2007

GOVERNMENT FISCAL DEBT REPORT

1.0 INTRODUCTION

1.1 Government has over the years operating under a deficit budget. 2007 is no exception considering the size of civil service, huge operating costs and large infrastructure projects that's needs to be funded by Government are major factors causing rise in government expenditure. Total estimated expenditure for 2007 was $1.57 billion against revenue of $1.47 billion. The variance between revenue and expenditure is major factors that leads to borrowing and subsequently rise in debt level.

1.2 The government is doing all its best to reduce the expenditure mix from 80:20 to 70:30. Over the years, a lot of expenditure is channel to operating costs (80%) and most of these expenses are for salaries and wages of civil servants. Funding more capital projects is key to economic development and also maximises rate of return to government. Expenditure mix will be addressed in government fiscal policy's framework as overall objective to reduce debt below 40% in medium term.

1.4 The debt report outlines the debt position of government for the period ending December 2007. The report highlights some of the issues raised above and what policy action needs to be undertaken to address them. The report goes on to show the level of debt outstanding, major holders of government securities, major lenders, interest rate movement and other factors influencing government debt position.

1.5 This report is structured into 3 main areas. The first part will highlight domestic market conditions and debt policy of government. The second area will look at the total debt composition, that is, foreign and domestic debt and finally a detail analysis of domestic and foreign debt. These are issues for consideration highlighted in this paper that needs to be considered in designing future fiscal policies of the government.

2.0 DOMESTIC MARKET CONDITIONS

2.1 Domestically, the economy remained relatively weak substantiating the 3.9 percent contraction estimated for 2007. Tourism earnings fell by 9 percent on an annual basis, cumulative to June of 2007. In addition, the cane and sugar industry recorded a weak performance at the end of the 2007 crushing season, mainly due to unfavorable weather conditions. Partial indicators for the building and construction sector remained subdued for 2007.

2.2 Gross foreign reserves has somehow stable towards end of 2007, provisional figures show foreign reserves around $957 million, sufficient to cover 4.3 months of imports of goods.

2.3 The Reserve Bank of Fiji monetary policy stance remained unchanged towards end of last year with the policy indicator rate maintained at 4.25 percent. The credit ceiling continued and open market operations remained suspended. However, with the improvement in foreign reserves, exchange control measures on credit card and advance import payments were slightly relaxed.

2.4 A Provisional net deficit of $87.0 million or 1.6 percent of GDP has been achieved for 2007. This is expected to have been underpinned by estimated annual declines of 5.1 percent in expenditure and 0.2 percent increase in revenue. The estimated annual decline of 5.1 percent in government expenditure is mainly attributed to an expected annual reduction in investment payments by 16.2 percent, and, specifically, a reduction in capital purchases by an annualized 26.4 percent. Delay in implementation of capital projects is major factor for reduction in capital purchases.

3.0 GOVERNMENT DEBT POLICY

3.1 Government has set itself a target debt level of 45 percent of GDP in the medium term. To effectively achieve this, Government has committed itself to consistently reduce the net deficit (as percentage of GDP) over the medium to long-term. A sustainable reduction in the net deficit is largely achievable of Government's operating savings increases over time, thus reducing the need to borrow to finance the net deficit.

3.2 Government's debt policy for 2007 onwards focuses on introducing debt management strategies to reduce exchange loss and other costs associated with borrowing abroad. On the domestic front, Government will continue to refine its policies and guidelines for developing the domestic capital which is currently characterized by limited investment opportunities and lack of securities.

3.3 In terms of debt sustainability, the debt to GDP ratio is 52.5%, which is classified as moderate by international standards. In pursuance of its medium target of 45 percent Debt to GDP, Government debt management policy will continue to manage the issuance of domestic and foreign debt to reduce debt-servicing costs. Furthermore, Government will continue to build capacity and adhere to well-formulated debt and risk management strategies. This will necessitate thorough consideration of appropriate domestic-external debt compositions, bearing in mind the opportunities and risks.

3.4 Government is working towards strengthening its cashflow management to provide a more transparent and systematic approach to its borrowing.

With better and enhanced cashflow techniques, Government should be able to borrow within the approved ceiling. Debt strategies will mostly focus on sourcing funds domestically. However, depending on domestic interest and liquidity conditions, Government will also consider international financing opportunities.

4.0 TOTAL GOVERNMENT DEBT

4.1 In contrast to previous years when debts were increasing, 2007 was first year to register a decline in overall debt level. Total Government debt stood at **$2.73 billion**, a decline of 4.4 percent from the preceding year. The major factor attribute to the decline was the net redemption of government securities. Of the total outstanding, $397 million is associated with external loans and the balances are domestic loans.

4.2 Domestic debt is comprised mostly of bonds and t-bills. Approximately 98 percent of domestic debt outstanding is bonds that are issued in the domestic capital market.

Table 1: TOTAL GOVERNMENT DEBT OUTSTANDING($Million)

	2004	2005	2006	2007
Domestic Debt	2,114.8	2,258.4	2,446,4	2,337.8
External Debt	165.4	164.1	416.7	397.0
Total Debt	2,280.2	2,422.5	2,863.1	2,734.8
Source: Ministry of Finance				

Details of domestic and external debt are explained in the next paragraphs.

5.0 GOVERNMENT DOMESTIC DEBT

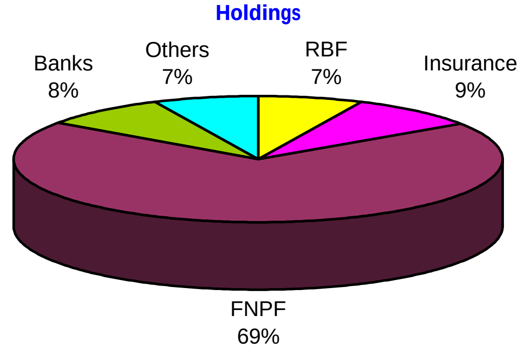
5.1 Government's borrowing in the domestic market is through the issuance of medium to long term Bonds and short term Treasury Bills. Government borrowings are based on the funding program approved by the Debt Policy Committee at beginning of the year in accordance with the borrowing provisions in the 2007 approved Budget.

Table 3: GOVERNMENT'S DOMESTIC DEBT OUTSTANDING($Million)					
	2003	**2004**	**2005**	**2006**	**2007**
Domestic Debt	1,963.5	2,114.8	2,258.4	2,446,4	2,337.8
Bonds	1,682.7	1,986.5	2,121.4	2,300.7	2,196.2
Treasury Bills	276.9	126.9	136.0	145.7	141.6
Source: Ministry of Finance & National Planning					

5.2 Borrowing in the domestic market was dominated by a few market players, and the Fiji National Provident Fund (FNPF) accounting for 69 percent of total outstanding. Insurance companies and Commercial Banks held 9 and 8 percent respectively of outstanding stock, Reserve Banks account for 7% whist the remaining 7% are held by other institutions, trusts and individuals

5.3 Domestic debt outstanding at the end of 2007 declined by $108.6m or 4.44% percent when compared to 2006. The bonds were substantially reduced by $104.5m or 4.54% whilst treasury bills declined by 2.81% (see Table 3).

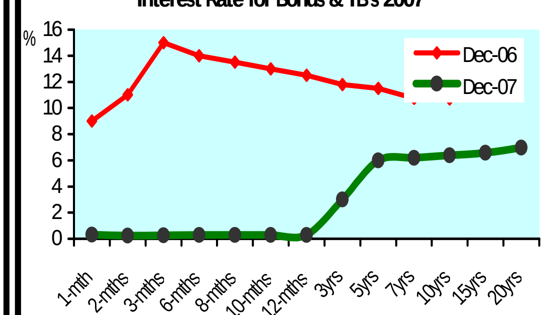
Figure 1: Government Domestic Debt Holdings



5.4 Domestic Debt-to-GDP Ratio

As a share of GDP, the Government's domestic debt fell significantly in 2007, when compared to 2006 (Refer Figure 1).
The downward trend was the result of reduction in borrowing of Government as major issuance to fund the financial year budget deficit was undertaken in 2006. Government raised approximately $80 million through bonds throughout the year.

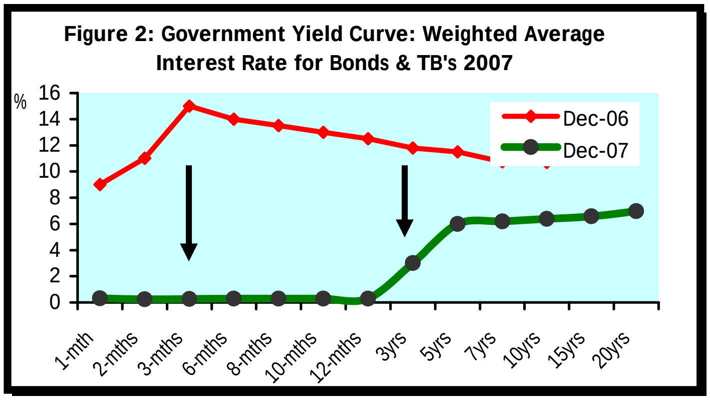
Figure 2: Government Yield Curve: Weighted Average Interest Rate for Bonds & TB's 2007



5.5 Development in Interest Rates

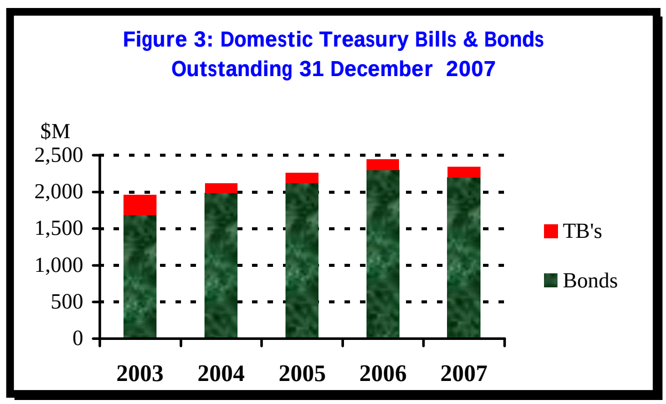
Figure 2 shows the Government yield curves (i.e. the structure of interest rates from short term to long term). The yield curve shows the enormous decline in interest rates for both the short and long term debt instruments in 2007.

One of the contributing factors was the easing of monetary policy by RBF which was underpinned by excess liquidity in the banking system thus reduce interest rates in the entire money and bond markets. High liquidity conditions have forced the rates to decline and these reductions have somehow been favorable to Government as they lower the cost of borrowing during the year.



5.6 Domestic Debt Instruments

At the end of 31 December 2007, Government bonds outstanding stood at $2,196.2 million, a decrease of 4.5 percent compared to 2006.



Treasury Bills outstanding fell by $4m or 2.81% when compared to 2006. Treasury bills were raised mainly to cover revenue shortfall and to offset timing differences between inflows of revenue and major payments by Government. In light of high liquidity, tenders for bonds and T-Bills were oversubscribed every time government issue in the market. It was evident that demand for debt instruments is significant but supply is minimal.

5.7 Issuance in the Domestic Market

Government Bonds and Treasury Bills are issued in the market with due consideration to the forecast budget and actual shortfall in the government cashflow[1.] In this regard, Government is working towards strengthening its cashflow management so as to provide a more transparent and indicative approach in it's borrowing in the domestic market.

[1]It is to be noted that the current financial system of Government runs on Cash-Accounting Basis.

Issuance in the Money Market-Treasury Bills

Treasury Bills as a means of short term borrowings for Government were raised with the following maturities; 14 days, 28 days, 56 days, 91 days and 182 days.

Table 4: Treasury Bills Outstanding at Month End-2007													
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	
	146.9	148.1	145.3	141.1	145.6	159.1	143.7	155.4	172.1	159.3	149.8	141.6	
Net Issuance per Month derived as New Issuance less Redemptions													
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Net Issuance Dec 06-07
	1.22	(1.2)	(2.8)	(4.2)	4.5	13.5	(15.4)	11.7	16.7	(12.8)	(9.5)	(8.2)	($4m)

With Reserve Bank no longer issuing its own Notes for monetary policy purposes, the excess liquidity in the market enable the oversubscriptions of Treasury Bills. At the end of last year, Tbills outstanding stood at $141.6m compared to $145.7m registered in 2006.[2]

Issuance in the Capital Market-FDL Bonds

The table makes a comparison of the funding program approved by DCPC Committee early in the year and the actual issuance in the market.

Table 5: Funding Program Approved by DCPC Committee :2003 - 2007 ($M)													
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
Bond	**20**	**20**	**-**	**10**	**-**	**10**	**-**	**10**	**10**			**30**	**110**
Actual Issuance in the Capital Market ($M)													
Bond	**24**	**15**	**-**	**9**	**-**	**10**	**-**	**10**	**12**	**-**	**-**	**20**	**100**

In absolute terms, a total of $100m million was allotted in government bonds in 2007 of which $82 million was approved in the 2007 Budget whilst Cabinet approved a further $30m in December to support deficit financing for the year.

Under the existing Government Bond Prospectus, Government has the right for a call option[3] on its high interest rates bonds. As at the end of

---

[2] Statutory limit of $150m for Treasury Bills: *Schedule 3 of the FM Act 2004*

[3] The right of Government to pay-off high rate bonds before maturity.

2007, a total of $1.897 billion or 86 percent of bonds outstanding are callable, while $298.6 million or 14 percent are not callable.

5.8 Debt Servicing

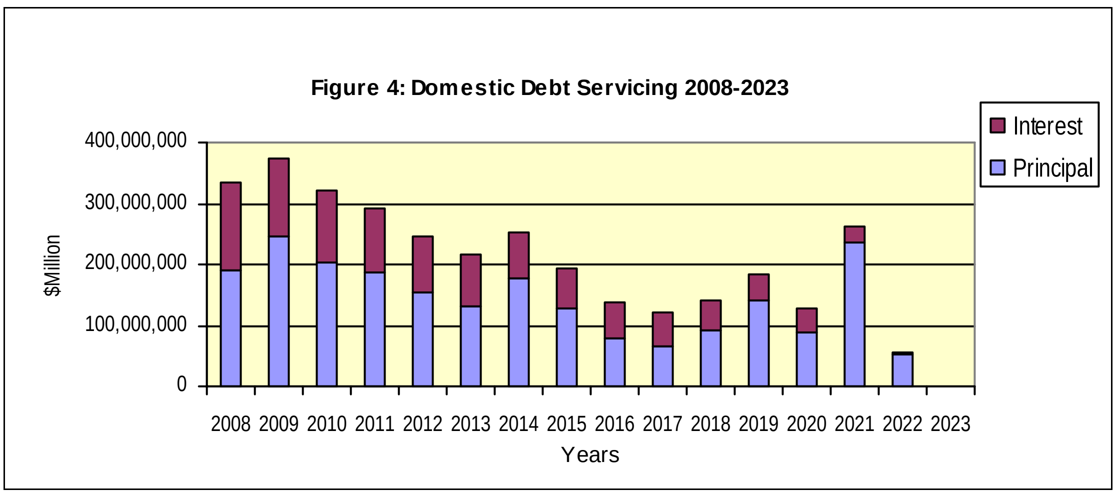
Debts servicing both in terms of principal and interest payment comprise a significant component of government expenditure for the past 5 years. Table 6 summarizes the debt servicing trend over the last 5 years which has shown an escalating trend.

Table 6: Domestic Debt Servicing : 2003-2007 ($m)

	2003	2004	2005	2006	2007
FDL-Principal Payment	109.4	145.4	185.1	177.5	204.9
FDL-Interest	122.0	108.6	120.2	138.7	148.1
T-Bill Interest	2.6	4.3	2.4	5.4	13.0
Total Domestic Debt Service	234.0	258.3	307.7	321.6	366.0

Debt Servicing Commitments over the next 15 Years

For the next 15 years, fulfilling its debt servicing obligations is the Government presents major challenges. As shown in Figure 4, the future interest and principal repayments on domestic loans would form a considerable portion of Government Expenditure in years to come.



Efforts have been directed towards reducing the overall debt level and undertaking alternative cheaper forms of borrowing that would be beneficial to government in the long run.

6.0 CASH MANAGEMENT

6.1 One of the functions of *Debt and Cash flow Management Unit* is the planning of financial requirements and that includes:

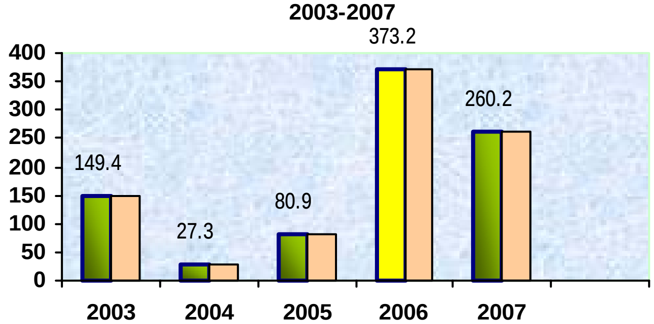
- Projecting government borrowing requirements in the context of fiscal and monetary targets as well as sustainable levels of debt
- Deciding on volume, type, timing and frequency of issuances in the domestic market
- Managing new issuances and redemptions

Section 59(c) of the Finance Management Act 2004 clearly states that the Minister may on behalf of the State, borrow money by means of overdrafts or advances, but so that the total amount outstanding by way of overdrafts and advances under this paragraph does not at any one time exceed *$20 million*. This facility is available to Government through the Reserve Bank of Fiji.

6.2 Ways and Means (W&M) Utilization

Total borrowings from Ways and Means in 2007 stood at $260.2m. This marked a **decline of $113m or 30%** when compared to $373.2m borrowed from the facility in 2006.

Figure 5: Ways and Means Borrowed and Repaid 2003-2007



It can be noted that the reduction in 2007 reflected a reduced reliance on the overnight borrowings facility to service debt and operating payments.

With improved cash and debt management practices, the utilization of Ways and Means will be significantly decline in 2008.

As a policy for prudent cash and debt management, any amount borrowed from this overdraft facility is fully repaid by the last day of the fiscal year.

6.3 The interest rate on Ways and Means currently stands at **9.25%.**

Total interest incurred on Ways and Means in 2007 amounted to $303,000.67 against $370,643.91 incurred in 2006 which constitutes a decline of 18% in interest cost paid by Government.

In comparison to the Commercial Banks, Overdraft Interest rates charged by ANZ stands at 15.75% and Westpac Bank 17.5% on daily balances, therefore Government is better off accessing this facility in terms of interest rate but also in accordance with section 59 (c) of the Financial Management Act 2004.

6.4 Utilization of the Ways and Means Facility with RBF

Borrowings under WM were to facilitate the timing differences between the inflows (receipts) and outflows (payments). Outflows in terms of the timely settlement of Debt that constitutes principal repayments on Domestic and External Debt as well as the interest component. Inflows constitute the receipts from borrowings as realized through the issuance of domestic debt instruments and through the disbursement of Global Bonds receipts as well as funds from external lenders.

With government's operating revenue averaging $2.5m to $3m per day, it places a restriction on the ability to meet payments lodged by Ministries and Departments, payment of Contractual Obligations to third parties such as operating grants, capital contact payments and more importantly debt servicing.

The demand for payment is huge thus forcing government to borrow via Ways and Means since our daily average revenue would not be able to cater for huge payouts and other operational expenses on a normal day.

7.0 EXTERNAL DEBT

Government's External Debt Outstanding

7.1 At the end December 2007, the Government's external debt outstanding was **$397.0 million** which declined by 0.5% when compared to the same period last year. The marginal decline in external loans was mainly due to appreciation of Fiji dollar against USD; as most of loan portfolio is denominated in US dollar. Disbursement drawdown in 2007 totalled $15.7 million while government also manage to recover arrears in disbursements from ADB of $2.6 million.

External debt servicing increased by $19.5 million during the review period, and this increase was mainly attributed to interest payment made for the Global Bond in 2007 which amounted to $16.9 million.

Table 7: Government External Disbursed Outstanding Debt (F$M)

	2001	2002	2003	2004	2005	2006	2007
DOD							
Central Govt.	204.0	195.0	171.5	165.4	164.1	416.7	397.0
Debt Service							
Total	**30.0**	**30.1**	**23.4**	**17.1**	**18.2**	**20.6**	**40.1**
Principal Payment	20.3	20.8	16.3	11.2	12.7	14.3	17.1
Interest Payments	9.7	9.3	7.1	5.9	5.5	6.3	23.0
Debt to GDP Ratio	5.4%	4.9%	3.9%	3.6%	3.6%	8.3%	7.1%
As %age of export of goods & services	1.5%	1.4%	1.0%	0.7%	0.7%	0.8%	1.4%
Total Disbursements	26.1	28.2	9.3	9	15.7	15.7	18.3

Source: Ministry of Finance & National Planning

7.2 Exchange Rate Movement

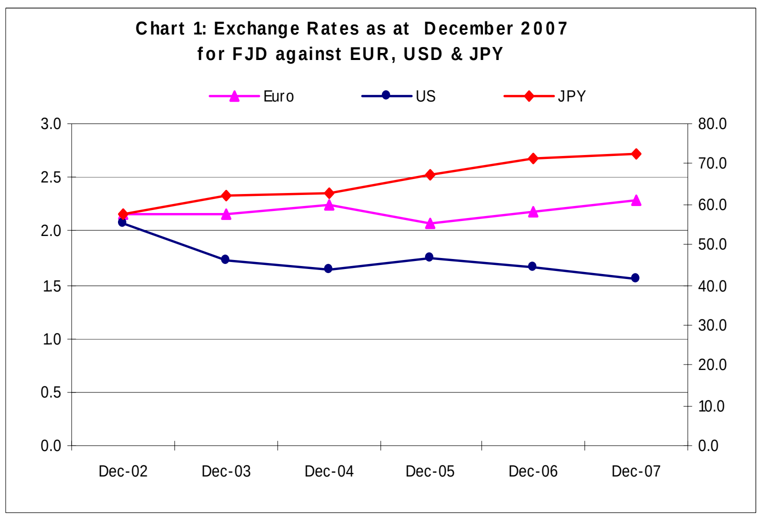
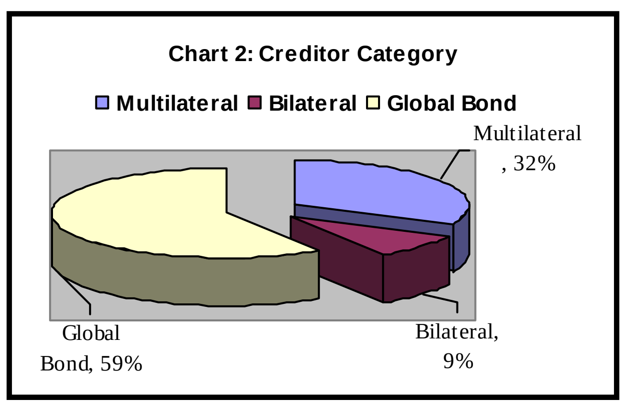


Chart 1 below shows the movement of the Fiji dollar against its three major currencies of repayment since 2002 to the end of 2007. There has been a steady movement of the Fiji dollar against the Euro and the US Dollar. With the exception of 2005, the value of the Fiji Dollar against the Euro dollar has remained mostly around $2.20 since 2002. As against the US dollar, the Fiji dollar value remained around $1.60 from 2003 to 2007. This is after a dip in value from $2.00 to $1.70 for the 2002-2003 periods.



However, a lot of volatility was seen in the performance of the Fiji Dollar against the Japanese Yen even within the years. These results in year end value increasing from 2004 to 2007, increasing to around $70.00 from $55.00. These unpredictable trends have resulted in Yen denominated loans been expansive for Government to service its debt.

On the other hand, with the continuous

weakening of the US dollar against the Fiji Dollar the government can expect some savings when servicing its US denominated loans such as Global Bonds.

7.3 Debt Composition

A. By Creditor Category

By the end December 2007, Global Bond made up 59% of the total external outstanding debt, followed by multilateral lenders holding 32% and bilateral lenders making up the remaining 9%.

During the year, the Government prepaid two of its most expensive ADB loans with interest rates ranging from of 9.65% and 10.25%, thus causing a slight reduction in the outstanding debt for the multilateral lenders category.

Also, Government approved the use of the direct payment method for two of its on-going ADB loans with effect from 2008. Direct payment method will be used to disburse the remaining unutilized loan funds held with ADB for these two loans.

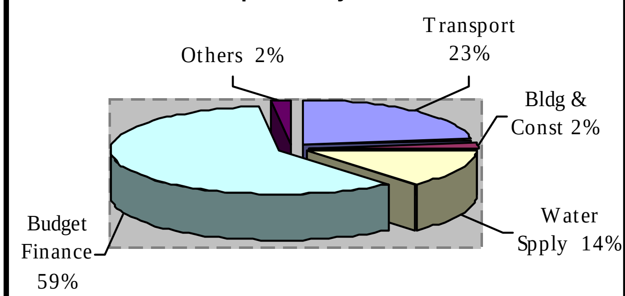
During the year, Government granted the transformation of at least 4 ADB loans from Pool Based Single Currency Interest rates to LIBOR market based. This will see Government playing active and technical role in debt management in order to minimize its interest cost bearing of all its ADB's outstanding. Similar position will be accorded to the outstanding IBRD loan which IBRD has provided its request to seek conversion of the same.

Furthermore, with the continuous weakening of the US Dollar against the Fiji Dollar, it has caused the disbursed outstanding debt for the Global Bond to drop by FJD17.0 million from FJD249.6million in 2006. If this trend should continue in the near future, the government could expect some savings when servicing this bond come 2011.

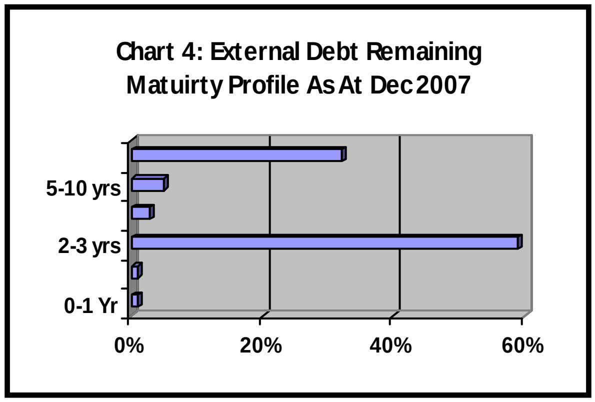
B. <u>By Economic Sector</u>

The global bond under the budget Finance sector continued to lead the distribution of debt by economic sector by 59%, whilst the Transport sector taking the second spot at 23% followed by the Water & Sewerage Sector by 14%. The remaining sectors were all below 5%.

Chart 3: Composition by Economic Sector



C. By Debt Maturity & Currency Profile



For the period ending December 2007, approximately 32.0 percent of total external debt have remaining years to maturity greater than 10 years, 5.0 percent are expected to mature between 5-10 years, 3.0 percent in the next 4 – 5 years, 59.0 percent are expected to mature in the next 2-3 years and the remaning 2 percent next year. Government has made appropriation in the national budget to build up sinking fund to support the repayment of the Global Bond due in September 2011.

The currency composition of debt continued to be dominated by the US dollar followed by the Japanese Yen, Euro and the Chinese Yuan. The Global Bond makes up 99 percent of the government's outstanding debt in the US dollar and with the continuous weakening of the US dollar against the Fiji Dollar, the government should expect to save when it will come to repaying this bond in the next 3 years time.

8.0 CONTINGENT LIABILITIES

In contrast to real government debt which fell by 4.4% in 2007, contingent liability on the other hand rose by 4.6%. Government's contingent liability outstanding stands at $3,175.69 million by the end of 2007, or approximately 57 percent of GDP. The increase was due to on-guarantee provided to institutions such as the Fiji Development Bank and Fiji National Provident Fund's (FNPF) member's contributions.

Apart from FNPF, guarantee now amounts to $2,481.08 million, government guaranteed loans stands at $637.11 million. Major guaranteed entities include the Fiji Electricity Authority, Housing Authority of Fiji, etc. With the view to remove FNPF contributions from calculation due to double counting, contingent liability is expected to decline significantly in future.

In terms of defaults, Government paid out $0.2 million of Fiji Pine Limited Bonds interests and principal repayments in 2007. Also, through Cabinet's directive, Government is now servicing the Fiji Sports Council guaranteed debt with FNPF for $0.37 million on annual basis.

Table: 8 below shows breakdown of contingent liability and trend over the last three years			
	2005	**2006**	**2007(p)**
Total Contingent Liabilities ($M)	**2,780.00**	**3,036.69**	**3,177.08**
FNPF, members contribution	2,186.40	2,347.16	2,481.08
Term Loans & Bonds	532.62	630.08	637.11
Of which components includes:			
FEA	*120.8*	*165.60*	*73.82*
FDB	*231.9*	*271.57*	*347.9*
HA	*110.1*	*118.8*	*106.51*
Deposits & Mortgages	9.24	6.33	5.92
International Subscriptions	51.80	52.56	51.72

The government guarantees the borrowing and the financial transactions of a number of public entities. This implies a risk for the government. This risk is limited by setting up guidelines for the borrowing activities of the entities. To safeguard government interests and state of finances, the guarantee policy will be reviewed to minimize dependency on state and improve financial performance of government owned entities to be self dependent.

9.0 Conclusion and Way Forward

Even though total debt level declined in 2007, for small open economy like Fiji; the level of debt outstanding is well above the international benchmark. Total debt as percentage of GDP stands at 56% against 40% as benchmark set by IMF. Government will continue to focus on domestic capital markets as major source of borrowing in future. These strategies are well supported by the RBF monetary policy stance and the excess money supply that currently exists in the banking system.

In moving forward, the Government will undertake the following measures to reduce the debt level;

- Repayment of expensive and high coupon bonds;
- Review terms and conditions of existing loans and contracts;
- Utilize proceeds from dividends, government owned entities profits for prepayment and early redemption;
- Restructure of debt portfolio;

- Implement, review and develop methodologies for quantifying contingent liabilities on existing guarantees and new applications for guarantees;
- Design new instruments to deepen the primary market and activate the secondary market; and
- Minimize issue of TBills to reduce high level of short-term debt

Cashflow management in whole of government will be enhanced to minimize wastage and unplanned expenditure which normally attribute to rise in unnecessary borrowings. Overall, the aims is to maintain a relatively even maturity profile for term debt across the yield curve to reduce pressure on domestic bond market when supply increases unexpectedly and provide the government with greater flexibility in an environment of fiscal surpluses.

Given the size of the market borrowing program of the union and the states, the approach to risk management has been one of minimizing the cost of raising debt subject to refinancing risk. Thus, the decision on composition of debt reflects a risk-averse preference in the context of prevailing fiscal deficit and likely fiscal deficits in the future. It comprises three tenets:

- Minimizing refinancing risk,
- Minimizing external debt, and
- Minimizing contingent liability risks.

The government will focus its attention on the above criteria to ensure debt level is sustainable in the medium term and more funds are channel towards more high yield capital investment instead of loan servicing.