling 175 million euros, and the withdrawal of a general allocation of Special Drawing Rights of the International Monetary Fund by the Central Bank of the Republic of Macedonia in the amount of 55.9 million euros and a special allocation of Special Drawing Rights in the amount of 6.7 million euros.

Certainly the 2009 crisis reflected the composition of the currency structure of public debt where the euro has kept its greater participation of 65% and debt in local currency decreased by 9% compared to 2008, ie from 23% to 14% total portfolio. This situation was initiated by the need to issue securities with foreign currency clause (Euro) of 3, 6 and 12 months to preserve the stability of the national currency and reject all speculations about devaluing the exchange rate, and reduce costs on the basis of higher interest rates.

Unlike currency structure, changes in interest structure is not so remarkable, that no significant shift in interest debt structure which at the end of 2009 totaled 51% in fixed-rate and 49% variable interest versus 53% and 47% from the previous year.

Therefore, remains the conclusion for stage, but regulated increase of the risk of changing interest rates in managing the public debt portfolio in Macedonia, which focuses on the numerous risks outlined above. However, the increased share of debt in domestic currency led to a reduction in the risk of foreign exchange rate changes. However, the fixed exchange rate regime, where the rate is pegged to the euro as a major currency in the state portfolio, leads to a significant reduction in the risk of exchange rate.

## Conclusion

This paper englihtens one of the most important subjects in the area of fiscal policy, public debt management. It focuses on major risks that are essential for credible and prudental fiscal policy in situation of intensive borrowing on the capital market. It determines the potential negative effects on public debt in case of unefficiant and irresponsible government with public debt and closely describes this area of government activity. However, the prudent public debt management in Macedonia was registered also by the credit rating agency of Japan in its report for Macedonia: "Macedonia in comparison with other countries in Central and Eastern Europe is least affected by the economic and financial crisis, and it is due to the successful implementation of appropriate measures by Government, lower dependence on external debt and low exposure to external risks. Stable credit rating is a good signal to foreign investors and positively affect the interest rate at which the country borrows in credit markets and the overall economic and political image of the Republic of Macedonia".

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