

## **FNPF should not fund the budget deficit this year**

Satish Chand,  
The Australian National University  
Canberra

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The Government Budget will once again be in deficit in 2007. Judging from past experience, the pressure will be on the Fiji National Provident Fund (FNPF) to fund the shortfall between government revenue and expenditure. In the process, FNPF will increase the very large pile of government paper in its asset portfolio. Such action, however, runs the risk of putting the Fund under considerable financial strain, a strain that could compromise the health of the financial sector as a whole. The deficit has to be funded: however, I argue that this should be done with concessional borrowing from abroad whilst allowing FNPF to diversify its portfolio away from government bonds and into international equity.

The policy challenge in funding the deficit this time around is to avoid a further drain on foreign reserves, thus preventing the RBF from jacking up interest rates even further, whilst reducing the financial strain on the FNPF. Given the size of FNPF in relation to the economy, its health is critical to the health of the domestic whole financial sector. Failure to stem the decline in foreign reserves or to endanger the financial health of the FNPF could put the economy on the slippery slope to fiscal and balance of payments (that is, “twin”) crises.

The long-term challenge is to bring the level of public debt down to the norms of the past. This requires a medium-term debt management strategy and perseverance with policies for growing the economy. A quick fix in the form of a sharp reduction in government expenditure runs the risk of triggering a recession that could lead to the perverse outcome of a rise in debt as a proportion of GDP. Policymakers are on a tightrope, requiring the balancing of the books now while navigating towards long-term fiscal sustainability. A plan for and persistence with debt-reduction is critical to avoiding further build-up in public debt. Early action, moreover, could save some painful recovery in the aftermath of a crisis.

Government debt as of December 2005 amounted to some \$2.45 billion; equivalent to 52 percent of GDP. Some 93 percent of this debt is funded from domestic sources. The FNPF held \$1.56 billion (or 69 per cent of the total domestic debt) while commercial banks and insurance companies held \$112 million and \$193 million, respectively. As of September last year, the most recent period for which published data from the RBF has been made available, 72 percent of the total assets of the FNPF were in the form of government paper. Therefore, the return on investments by the fund is largely determined by the bond rate and nearly totally dependent on the performance of the local economy.

The returns on FNPF investments are likely to be adversely affected by two major developments. First, growth in GDP is falling: last year’s GDP growth rate has been revised down by the Bureau of Statistics to 0.7 percent. Second, the

telecommunications sector is due for further liberalisation; this will lower returns from Amalgamated Telecom Holdings (ATH) in which FNPF is the majority stakeholder. The above could compromise the ability of FNPF to deliver on its vision: “that the people of Fiji will enjoy peace of mind during their working life and in retirement”.

FNPF cannot continue to almost completely tie its fortunes to the performance of the Fiji dollar and the domestic economy. The members of the FNPF, the owners of the fund, were saddled with the costs of the NBF-rescue of the mid-nineties. ATH shares were bought by NBF at above-market value but with an understanding that the values would be protected via regulatory protection of the monopoly position of ATH. The deregulation of this sector will benefit the community at large, in the form of lower costs of telecommunications, but FNPF, as the largest shareholder, will lose income in the process. This makes it all the more important for the FNPF to be unshackled from having to invest locally.

The FNPF to date has had little choice but to accumulate government paper since its ability to invest offshore has been limited by legislation, while alternative investment opportunities are limited given the close-to-stagnant economy. Adding to the existing pile of government paper by the Fund would lead to an even more lopsided asset portfolio. This probably explains the recent push by the Fund for acquisitions in other sectors such as real estate and tourism developments; however, the Fund’s risks have been increased as a result. Moreover, the returns from these investments are still tied to the health of the local economy, and are thus not too different from investments in government bonds.

A financially prudent strategy would be to allow FNPF to invest offshore (through fund managers) to enable it to diversify its asset base. Such a push, however, will encounter two immediate problems: first, loss of foreign reserves; and second, a rise in interest rates on government bonds. The RBF will be opposed to the former while the Ministry of Finance (MoF) would object to the latter.

Some experts have suggested that there is the capacity for further borrowing by the public sector. This would be the case only if the additional debt improved the net worth of the state. The reality, however, is quite the opposite. Returns on public investment have been marginal at best. Contingent liabilities of the state, as of last year, amounted to some 22 per cent of GDP. The Government may have to come good on these guarantees since most of the state owned enterprises that have taken these loans continue to register poor performances. Thus the 52 percent official public debt may in effect amount to some 77 per cent of GDP: high by any comparison.

The worst-case (scariest!) scenario is where this year’s deficit is financed by the FNPF. This would lead to a worsening of the foreign exchange position, inducing the RBF to further tighten monetary policy. In conjunction with rising oil prices, this could trigger a recession, leading to spiralling debt. The domestically financed deficit places FNPF in financial difficulties as a result of its contributions grinding to a halt while withdrawals rise. The repercussions of financial problems in FNPF could ripple through to the rest of the financial sector. The above paints a scary possibility and one that justifies preemptive action.

The FNPF must be allowed to invest offshore while foreign reserves are protected and public debt is placed on a trajectory of fiscal sustainability. This calls for a long-term debt strategy.

One possible debt strategy is to fund the deficit with concessional borrowing from International Financial Institutions (IFI). The low level of foreign debt makes this possible. Such a strategy would replenish the foreign exchange reserves, thus allowing some relaxation of rules relating to offshore investment by the FNPF. The concessional terms of the loans will keep debt-service commitments low. Engaging an IFI as a creditor could also provide the external anchor, and thus the credibility, to remain on course to fiscal sustainability.

Fiscal sustainability depends on the debt to GDP ratio stabilising at or below 40 percent. This could be achieved by cutting the volume of public debt (the numerator in this ratio) and/or through growing the economy (that is through raising GDP, the denominator in the ratio). The first could be achieved by accelerating the pace of reforms of the state-owned sector, the inefficient public enterprises. The Government must retract from its current position of providing debt-guarantees. The second, involving growing the economy, requires concerted efforts to relieve the major impediment to growth of private enterprise. An open trading regime is necessary for that to happen.

Growing the economy requires addressing many of the longstanding obstacles to economic progress. Private domestic savings and investments are at record lows and showing little signs of revival. Breathing life into private savings and investment, at a minimum, requires an immediate resolution of the problems to accessing land for long-term development and a clampdown on the deteriorating law and order situation in the country. Given the declines in sugar and garment exports, and the worsening terms of trade as trade preferences fall and oil prices increase, tourism holds the most promise for growth of GDP. For tourism, the prognosis is miserable given the threat by hoteliers to take court action over the Qoliqoli bill and the prospects of another drawn out legal battle. There is little time to waste on any one of the concerns raised above.