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DEBT MANAGEMENT

GOVERNMENT GAINS VALUABLE BREATHING SPACE

Funding needs are on the way down

Government's debt position has never looked better. Its almost R400bn interest bill for the coming fiscal year is only 1% higher than the 1999/2000 Budget estimate, and the amount of money it needs to raise from the local bond market is expected to decline to R1,1bn by 2002.

"The market is soon going to be begging for bonds," says outgoing Finance Department deputy director-general Andre Roux.

This year, government plans to raise R10,1bn from the market — more than the R4bn anticipated by the market — but its domestic funding requirement will drop steeply to R7,1bn next year.

Finance has made provision to raise US$1bn offshore this year. Finance Department director Lesetja Kganyago says the US and European debt markets are favoured.

An issue is more likely to be denominated in US dollars because government still has $1,7bn capacity on its European medium-term note programme after using up $300m last year.

Government's overall debt pressures were eased substantially during 1999/2000 when significant privatisation proceeds, including the SA Special Risks Insurance Association (Sasria)'s R6,1bn special dividend, were used to reduce the funding requirement.

After forecasting a funding requirement of R14,3bn for the year, government had to raise only about R5bn. During 2000/2001 it expects to receive another R5bn from the restructuring of State assets, which will be used to reduce debt.

The comparatively small amount of money government will raise during the next few years gives the Finance Department's debt management team the ideal opportunity to sort out its patchy debt commitments and to concentrate on reducing the cost of its debt. Such opportunities don't come often.

Current plans include the issue of inflation-linked bonds and the introduction of switch auctions.

The Budget has made provision for the issue of R40,3bn inflation-linked, or Consumer Price index (CPI), bonds, to be called R189s.

But Kganyago says this is only an indication of what it would like to do and says the department hasn't yet set a specific target.

"We know the inflation-linked bonds are unlikely to be liquid and trade actively. We want to issue as the demand arises rather than build volume rapidly," says Kganyago.

Inflation-linked bonds offer investors real returns because their principal payment at maturity and twice-yearly coupon payments strip out the impact of inflation. They also eliminate the premium government usually has to pay to conventional bond investors because of inflation uncertainty.

However, the drawbacks are that inflation-linked bonds don't usually trade as actively as their nominal counterparts because investors usually buy them to match their longer-term liabilities and keep them in the bottom drawer.

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As a result, they have had varying degrees of success internationally. Inflation-linked bonds comprise 25% of US total bond issues but have low tradeability. The UK, Australia, Canada and New Zealand CPI bond markets also suffer from illiquidity. France's market has been the best performer because the government debt manager has managed to match supply with demand, says Merrill Lynch director of debt markets Andrew Roberts. He adds that France is the only issuer of CPI-linked bonds in Europe and thus they offer the only diversification opportunity to investors.

According to the Budget, the first local issue of CPI-linked bonds is scheduled for the first quarter of this year, and the market is expecting an issue of R2bn. They will be sold at an open auction and not by the primary dealers since four of 11 participating banks weren't interested in making a market in the bonds because of their expected illiquidity.

Kganyago says the other seven will be keen participants and several other players that are not primary dealers have shown interest. They say the bonds offer diversification and low-risk investment opportunities.

Another innovation, switch auctions, is given a one-line mention in the *Budget Review* but will be a valuable tool government can use to lower its average debt costs and smooth the maturity profile of the outstanding debt (see guide). Finance describes them as "a low-risk mechanism for reducing borrowing costs".

Kganyago says the department is in discussions with primary dealers and will announce a switch auction in due course.

These two developments will enhance government's debt portfolio management skills and build on the Finance Department's already significant debt reduction achievements. Three years ago the department narrowly averted the interest bill topping 50% of gross domestic product. By the end of the current fiscal year, it will comprise 45% of GDP and the Budget forecasts 42% by 2002.

Sharon Wood

INFLATION-LINKED BONDS

PAY:

- A rate linked to inflation
- Interest twice a year
- A capital sum at maturity that is inflation-protected

ARE OF ADVANTAGE TO:

- Government: because it does not have to pay a premium for inflation uncertainty
- Investors: because they're inflation-proof

BUT:

The drawback is that they're often difficult to trade because they become bottom-drawer investments

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SWITCH AUCTIONS

What they are: Government has an auction in which it offers to exchange one of its bonds for another at a specified ratio.

Why they are used: Switch auctions allow government to issue debt that is attractive to the market, then to exchange that debt for other bonds later if it needs to adjust the maturity structure of its funding profile.

The Finance Department often has to choose between issuing bonds that are popular with the market but do not meet its particular funding needs, and raising more expensive money by issuing bonds at a higher coupon because they are not in high demand.

How they would work: The Finance Department would schedule regular auctions modelled on the current weekly bond auctions. The department would announce that it was buying, say, R153s, and selling R186s at a certain ratio. The bid amount, bid level and conversion ratio would be revealed 15 minutes before the auction.

Attractions to government: The main attraction is that government would be able, in time, to build up a smooth maturity profile and would not have to worry about big roll-overs in debt. Government currently faces a funding gap between 2018 and 2024 because investors have the keenest appetite for R150 bonds, maturing between 2004 and 2006, the R153, now a 10-year bond, and the long-dated R186 bond maturing in 2025.

Standard Corporate & Merchant Bank fixed-income analyst Robert van Eyden says the auctions allow the Finance Department to have clearly identifiable bonds of sufficient size and liquidity.

The department also gets rid of the administrative hassle of managing the coupon flows of several small bond issues.

It reduces average funding costs because government doesn't have to pay a premium for the funds it needs to fill a funding gap.

Attractions to the private sector: Investors see bigger issues of the bonds they want. Market liquidity improves. Investors who run swap books by taking positions in money-market and fixed-income derivatives are able to hedge their exposures more effectively.

Who else uses them: Countries that use switch auctions are the UK, Sweden and Canada. Auction participants tend to be institutional investors and pension funds.

Why now: Government has particularly low funding costs during the next fiscal year. It is expected to raise only R4bn during the year and may have no funding requirement the following year. In contrast, 1998/1999's bond issues were a hefty R34,2bn.

The lack of funding pressure creates an invaluable opportunity for Finance to manage debt actively, using switch auctions and reshuffling the maturity profile of its outstanding debt. That will put it on a smooth footing for future issues or times when it has higher funding needs.

Sharon Wood