Managing External Debt in Developing Countries

Proceedings of a Joint Seminar, Jeddah, May 1990

Thomas M. Klein, editor

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Foreword

The Seminar on Debt Management, which was conducted in English, was organized by the Islamic Research and Training Institute of (IRTI) of the Islamic Development Bank (IDB) in collaboration with the World Bank in the premises of IRTI in the period between May 12-16, 1990 (17-21/10/140H on the Islamic calendar). The program was organized in response to a felt need in IDB member countries as a result of the continuing debt problem worldwide and the issues and problems associated with it.

The seminar addressed and was designed for senior government officials concerned with policy matters and institutional arrangements related to external debt management working in central banks, ministries of finance, planning or specialized branches of government dealing with external financial obligations. The main objective of the seminar was to increase the participants' awareness of the need and ways to improve their countries' institutional structure so as to promote effective debt management.

We hope that this publication will increase awareness of issues and problems related to external debt management. This volume of conference proceedings was edited by Thomas Klein of the Debt and International Finance Division, World Bank. Mrs. Salma Cellier, Mrs. Leah Chavarria, Miss Allison Tsatsakis and Miss Alison Fitzgerald were responsible for transcribing the text and preparing it for publication. Miss Fitzgerald also provided valuable editorial assistance.

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Background and Summary

Thomas M. Klein
World Bank

This seminar was the first joint activity between the Islamic Development Bank's Islamic Research and Training Institute and the World Bank's Debt and International Finance Division. It was directed at senior government officials responsible for debt management in countries that are members of both institutions. Twenty-seven people from fifteen countries took part. A similar seminar took place in May 1990 for francophone countries that are members of two sponsoring institutions. The program is reproduced in Annex A, the list of speakers in Annex B and the list of participants in Annex C.

I. Background

"Neither a borrower nor a lender be . . ." begins Polonius' famous advice to his son, Laertes. Economic theory appears to reject this admonition out of hand. Countries wanting to expand capital formation and economic growth beyond what can be financed by domestic savings should seek external financing. During the 1950s and early 1960s, export credits were the major source of financing, supplemented by foreign aid. To help the development process, industrialized countries provided assistance through concessional loans and grants, extended directly through bilateral assistance or channeled through multilateral lending institutions. Following the quadrupling of oil prices at the end of 1973, oil-exporting countries accumulated tremendous reserves, which were deposited in the Eurodollar market. These funds were re-cycled to developing countries from the mid-1970s through the early 1980s, providing substantial external financial resources to middle-income countries but also to some lower-income countries with commodity, primarily mineral exporting, potential. Other factors which stimulated commercial bank lending to developing countries were slow growth in the industrialized countries and the efforts of commercial banks to seek new sources of earnings.

Because of gross economic miscalculations, several countries ran into severe balance-of-payments difficulties in the late 1950s and 1960s and were unable to service their debts. Such debt servicing problems were isolated: Argentina, Brazil, Chile and Peru in Latin America; Turkey in Southern Europe; India, Indonesia and the Philippines in Asia; Ghana in Africa. All of these countries had a common problem: use of export credit finance in excess of debt servicing capacity. The solution was twofold: adopt economic policies designed to reduce dependence on imports, accelerate exports and enhance domestic savings and, secondly, to secure debt relief to smooth out the "hump" in amortization payments due in the near term. The International Monetary Fund supported these efforts with credit tranche resources.

Through adoption of appropriate domestic policies, most countries concerned were able to resolve their balance-of-payments problems within a few years, and were able to renew their access to private-source credits. In the mid-1970s, however, debt servicing problems became both more general and more intractable. First, following the oil shock and the subsequent global recession, many African primary producing countries encountered balance-of-payments difficulties that were hard to resolve in a medium-term time frame. Then, after the sharp rise in world interest rates in 1980, most middle-income countries that had borrowed from banks, particularly in Latin America, were unable to service their debts. When oil prices fell in 1982, several oil exporting countries also found themselves unable to make debt service payments as scheduled; other primary commodity exporters suffered sharp terms-of-trade losses in 1984 and 1985.

Thus, in the 1980s, there was a generalized debt problem. More than fifty countries rescheduled their debts through multilateral arrangements; 46 developing countries could be classified as "severely indebted" owing to the size of their debts relative to exports and to domestic production and owing to the size of scheduled debt service payments relative to exports. Exceptional financing from the IMF was insufficient to cover the near-term balance-of-payments difficulties. Worse yet, many countries found themselves unable to repay the IMF within the required 3-5 years.
The events of the late 1970s and early 1980s demonstrated that old Polonius was really not too far from the mark, and sovereign borrowers and private lenders (banks in particular) should have paid attention to the last part of his sentence: ". . . For a loan oft loses both itself and friend; and borrowing dulls the edge of husbandry." The write-offs of official and private-source loans to developing countries, the weakening of the banks in the industrialized countries and the disappointing investment ratios of most developing countries has forced economists to look far beyond basic growth theory to deal with the debt crisis.

During the 1980s, the need to resolve the debt problem overshadowed all other development issues. Thus, improving the quality of external debt management has become a vital aspect of public administration. Academic economists, research departments of international organizations and debt managers in the debtor countries themselves have developed a significant literature on the theory and practice of external debt management, which provides a basis for the training courses and seminars offered by the World Bank since the mid-1980s.

The Debt and International Finance Division of the World Bank has joined with the Training Division of the Islamic Development Bank's Islamic Research and Training Institute to expand the scope of training on external debt management. Beginning with this seminar in May 1990, the two institutions have initiated a series of policy-level seminars and training courses for countries that are members of both organizations.

The objective of this seminar, as announced in the bulletin of invitation was:

to bring together officials responsible for managing debt in member countries of the Islamic Development Bank and the World Bank so that they may compare individual experiences and problems. The participants will examine the role of external borrowing in development, current trends in foreign financing (with a view to hedging risks), how to improve the quality of information on external debt and how to evaluate their organizational procedures for debt management.

The countries that took part in the seminar differed both as to their stage in development and their debt management problems:

- Low income countries:
  - Severely indebted: Sierra Leone, Sudan
  - Moderately indebted: Pakistan, Uganda, Yemen (PDR)
  - Other countries: Maldives

- Middle income countries:
  - Moderately indebted: Turkey
  - Other countries: Jordan, Malaysia

- Oil exporting, balance-of-payments surplus countries: Bahrain, Iran, Iraq, Kuwait and Saudi Arabia

- Islamic Development Bank country not a member of the World Bank: Palestine (represented by the Palestine Liberation Organization)

Mr. Osman Sek, Vice President of the Islamic Development Bank, opened the seminar. The program (set forth in detail in Annex A) covered seven major issues: the current debt situation, finance for development, organization for debt management, debt information systems, the use of computers for debt management, macroeconomic policy issues and debt renegotiation. World Bank staff members made the initial presentation for each segment. This was followed by short presentations by individual participants illustrating how the problem under discussion manifested itself in their respective countries. A general discussion followed. After each segment, a group of participant rapporteurs assessed what transpired, circulated a brief written report and made an oral presentation during the concluding session of the seminar.

This Conference Proceedings reproduces the contributions of the lecturers and the individual participants, the rapporteurs' summaries plus other key documents used in the seminar and whose dissemination will be useful to debt managers world-wide.

II. Summary of the Seminar

The topics of the seminar reflected the responses to the debt crisis. Debt-distressed countries have had
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to adopt economic policies designed to secure their balance-of-payments over time, often in the context of major structural adjustment. These policy measures include improved debt management. The response on the part of creditors has been to restructure debt in a multilateral framework. The IMF, the World Bank and bilateral lending agencies have supplied exceptional financing designed to support stabilization and structural adjustment measures.

Debt management has several facets. Heads of ministries of financing, ministries of planning and of central banks must be able to calculate the debt supporting capacity of their countries through realistic appraisals of export capacity and an understanding of potential future shocks that their country may be required to withstand over time. They must also know what are the appropriate forms of borrowing for different types of projects and objectives. They must understand how to cover the risks created by exchange rate and interest rate swings. And, to have the factual information required to make these assessments, they must have detailed, up-to-date knowledge of their country’s debts: accurate accounts and comprehensive statistics that can be manipulated for analytical purposes. The seminar dealt with these issues and problems in seven segments.

A. The Current Debt Situation

To provide perspective on debt management issues of the 1990s, the seminar began with a review of the current debt situation. Mr. Husain of the World Bank introduced this segment with a lecture on the relationship between external finance and development, the evolution of the debt problem, particularly as it affected countries represented at the seminar. He pointed out that borrowing for non-productive purposes and overborrowing in relation to foreign exchange resources has created a debt overhang in several countries. While relief is being provided to low-income countries via the "Toronto Terms" and to middle-income countries via the "Brady Initiative", the debtor countries themselves must establish criteria for making effective use of the limited external resources that will be at their disposal in the foreseeable future.

The delegation of Palestine circulated a paper giving details on the debt situation of countries that are members of the Islamic Development Bank.

B. Finance for Development

Debt management policy must be conceived with an understanding of the volume and structure of external finance that potentially will be available to developing countries. Mr. Husain of the World Bank spoke on the outlook for lending from official and private sources to developing countries as a whole and to countries that are members of the Islamic Development Bank. He presented statistics on trends over the past decade and pointed out that the outlook for increased flows during the early 1990s, particularly from commercial banks and other private sources, is bleak.

In view of this prospect, the reading materials for this segment included essays on the possibility of financial flows other than debt-creating flows. The essay by Stijn Claessens of the World Bank described the various forms of alternative finance and the conditions under which they would be forthcoming. The essay by Andrea Gubitz of the Deutsche Bundesbank reported on empirical studies of the factors influencing direct investment flows and took note of host country policies that could help expand direct investment.

Borrowing techniques to reduce risk was the subject of one session. Miss Irgat of the Turkish Undersecretariat of Treasury and Foreign Trade and Mr. Hadenan of the Federal Treasury of Malaysia described the borrowing strategies their countries have adopted to control the currency composition of debt. Mrs. Üçock of the Turkish Undersecretariat of Treasury and Foreign Trade described how Turkey had managed to renew its borrowing from international capital markets. The reading materials included an essay by Bengt Rådstam of the Swedish National Debt Office on risk-minimization strategies followed by Sweden.

C. Organization for Debt Management

In this key segment of the seminar, the participants examined the general principles of external debt management and then discussed them in the context of the debt management systems of the countries represented at the seminar. Mr. Husain of the World Bank began by presenting his essay, "Organizing for Efficient Debt Management". He pointed out that, while institutional arrangements differ among countries, there are a number of debt management functions that must be performed in all countries. There must be a policy-
making body to coordinate the functions of debt management; there must be a control unit to act as a secretariat for the policy body; there must be an advisory unit that follows trends in international financial markets, interest rates, etc.; there must be an operation unit that actually negotiates foreign borrowing; there must be an accounting/statistical unit to provide data.

Mr. Klein of the World Bank spoke on the administrative arrangements for effective foreign borrowing, elaborating on a essay by Lars Kalderen (former Director of the Swedish National Debt Office), "Institutional Aspects of External Debt Management." It was noted that special staffing is required for negotiating loans from each of the major providers of foreign loans: concessional aid agencies, export credit agencies and financial markets. Mr. Kalderen’s essay and both Mr. Husain’s and Mr. Klein’s talks emphasized that economic and statistical support services were essential, and that there must be a coordinating group that represents the interests of the planning and finance ministries and of the central bank.

The Malaysian delegation presented its debt management system in detail, and other participants commented on special features of their respective systems.

D. Debt Information Systems

Monitoring external debt was a subject sufficiently complex and detailed to warrant two sessions. In the first session, Mr. Klein of the World Bank presented a lecture on the sources of information on external debt, on the essential characteristics of a good debt monitoring system and on possible technical assistance for improving debt management systems. He explained how senior officials can diagnose problems in debt monitoring systems and seek out the probable causes of difficulty. The delegations from Sierra Leone and Turkey described their debt management systems. As background for this segment, seven delegations circulated papers describing their respective debt management systems: Bahrain, Malaysia, Maldives, Pakistan, Sierra Leone, Sudan and Turkey.

The second session examined the World Bank’s Debtor Reporting System (DRS), under which all countries that borrow from the World Bank Group must report their external debt in detail. Mr. Klein explained the background and rationale of the DRS, reviewed the debt reporting requirements and discussed with the participants common problems that countries have experienced in filing debt reports.

E. Use of Computers in Debt Management

The micro-computer revolution, which has produced powerful desktop machines that do not require professionally specialized operators, has made possible the use of computers for debt management in all countries. Two sessions were reserved for this topic. Mr. Klein presented a summary of how computers are used with respect to debt accounting, developing debt statistics and analyzing the debt burden. He reviewed the characteristics of an effective computerized debt management system, basing his remarks on a paper by Robert Valantin of the International Development Research Centre (Canada). Then Mr. S. S. Hussain Zaidi of the Pakistan Ministry of Finance described in detail Pakistan’s computerized debt management system, which was based on UNCTAD’s DMFAS system. This case study provided the basis of a discussion of the various computerized debt management systems used by countries represented at the seminar.

The next session dealt with the use of the computer as a management tool. Mr. Khanini of the Islamic Development Bank described the evolution of user-friendly off-the-shelf software packages that are intended to be used by managerial staff in the areas of word processing, spreadsheet and data base analysis. Mr. Khanini demonstrated some of these systems to the participants. The benefit of these tools for managers is that they can evaluate the consequences of alternative courses of action quickly and accurately and so improve their ability to make sound decisions.

F. Macroeconomic Policy Issues

One part of the seminar was devoted to discussing debt management in the context of overall macroeconomic management. Mr. Michalopoulos of the World Bank introduced this session with a lecture relating debt variables (debt stocks and net foreign borrowing) to domestic production, private and public savings, private and public investment and to the balance of payments. Using this analytical framework, Mr. Michalopoulos showed how macroeconomic imbalances have resulted in a debt overhang and explained
what are the central features of domestic economic policy required to restore equilibrium. As background for this session, the participants studied John Underwood's paper, "Debt in a Macroeconomic Context."

G. Debt Renegotiation

In this segment, the participants examined the response to the debt crisis by creditors and by multilateral lending agencies. Creditors have helped by negotiating debt relief; multilateral agencies by exceptional financial assistance to severely indebted countries support their adjustment efforts. Mr. Klein spoke on the institutional arrangements for debt relief through the Paris Club for official bilateral creditors and through consortia of commercial banks for debts to financial institutions. He focused on the recent approaches for debt and debt service reduction that are taking place under the Toronto Terms for debts to official creditors and under the Brady Plan for debts to commercial banks.

Mr. Husain and Mr. Michalopoulos spoke on the role of the IMF and the World Bank in supporting adjustment and debt reduction. The delegations of Jordan and of Sudan described the experiences of their countries in negotiating debt relief.

During the discussion, the participants made several observations on the debt rescheduling process and on officially-supported adjustment programs:

(a) Commitments on the part of both debtors and creditors are needed to solve the debt problem. Some debtor countries have failed continually to follow adjustment policies. At the same time some initiatives to overcome the debt problem have been frustrated by the lack of financial support, particularly from the banking community.

(b) The time required to arrange debt relief should be shortened.

(c) Some debt relief agreements are not viable because the terms for repayment of the consolidated debt are beyond the means of the debtor country.

(d) The World Bank and the IMF have played an important role in helping debtor countries programs. It would be useful if the World Bank could assist negotiators from debtor countries in acquiring the skills needed to negotiate effectively with official creditors and with commercial banks.

(e) With regard to World Bank and IMF conditionality for structural adjustment loans and credits, the conditions should not create an unreasonable impact on the social, economic and political framework of debtor countries. Conditionality should be reviewed from this point of view.

In concluding the seminar, the participants agreed that effective external debt management requires attention to macroeconomic balance, a good debt information system, and careful analysis of a country's future debt supporting capacity.


2. The income groups and degree of indebtedness are as defined in the World Bank, World Debt Tables 1989/90 Edition. See Volume I, p. 121.
Opening Remarks

Ousmane Seck
Vice President
Islamic Development Bank

Distinguished Guests,

Assalamo Alaikum Wa Rahmatullahu Wa Barakatuhu,

It gives me a great pleasure to welcome you all to the seminar on this timely and important subject.

This seminar is the first of its kind sponsored by Islamic Development Bank for this particular group of officials from member countries. The seminar is being organized jointly by the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB) and the World Bank. It is the first joint effort by these two international institutions in providing a forum on an issue of wide concern. This was motivated by the widely felt need in many developing countries, including IDB member countries who are members of both institutions.

IRTI was established in order, inter alia, to extend training services to officials in IDB member countries. In the course of the past few years, IRTI has organized a wide variety of training programs.

This seminar is expected to be the first in a series of such seminars designed for senior policy makers and executives in member countries. Similar seminars in Arabic and French are planned by IRTI within the next three years. I am optimistic that these programs will have a beneficial impact on the process of debt supervision and management and will have a positive effect on the appropriate national institutions in member countries.

The objective of this seminar is to provide an opportunity for senior executives and policy makers in IDB member countries to examine the problems and issues related to debt management in today's world from the perspective of indebted developing countries, and to explore the means to alleviate these problems which represent such heavy burdens on their resources and impede their development efforts. It is also hoped that this seminar for senior officials from member countries will enable participants to learn from each other, share experiences and work out practical strategies on debt management.

I need not remind you of the extent to which issues related to the debt burden of developing countries have come to dominate the agenda of international fora and conferences. Indeed, it is among the leading issues of common concern in the world today.

By any measure, the magnitude of the external debt of countries is staggering. Latest statistics indicate that it is in excess of US $1.3 trillion. According to the World Bank, this amount is equivalent to about 50 percent of the combined GNP of the countries concerned. More significantly, this debt burden is increasing each year. In terms of its impact on the national economies of these developing countries, the servicing of this debt burden consumes a considerable portion of their foreign exchange earnings, which results in declining output and overall economic performance. This explosive situation requires urgent solution, and I am confident that your deliberations during the seminar will contribute to this objective.

The seminar’s methodology stresses not only lectures by international experts, but also case studies and discussions of the debt burden and its management. A substantial portion of the seminar will be devoted to the presentation and discussion of country papers by the participants in order to shed light on various aspects of the problem and the policy options available to resolve them. During these discussions, there will be ample opportunity for participants to introduce new ideas and approaches with the technical assistance of the instructional staff.

The seminar topics cover a wide area of common concern that should be of interest to all participants. Among the topics to be covered are problems of debt and economic adjustment, including debt negotiations and their impact on the development
process. Institutional and technical issues will also be examined during the seminar, with a view to analyze them and identify solutions. Given the objectives, methodology and content of the seminar which I have briefly outlined, I am confident that this meeting will prove to be a worthwhile effort and will be highly beneficial to participants and observers alike.

I would like to take this opportunity to thank the World Bank, which has substantial expertise and wide experience in the field of debt management for agreeing to jointly sponsor this seminar. I am confident that this will not be the last collaborative effort between the Islamic Development Bank and the World Bank.

I welcome you all most heartily to the premises of the Islamic Development Bank and wish you all success. May Allah guide and bless you.

Wassalamo Alaikum Wa Rahmatullahe Wa Barakatuhu,
Part I - The Current Debt Situation

1. Introduction

The debt situation of Islamic countries is varied. At one end of the spectrum are the oil-exporting countries of the Gulf region whose external assets vastly overshadow their external liabilities. These countries were represented at the seminar by Bahrain, Kuwait and Saudi Arabia. At the other end of the spectrum are the low-income countries with poor export prospects, often with a large debt overhang. They must rely entirely on official-source financing, and have very limited capacity to service loans other than the most highly concessional. Sierra Leone, Sudan, Uganda and Yemen represented this group of countries. But also among Islamic countries are nations which are relatively advanced on the path to development and have the ability to tap a wide range of market finance. Malaysia and Turkey were typical of this group of countries.

Mr. Husain of the World Bank opened this segment of the seminar with a lecture on the relationship between external finance and development (Chapter 2). He traced the origins of the debt overhang to borrowing beyond debt-servicing capacity and to the failure to use external finance to improve the productivity of the borrowing country. Mr. Salah Elaian of the Department of Economic Affairs, Palestinian Liberation Organization, contributed a paper (Chapter 3) that described in depth the range of debt problems faced by Islamic countries.

The tables accompanying Mr. Elaian's paper provide a useful source of reference to the debt situation of Islamic countries.
2. External Debt and the Development Process

Ishrat Husain
World Bank

The determinants of economic growth and development are complex, varied and not fully understood. By now, however, what is generally known is that the initial resource endowment, economic structure, social and political organization, domestic policy performance and economic management practices of the developing country itself and external factors such as terms of trade, external capital flows, natural disasters - drought or floods, man-made disasters such as civil war or inter-country wars, all affect output either in an additive or interactive manner.

The popular development paradigm followed in the 1960s and 1970s emphasized central planning and physical target setting, administrative and discretionary controls on the allocation of scarce resources, state enterprises established for production, distribution and trade in all economic sectors, expansionary fiscal policies with budgetary deficits supported with external borrowing and import-substitution strategy of industrialization under protective barriers neglecting the agricultural sector.

The results of this strategy have now become apparent mostly in Latin America and Africa which are heavily burdened with debt, stagnant per capita incomes, declining living standards, massive unemployment, decaying physical assets and undeveloped human resources. Those who have benefited from this strategy are a very small group of elites who have accumulated a lot of wealth. Their large incomes have been the result of access to subsidized credit, to scarce foreign exchange at overvalued official exchange rate, to import licenses or to be able to produce behind a protective wall. Rents based on Government policies have replaced rents based on property ownership.

How does debt enter into the picture of economic development? Conventional wisdom suggests that domestic savings in developing countries are insufficient to finance the desired level of investment and therefore of growth. A higher level of investment financed by foreign saving will allow for a faster growth of GDP than would otherwise be possible if only domestic savings are relied upon.

Foreign saving - either in the form of grants, concessional or non-concessional debt finance - became a significant source of investment in almost all developing countries. The outcome has been mixed. In some instances, the import-GDP ratios were continuously reduced at the same time as GDP was growing. In other cases, and these are the countries which are today faced with debt crisis, the dependence on imports in consumption and production kept on rising over time. These imports were financed by external borrowing while the GDP and export earnings stagnated.

This differentiated approach in the utilization of foreign savings is becoming apparent in the form of a two-track approach to economic development. Some countries, especially in Asia, have grown rapidly, improved the living standards of their people, are on the way to industrialization and have avoided debt crises. The outcome in others, particularly in Africa and Latin America is a source of growing concern.

It may, therefore, be instructive to examine the experience of the former group of countries. The question I wish to ask today is: why has the debt crises affected some countries whereas others have performed reasonably well during the 1980s?

A large number of developing countries have been able to service their external debt in the 1980s, and their development process in this decade has not been much different from that in earlier periods. A number of factors explain why these countries have not suffered debt crises.

First, they were generally less affected by the external shocks of the early 1980s. Being typically less heavily indebted, they did not suffer as much from the sharp increase in real interest rates; being less dependent on commodity exports, they were able to better withstand the decline in commodity prices. The lesser dependence on commodity exports of some of the Asian economies - particularly those in East Asia - reflects in
part the outward oriented policies that they pursued. When the global recovery began in 1982, they were able to take advantage of the rapid expansion of manufactured goods exports, raising export earnings sufficiently rapidly to reduce their debt/export ratios and escape the debt crisis.

Second, the countries that promptly undertook adjustment in the case of exogenous shocks - especially those that curtailed consumption, particularly in the public sector - did not have to resort to excessive foreign borrowing. By contrast, those countries that considered these shocks to be temporary aberrations and postponed adjustment, continuing with normal levels of expenditure financed by external borrowing, faced severe payment difficulties as the borrowed resources were used mainly for consumption. Clearly, countries must be prepared to react rapidly and sharply to negative shocks.

Thirdly, they followed relatively cautious macroeconomic policies in the 1970s, thereby avoiding high inflation. Simultaneously they made productive use of borrowed external funds, eased infrastructural bottlenecks, invested in human resources and/or expanded productive bases and did not allow public sector enterprises to run massive deficits.

Finally, countries that emphasized more effective decentralized economic institutions and a more diversified pattern of production did relatively better than those who chose to promote central control over economic activity and single commodity based pattern of production and trade.

There is a great deal of emphasis these days on debt reduction, debt relief, debt forgiveness and debt write-off. In some countries, this is an inevitable conclusion as the debt overhang is so pervasive that unless some action is taken to reduce the debt burden the process of adjustment itself could not be set on a sustainable basis. Debt reduction in some form or other is therefore justified if we are persuaded that this will enable the country to get back on the path of resumed growth. Mexico and Chile are examples of countries which fall under this category.

But there is also a worrying aspect to this emphasis on debt reduction. Debt reduction is probably a necessary but certainly not sufficient condition for an eventual return to creditworthiness. If we do achieve a write-off or reduction in the debt stock or debt servicing but the underlying economic policies and management practices remain unaltered, then the reduction of debt, by itself, is unlikely to benefit the country’s economic prospects. Sooner or later, the country would find itself in the midst of another debt crisis despite the reduction in debt burden. It is for this reason that the international finance institutions advocate debt reduction in the context of an adjustment program.

This is premised on the expectation that by making suitable changes in relative prices, policies, institutions, and by reorienting public investment, bringing about other structural changes in the economy and at the same time freeing the domestic resources from being transferred to external creditors the country’s debt servicing obligations would become commensurate with its debt servicing capacity and creditworthiness would be eventually restored.

The next question is: Why is there so much stress on adjustment? What is the link between adjustment and economic development? The answers to these questions are by no means straightforward, but let me attempt to offer a few observations. Adjustment involves abandoning certain notions of development that have not worked in the past, adopting different approaches, and reshaping and redirecting policies and institutions to conform to this new approaches. Once the imbalances are corrected through the adjustment process in a given time phase, economic development can proceed on a sustained basis on the strength of the improved policies and institutions. Attention could then be focused on the fundamental questions relating to human capacities, institutions, governance, the environment, population growth and distribution and technology, instead of resolving day-to-day crises situations.

The other issue that requires some elaboration is: What are the ingredients or essential elements of a successful adjustment process? I again wish to reiterate that this is not the recipe which should be followed by every country that wishes to pursue structural adjustment. As I pointed out earlier, every country should design the program in the light of the diagnosis and source of problems, the feasibility and workability of reforms, and the sequence and speed of implementation. But the World Bank has in recent years carried out in-depth studies of adjustment lending and I would like to share these findings with you this morning.

The experience of the countries that had relative success in implementing adjustment programs provides some useful insights and lessons:

(a) The success of adjustment programs depends to a large extent on the commitment of a wide
range of policymakers and decision-makers to the reform process. The programs should be owned by the government itself and not perceived to be imposed by outsiders. Adjustment programs usually involve up-front costs to many groups in society and the benefits usually take time to emerge. This can complicate the task of securing a domestic constituency for reform. But to be effective, reforms must be followed through and sustained despite the short-term transitional costs it imposes upon some vocal segments of the society. Reversing or switching gear in midstream reduces the credibility of subsequent adjustment efforts. Implementation takes time and effort.

External funding to support reasonable and sustainable adjustment has to be sufficient. Adequate financing can give a country the time and resources needed to make orderly adjustments, so long as it does not lead to the indefinite postponement of necessary reforms. Not only financing should be adequate but there should be coordination among various donors and creditors. Financing and sustainability are mutually reinforcing.

Adjustment programs should have stabilization elements designed to bring domestic demand more in line with available resources. Reforms have succeeded in either increasing the efficiency or resource use or increasing domestic saving and hence the resources available to finance investment and growth. Improvement in public sector management (e.g., the quality of development expenditures and management of public enterprises); removal of price distortions that adversely affect productivity such as low producer prices for farmers and excessive protection for some industrial goods; progress towards a more open economy (export expansion and import liberalization); these are some of the measures that have paid dividends in the form of efficiency improvement in resource use. Reforms that promote savings involve either the public sector (budgetary and state enterprise savings) or the private sector (financing sector policies).

The speed of the supply response has determined sustainability. A strong export performance helped the continuation of reforms in Turkey. By contrast, policy reversal in Zambia partly resulted from the lags in export growth. The supply response also depends on greater institutionalization of reforms, thereby strengthening their credibility to investors. Also, complementary reforms to reduce internal regulation and market rigidities are sometimes essential for a stronger supply response. In countries with weak institutions and poor infrastructure, support from sectoral reforms is crucial.

The protection of state-owned manufacturing enterprises has interfered with liberalization programs. If market exit or entry is difficult, inefficient firms may linger, and new firms may not start up. Regulations that make it costly for firms to restructure or shut down have been a factor in failed liberalization attempts. Price or wage controls are incompatible with trade policy reforms. In the presence of severe labor market controls, firms may have to shed labor or close down in response to import competition even though the workers could have been profitably employed at lower wages, while industries trying to expand may be unable to bid labor away from contracting sectors with high minimum wages.

These elements of success which I have listed above should not fool us in exaggerating the benefits of adjustment or underestimating its costs. Adjustment is by no means an easy task. Difficult and painful choices have to be made. Tariff reduction may improve the trade regime but also erode the Government revenues if the main source is tariff duties. Successive devaluations may restore the competitiveness of exports but also increase the budgetary deficit if external debt service payments form a large proportion of the Government expenditure. Cuts in real wages of civil servants may reduce their incentive to implement policies or restructure institutions that form part of the structural adjustment program. In all cases, the results have not always been an unqualified success. Investment ratios have declined, and budget deficits are higher than
before adjustment programs in many highly indebted countries. Nutritional intake among low-income groups has stagnated.

To sum up, despite the harsh and at times adverse external and exogenous circumstances and environment, several countries, including a few in Africa, have made some modest progress in developing their economies. The external debt problem is a real constraint and should not be ignored. But at the same time empirical evidence shows that the debt-burdened countries that have embarked upon the difficult and long process of structural adjustment have done better than those who did not. Even within the same country the performance was better under the adjustment phase compared to the earlier phases of their economic life i.e. non-adjusting phase. The international community has intensified its efforts to provide adequate resources including debt reduction and debt relief in support of adjustment process but the debtor countries themselves must continue to assume primary responsibility for their own fate by sustaining economic reforms and adjustment process.
3. External Debt Of The Islamic Countries

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The world economic and financial situation has become increasingly obsessed in recent years by the problem of external indebtedness of developing countries. The increases of foreign debt carried by non-oil developing countries has long been considered a source of concern, as the magnitude was rapidly accumulating through time into a massive "debt mountain". Then, during the early 1980s, the situation entered an acute phase, when some of the large borrowing countries began to face debt-servicing difficulties as their external obligations exceeded their capacity for repayment. Since then, the emerging debt crisis began to attract greater world-wide concern and was soon turned into a heated issue. The spread of debt rescheduling among a growing number of debtor countries has given evidence of the threat posed by the emergent debt crisis.

Among the countries involved in the present crisis of international indebtedness are the Islamic countries in Asia and Africa. Some countries are capital-surplus and thus are involved in the debt crisis as creditor economies, whereas the others are debtors. The Islamic-member group of debtors has gradually developed a relatively large-sized external indebtedness over the past years.

The group of Islamic creditor countries have accumulated large financial surplus out of their oil exports. The surpluses have been used abroad in various forms. A good part has been extended as Official Development Assistance to a large number of developing countries. Another part has been placed as short-term deposits in foreign banks for recycling in external economies, and some of these surpluses has been used in portfolio and direct investment abroad.

This study examines the position of the Islamic countries in connection with the current international debt crisis. Its main purpose is to identify and assess the implications of foreign debt problems with regard to the external position of the Islamic countries. And it also aims to advance the incentives to adjust the debt, expand debt reduction techniques, and examine policy implications.

I. External Debt Problems At the Global Level

The total long-term foreign debt of developing countries accumulated continuously throughout the 1970s, and 1980s, escalating from $62 billion in 1970 to $633 billion at the end of 1983. Including short term debt and IMF credits, total external liabilities of all developing countries were $807 billion at the end of 1983, double the export earnings of all these countries. Figures for the total debt of developing countries are shown in Annex Table 1, at the end of the paper.

The huge increase in foreign debt, coupled with the sharp rise in interest rates, has caused a large upsurge in the total debt service obligations of debtor economies. For all developing countries debt service continued to rise, reaching an estimated $109 billion in 1983, compared with less than $10 billion in 1970.

The dramatic accumulation of external debt and the sharply increasing debt service obligations have put many developing debtor countries in an extremely difficult situation in recent years. The impact of foreign debt burden has become so heavy that some developing debtor countries were practically on the verge of default, exposing their creditors (the banks) to problems of illiquidity and possible insolvency. Indeed the whole international financial system seemed to have become exposed to possible collapse.

A. Financing in Developing Countries

External borrowing by developing counties has become heavily skewed toward official sources, as has

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been the case since the onset of the debt crisis in 1982. From 1985 to 1989, official creditors (governments and international institutions) provided some 70 percent of total financing flows to developing countries, compared with about 30 percent in 1980-82.

Total net lending to developing counties by the nonofficial sector (including short-term flows) has declined in the 1980s. This trend can be seen from the figures in Annex Tables 2 and 3. The balance on goods, services and private transfers was substantially in deficit in 1981-82, and this deficit tapered off only very slowly during the remainder of the decade. Financing by non-debt creating flows was limited. The increase shown during the latter 1980s was concentrated in Asian countries.

Lending by private creditors in the early 1980s was substantial, but it declined sharply after 1983. Commercial bank net lending was negative after 1984 (and during 1982-83, the lending shown was largely "concerted" in nature). The shift from large positive to negative flows was particularly marked in Western Hemisphere countries and in Africa. This may be seen from Annex Table 3.

Annex Tables 2 and 3 indicate a shift in direction of "reserve related liabilities". This was the consequence of the large-scale drawings on the IMF and the necessity of repaying these credits during the latter part of the decade. IMF tranche drawings must be repaid between 3-5 years.

In the absence of a further recovery of oil prices, the fuel exporters probably will continue to register moderate current account deficits. The borrowing requirements of exporters of manufacturers are likely to be modest, and would be met primarily from market sources. Borrowing by other countries would rise broadly in line with the expected widening of their current account deficit.

B. Causes of External Debt Crisis

The symptoms of the present international debt crisis were clearly felt and identified when arrears on repayments of debt obligations (of non-OPEC developing countries) began to accumulate rapidly, especially between 1981 and 1982 (from $6.1 to $18.1 billion). These arrears figures represented the size of deficit, in terms of foreign-exchange resources, experienced by these debtor countries in those years. The aggregate deficit actually began to accumulate since 1976, as many developing countries external obligations started to exceed, by increasing amounts, their capacity for obtaining necessary foreign-exchange resources. This gave rise to the external debt problem, which later turned into debt crisis in the opening years of the 1980s.

The chain of causation that precipitated the debt crisis involved a complex set of causes and effects. Some were in operation long before the eruption of the international monetary system and its inherent inflationary tendency, which increased considerably after the end of the gold-convertible dollar in 1971 and the increase in international liquidity represented then by the accumulation of Eurodollars in the largely unregulated Euromarket. These factors were mainly responsible for creating the substantial waves of inflationary pressure experienced in the early 1970s, and thus set the stage for further problems.

The other causes were related to the different series of actions exercised by various groups of countries and by the international private financial market, in reaction to inflation and its consequences. As a result of these series of reactions, the situation of external indebtedness began to experience the adverse effects of many factors and forces that have been largely beyond the control of the borrower countries. Among these such factors, the following are important:

a. The Price of Oil Skyrocketed.

While OPEC's price hikes in 1973-74 and again in 1979-80 helped oil exporting nations, the consequences were devastating for most of the developing world. Many countries rely heavily on imported oil, and this takes a tremendous chunk of precious foreign exchange. To avoid throttling their economies, many nations took out loans to pay for their now more expensive oil imports. later, sharp declines in the price of oil and in total oil revenues wrecked havoc on a number of oil-exporting nations that had themselves borrowed heavily, such as Trinidad and Tobago, Mexico, Algeria, Indonesia and Nigeria.

b. Export Earnings Fell.

The developing countries did not adequately foresee the new trend toward low commodity prices in the 1980s. The rise of synthetic substitutes (for natural fibers, agricultural goods, metals) and protectionism in Northern markets depressed prices, as did the economic recession and sluggish growth in the industrialized
External Debt of the Islamic Countries

nations. Africa's export earnings, for example, grew 22 percent a year between 1970-79 (although the volume was shrinking 0.2 percent a year), and then fell 9.0 percent a year 1980-84, with sizeable drops since (-0.7 percent in 1985, -26.0 percent in 1986 -6.0 percent in 1987). The picture is similar even if oil exports are excluded.

Developing countries likewise saw a worsening of their terms of trade, the purchasing power of their exports in relation to the cost of imports especially manufactured goods. Over the long-run, it has become relatively more expensive for them to import needed products for development and harder to earn foreign exchange needed to service debts. For example, now it may take 7 tons of sugar to buy a tractor where it used to take 2 tons. Overall terms of trade for primary products are at their lowest values since the Great Depression of the 1930s.

c. Real Interest Rates Rose

In the fall of 1979, the United States adopted a tight monetary policy, in part to try to curb inflation and staunch a major outflow of capital. This pushed up real interest rates to historically high levels. A few further key developed nations followed similar contractionary policies, which triggered a world-wide recession and drove up the cost borrowing on a world price. For the debtor countries, this not only made new borrowing more expensive, but also unexpectedly increased the amount of interest they had to pay on their old loans, since much of their commercial bank borrowing was originally contracted with floating interest rates. The increase in international interest rates in 1988, for example, hiked the net interest bill of Latin America and the Caribbean for that year by $2 billion.

While real interest rates have come down from the levels of the early 1980s, they are still high relative to the 1970s, and far above the levels which prevailed for much of this century. The domestic policies in creditor countries, then, can have a quite severe impact on debtor nations - a component of the crisis over which they have no control.

Another related trend has been the rise in interest rates on loans from official sources, namely other governments and multilateral agencies like the World Bank and IMF. Since these official lenders themselves often borrow their funds from commercial markets, they were obliged to pass on the higher interest rates to their borrowers.

d. Stagnation in External Financing

As the global economy slows and developing country debtors began to have real troubles servicing their debt, they found commercial bankers no longer eager to make new loans. The global financial industry has entered a period of major restructuring, and banks have shifted to new markets closer to home. Debtors found themselves paying back more money than they received in new commercial loans.

Multilateral lending also slowed while repayments increased, further squeezing debtors. The value of loans authorized by the Inter-American Development Bank, for example has been declining since 1984. The 1988 nominal level, $1.7 billion, was 18 percent lower than annual lending 10 years ago. It is far lower if a decade of inflation is factored in. According to the World Bank's 1989 annual report, it received $1.9 billion more in payments from 17 medium-income, highly indebted countries than it lent to them. The IMF credits to sub-Saharan Africa grew 1 percent annually in real terms. This fell to 0.5 percent in 1984, 0.1 percent in 1985 and then turned negative. In both 1986 and 1987, sub-Saharan Africa paid the IMF $500 million more than the continent received in new credits, and in 1988 it paid $250 million.

Although foreign aid from the industrialized countries increased, this was offset by declining flows from the OPEC donor countries, which were facing financial difficulties of their own. Overall foreign aid level thus remained largely stagnant during the first half of the 1980s. They have since increased; but, when inflation and shifting exchange rates are factored in, the rise has been relatively modest.

Like the commercial bankers, private investors have likewise shifted their attention to less risky regions. According to the IMF, net direct foreign investment in the developing world plummeted from $20.2 billion 1982 to exactly half that amount, $10.1 billion in 1986. By 1988 it had rebounded to $16.3 billion, but much of the increase was to East Asian countries and other nations without serious debt problems.

One condition that can exacerbate financial problems in debtor countries is the phenomenon called "capital flight". This refers to individuals within a country moving their wealth to another nation, draining
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money out of the country which could have used these resources for investment and development. The IMF estimates that $30 billion of flight capital left between 1974-85. The US government estimates that the total amount of flight capital leaving Latin America is equivalent to more than half the external debt of the major Latin Nation. According to various analyses of the increase in Mexico’s indebtedness, between 38 percent and 53 percent of the debt accumulated from 1977 to 1982 ended up financing capital flight.

The slowdown in external financing, combined with the heavy debt servicing burden that most developing nations must shoulder, brought about a reverse flow of resources by 1983. Every year since then the developing world has transferred to the North more financial resources than it receives. According to UN data, drawings on all major sources for financial flows (loans, foreign investment, aid, etc.), a sample of 98 developing nations shipped $115 billion (net) to the developed world in the period 1983-88. The World Bank, looking only at banking transactions, estimates that the debtor countries transferred to foreign creditors more than $50 billion in 1988 alone.

C. The Islamic Countries and the Debt Crisis

Both the capital-scarce and the capital-surplus countries have been affected by changes in international economic and financial circumstances that led to the current debt problems. The capital-rich Islamic creditor countries became involved in the debt problem, partly by extending financial aid to developing countries, and partly by recycling a portion of their surpluses through foreign commercial (private) banks. The capital-deficit group of Islamic countries has also been involved in the foreign debt problem, but through expanding their borrowings abroad. The growing size of debt carried by these countries has come about as a result of interaction among a set of factors pertaining to their needs for development and to adverse changes in terms of trade as well as in terms of borrowing abroad.

Analysis of the external position of each of these two groups of Islamic countries reveals that they are involved more and more in the hot core of the current international debt crisis and that they have been negatively affected by the adverse repercussions of the crisis. If they do not take counteractions by adopting proper policies and suitable measures, they will be involved directly in the international debt crisis.

II. External Debt Situation of the Islamic Debtor Countries

The Islamic member group of debtor countries (IDCs), taken collectively, experienced a rather fast growing external indebtedness during the 1970s. The total debt increased from about $147 billion in 1980 to about $340 billion in 1988. The debt of the Least Developed Islamic Debtor Countries (LDICs) grow from $18 billion in 1980 to US$46 billion in 1989 (see Annex Table 4). The ratio of total debt service to exports of goods and services for all the IDCs has fluctuated between 27 and 31 percent between 1985 and 1989, and that ratio for LDICs fluctuated between 19 and 24 percent during this period. (See Annex Table 8).

A comparison between the Islamic Debtor Countries (IDCs) is shown in Annex Table 4. Total external debt of all Islamic developing countries increased from $245 billion in 1985 to $341 billion in 1989. It should also be noted that the total external debt carried by the LDICs is almost more than half the debt of all least developed countries.

The accumulation of external debt by the IDCs arose as a direct result of the pressing needs for larger volumes of foreign exchange required to meet growing external obligations, which had been generated mainly by "excessive" imports. This implicitly means that the volume of foreign financial resources needed annually by these debtor countries has actually been exceeding, by growing magnitudes, the volume earned by their exports of goods and services, thus giving rise to a widening gap that necessitated borrowing larger amounts of foreign resources, year after year as shown in Annex Table 4. However, borrowing in its turn, has started generating an additional sort of obligation besides financing imports, namely, debt-service payments.

As can be seen, the expansion in imports experienced by the IDCs has become coupled with the growing size of debt-service payments. Eventually, both factors, after exhausting the foreign exchange earned by exports (as well as a good part of international reserves), have been acting in unison and in a direct way toward a wider gap and hence larger borrowing.

Of course, behind these direct factors, there are deeper causes of the accumulation of debt. The widening gap, in essence, has been generated in these debtor economies by the divergence between, the evolving national aspirations and growing needs, on the
one hand, and the domestic means available for satisfying such needs and aspirations, on the other. The group of factors which have led directly to larger borrowing have actually been created by a complex set of causes that are deeply rooted in the structure of the domestic economies of the IDCs. Thus, the national desire for a rapid transformation of domestic economies by development programs has often been confronted. In these countries, by various types of physical shortages, gaps and defects, coupled with small-sized market and limited foreign exchange resources.

Consequently, as the process of development starts, it soon gives rise to greater interaction with, and greater dependence on, foreign economies, especially of the industrially advanced countries. The dependence may expand first through import-export activities, but it soon winds up in finance as well, especially in the case of the capital-scarce countries such as most of these IDCs. Thus, the inherited structural defects have exercised their role in reinforcing the direct causes of debt accumulation, leading to further indulgence in borrowing of foreign financial resources.

The chain of cause and effect which has generated accumulation of foreign debt of the IDCs emanates originally from the structural defects embedded in their domestic economies. Since it is still undergoing early stages of transformation and development, the economic structure of these countries is still full of gaps and shortcomings, in the sense that the composition of their domestic production is neither diversified in kind nor sufficient in quantity to satisfy their varied and growing needs.

The effect of structural defects and shortcomings are directly reflected in the composition and the volume of both imports and exports of these developing countries. The complete absence of a wide range of basic and intermediate industries, as well as the lack of advance technical methods of production in agricultural and other activities, has been responsible for the widening gap between the limited supply of domestic production and the fast growing demand. This gap has actually forced these countries to enlarge their reliance on imports to meet the pressing needs for goods and services required in the areas of development, current production processes, and consumption.

The expansion of imports necessitates, of course, a parallel expansion in exports, in order to earn sufficient foreign exchange for financing the increase in imports. But the scope of export expansion was limited by constraints resulting from the same structural defects and shortcomings. This is evidenced by the fact that the exports of these IDCs countries are limited in volume as well as in variety, consisting actually of a single or few commodities of raw materials. This situation has resulted in limiting the capacity to earn foreign exchange through exports.

The expansion of imports far beyond the capacity to finance them by export earnings eventually led, first, to the decline in the international reserves of most of these countries and, then, to borrowing from foreign sources of credit. With the expansion in borrowing, debt-service payments emerged as a new, additional factor, besides imports, requiring larger amounts of foreign exchange resources.

The increases over time in debt-service payments, coupled with the continued expansion of imports, have contributed to further borrowing, leading to the accumulation of external debt. The chain of cause and effect seems to have created a sort of vicious circle, whereby borrowing leads to further borrowing through the growing burden of debt-service obligation.

Thus, with the structural shortcomings acting as the prime cause of "large-scale" dependence on external economies, in the fields of imports, exports and borrowing, the above-described chain of cause and effect has made the situation in the IDCs economies, as in the case of many other developing debtor countries, highly susceptible to any adverse changes in the terms of international trade and/or in the terms of foreign debt.

What has actually happened, during the past 15 years, causing fast accumulation of foreign debt by the IDCs (by other developing debtor economies), is that:

(a) The prices of imports of these countries have increased to very high levels, as a result of the inflation in the prices of manufactured goods, oil and food-stuffs. This price rise is responsible for most of the expansion in the value of imports experienced by the debtor countries.

(b) The prices of exports (other than petroleum) of these debtor countries have declined to a very low level, due to the world wide fall in the price of primary commodities.

(c) The external demand for the exports of these debtor countries has been stagnating, due to the state of recession in the world economy, especially in the industrially advanced coun-
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tries. This factor, coupled with the decline in export priced, acted to curtail the volume of foreign exchange earned by the exports of these debtor countries.

(d) In addition, borrowing from official sources of credit began to became difficult owing to restraints. This is especially true in the case of borrowing from the governments of the industrially advanced countries.

(e) Finally, in order to offset the effect of strained official development assistance, most of the IDCs began enlarging their borrowing from private financial markets, especially during the second half of the 1970s and early 1980s. Consequently, the hard terms of borrowing from private sources have led to the increase over time in debt-service payments.

Generally, foreign financial resources are borrowed by a country to finance the deficit in its balance of current accounts. Such a deficit usually comes about when the country's current obligations to foreign entities exceed its now capacity to finance them. The sources of foreign obligation are the various kinds of transactions between the given country and the rest of the world.

In the case of the IDCs, the principal sources of their external obligations are first, the large excess of imports of goods and services over exports and, secondly, the debt-service payments, with the latter being a consequence of the former. The excess of imports is indeed the major cause which has initiated the deficit in the current accounts and eventually led to the accumulation of foreign debt of the IDCs.

The factors that have been exerting pressure in the direction of foreign debt accumulation through import expansion are certainly the needs for foreign goods and services. It follows that the uses of external debt would be determined, largely, by the types of needs prevailing in these developing debtor countries.

The general conviction is that foreign loans are borrowed by capital-scarce developing countries mainly to finance the imports needed by their development programs, and possibly the debt-service payments as well. However, in the light of the data concerning the composition of imports of the IDCs, it seems that borrowed foreign funds might have been used also to finance imports for current production, and even for consumption, whenever exports earnings fall short of covering such types of imports.

A complete quantitative evidence to this effect is lacking, and it would take us too far afield to go into such details. However, some partial indicators actually reveal sufficient evidence that external debt is used, with different proportions, to finance imports for development programs, current-production processes, consumption and debt-service payments.

III. Relative External Debt Burden of the Islamic Developing Countries

A debtor country's capacity for repayment of foreign debt and debt service obligations depends largely on that country's own production and ultimately, on its export earnings of foreign exchange. Relating debt size to the relevant macro-economic aggregates, therefore, generates ratios or indicators provide "various measures of the cost of, or capacity for, servicing debt in terms of foreign exchange or output forgone". Some of these indicators are as follows:

A. External Debt Relative to Exports and to GDP

Since repayment of external debt is financed out of export earnings, it follows that a debtor economy's capacity for repayment is indicated by the ratio ED/XGS, which expresses foreign debt as a percentage of the volume of product. Likewise, relating foreign debt to Gross Domestic Product, ED/GDP, gives an indication of the relative burden of debt, in terms of output forgone.

(1) External Debt to Exports, ED/XGS

Annex Table 6 contains data relating foreign debt to exports of goods and services, ED/XGS ratios. The ratios are shown for each individual debtor country covering 1980-1989. Only a handful of countries had an ED/XGS value in 1989 lower than the developing country average: Burkina Faso, Chad, Gabon, Malaysia, Oman and Tunisia. The ED/XGS ratio for all severely indebted countries was 315 in 1989. Fourteen countries had higher ED/XGS ratios; some were extraordinarily high, over 1.000 (Guinea-Bissau, Somalia and Sudan).
3. External Debt of the Islamic Countries

(2) External Debt Relative to GDP (ED/GDP)

The foreign debt of each of the IDCs, relative to GDP, appears considerably high in comparison with all developing countries and with the 15 severely indebted countries. The ED/GDP ratios in Annex Table 7 show that during the years 1985-1989, the debt burdens carried by 23 out of 33 IDCs were heavier than those of the severely indebted countries in 1989. Among the IDCs, the ED/GDP ratio of the Guinea-Bissau increased from 195 in 1985 to 274 in 1989. In comparison, the ratios of the severely indebted countries, as shown in the table, were 64.3 in 1985 and 59.1 in 1989.

B. Total Debt Service Comparisons

Total debt-service payments consist of principal and interest payments made in foreign currencies earned from exports of goods and all services. Relating the total of these payments to the value of exports yields what is known as the debt-service ratio which indicates the proportion of export revenue that is allocated to finance total debt service payments annually.

It should be noted here that export earnings are, naturally, required for other purposes, besides servicing external debt. In developing countries, foreign exchange earned from exports is mainly devoted to financing imports, especially those needed for development. Of course, the more export revenue a country must devote to external debt servicing the less can be devoted to other uses; and, consequently, the process of economic growth might be impaired, as indicated above.

By relating the same TDS payments to GDP, on the other hand, we obtain a TDS/GDP ratio which indicates the annual cost of debt servicing in terms of output forgone. These ratios are given in Annex Tables 8 and 9. The reader should note that the ratios are "ex post" in the sense that they are calculated using figures for debt service actually paid, which is much lower for countries that have benefitted from debt relief (e.g., Egypt, Guinea, Niger and Senegal) or are simply building up arrears (e.g., Sudan after 1985). Countries that did not receive debt relief during the years 1980-89 were: Algeria, Bangladesh, Indonesia, Malaysia, Maldives, Oman, Syria, Tunisia, Turkey and Yemen. The World Bank's Publication, World Debt Tables 1990-91, lists all countries that have received debt relief and shows the period over which relief has been extended.

(3) Total Debt Service in Relation to Exports of Goods and Services (TDS/XGS).

Annex Table 8 presents the debt-service ratios for each IDCs and LDICs in comparison with the all developing countries and with the severely indebted countries. As the ratios in this table indicate, the burden of servicing foreign debt in 13 out of 33 IDCs is much heavier in the case of all developing countries in 1989. In contrast with 8 out of 33 countries in 1980. Among the IDCs, Algeria's foreign debt-service percentage had increased by 175.7 percent between 1985 - 1988. One may note that, as far as the debt-service payments are concerned, the burden carried by the IDCs undoubtedly less heavy than that carried by the severely indebted counties owing to a combination of debt rescheduling and the forgiveness of official development assistance loans. A number of IDCs have had TDS/XGS ratios above 20% despite debt relief: Egypt, Guinea, Guinea-Bissau, Jordan, Mauritania, Morocco, Niger, Nigeria, Senegal, Somalia and Uganda.

Algeria has had extraordinarily high TDS/XGS ratios in the late 1980s. The government has chosen to pay debt service as due (largely to commercial bank creditors) so as to maintain its creditworthiness for new loans.

(4) Total debt service relative to GDP (TDS/GDP)

The ratios of total debt service to gross domestic product are given in Annex Table 9. For all developing countries, the ratio has ranged around 5 percent. However, for a number of IDCs, the ratios have exceeded 10 percent for most of the 1980s. (Algeria, Egypt, the Gambia, Jordan, Maldives, Mauritania, Morocco, Tunisia, and Yemen). For a few countries, such as Sudan and Sierra Leone, the ratios are very low because debts are not being serviced. For many other countries, the ratios are low because of debt relief.

C. Ratios of Reserves to Imports

International reserves of a country consist of the country's savings in the form of gold and convertible currencies and IMF special drawing rights. Functionally, international reserves represent a means of payment acceptable to foreign creditors and exporters, and thus can be used for financing external debt-service
Managing External Debt in Developing Countries

payments as well as imports. The ratio relating the international reserves of a debtor country to its external debt indicates the country's external position. As means for meeting external claims, international reserves are related to the value of a country's imports to indicate how the country can finance its imports of goods and services during the year.

(5) International reserves relative to external debt (RES/DOD)

These ratios were high for 1980-81 for developing countries as a whole, because they include the oil exporters (Algeria, Indonesia, Malaysia, Nigeria and Oman). As oil prices declined, so did the RES/DOD ratios for these countries, as is shown in Annex Table 10. Turning to oil-importing countries one should note the precariously low ratios of the LDICs and of Cameroon, Guinea, Guinea-Bissau, Morocco, Senegal, Sierra Leone, Somalia and Uganda.

(6) International reserves relative to imports of goods and services (RES/MGS).

If we divide the RES/MGS ratios as shown in Annex Table 11 over twelve months, we will see that the international reserves of the IDCs, as in the case of the major debtors, have been sufficient to pay for imports of only a few months during most of the past years. In some countries, international reserves fell short of financing imports of even a couple of months as in the case of Egypt and Syria. The increases in the external obligations of these countries have been partially responsible for reducing their international reserves to such low levels. It is also obvious that, as a result, the external position of most of the IDCs has become practically totally dependent on their exports and foreign borrowing. The growing burden of debt servicing, in addition to import financing, required parallel expansion in their exports earnings else larger borrowing abroad.

Since export earnings have stagnated because of economic recession in industrial nations, reliance on borrowing became, inevitably, greater over time. And because of insufficient aid from official sources of credit, these debtor countries were forced to borrow from the international financial market at harder terms. Thus the share of commercial banks' loans became relatively larger in the composition of foreign debt carried by a growing number of developing countries, including most of the IDCs.

IV. Recommendations and Conclusions

To avert possible deterioration, the debt crisis, in its global context is in need of more fundamental solutions. The currently applied ad hoc policies and arrangements to manage the debt crisis are not only inadequate safeguards against deterioration of the foreign debt situation but also risk being counterproductive. These "patched-up" arrangements - rescheduling of bank debts, new lending to help pay interest on outstanding debt, IMF loans on conditions of severe austerity for debtor countries - have, for the moment, bought time. But the source of instability remains and some of the short-terms solutions may have deepened it. There is a strong need for a new alternative approach.

A. General Recommendations

Lately, several proposals have been offered with a more or less "balanced" approach to the debt problem. Two elaborate proposals emerged in 1984 are worth noting. One was put forward by a Commonwealth Group of Experts, and the second through the UNDP and the UNCTAD secretariat. The essential features of these proposals are:

(a) The debt crisis is considered not only as a problem of liquidity but also as an issue of equality, in the sense that there should be an equitable distribution of responsibility and costs between debtor countries, creditor country governments and the private banks.

(b) The developing debtor countries should be assisted to regain and foster their repayment capacity through economic growth and export expansion. This implies that proper arrangements must be made to accomplish the following:

- To put an end to the premature outflows of resources from the debtor developing countries (i.e. austerity must not be at the expense of investment and growth);
- To bring about a positive (net) transfer of resources which should be directed to
produce growth in the developing countries.

(c) Creditor countries must assist the debtors by guarantees or other means in the following goals:

- Raise the funds required to pay interest on outstanding debt;
- To ensure the flow of new funds to permit higher levels of growth, and imports;
- To obtain debt relief to shelter them from the extra damage that comes from the currently high rates of interest.

(d) Given guarantees by the industrial countries, this "additional financing" would come from a combination of:

- Commercial bank lending underpinned by a scheme of insurance by the industrial countries;
- Bilateral official lending;
- Multilateral lending through the IMF, the World Bank and the regional development institutions.

(e) Besides the additional financing, the debt-servicing burden of developing countries should be reduced through rescheduling arrangements, which should be enlarged in scope with a switch to longer maturities and grace periods, coupled with fixed or capped interest rates as some proposals suggest.

(f) Under such conditions, the debtor countries would be able to pay the interest and the lending banks would be in a position to "bear an equitable share of the burden involved" by making realistic write-down of the debts to sustainable levels.

(g) The role of direct foreign investment should be enlarged through measures of encouragement which "must be provided by both developing and industrial countries in mutually acceptable framework".

(h) The international financial institutions should play a much more active and enlarged role in resolving the debt problem and in meeting the financing needs of developing economies (in a long-term framework). To carry out such a task, the terms of reference of these institutions should be revised, and their resources should be increased substantially. Thus the IMF, for example, "should be enlarged substantially and should be transformed into a world central bank, or lender of last resort. Also, the third world should be better represented on its executive board". Among other required actions, the IMF adjustment programs should be designed with an emphasis on investment and growth. Similarly, the World Bank and the regional development banks should have greater resources and more flexibility to respond to the need for program loans - besides other forms of aid badly needed by low-income countries.

(i) The industrial countries, on their part, should throw their weight more in the direction of borrowers by seeking a limited, responsible debt relief for countries particularly burdened by debt service at current rates. Also, the industrial nations must increase ODA to developing countries, at a significantly lower level of interest rates, and roll back protectionist measures against the exports of developing countries.

The rationale of the proposals is based on the fact that the interests of creditors and debtor countries are intertwined, and the general purpose is to help to make the international economic environment more favorable to growth in the developing countries (and thus create sounder base from improved debt management). However, since the national policies are the crucial factor in economic development, it follows that the developing countries, in their turn, should improve on their domestic policies in order to secure:

- Better mobilization of domestic resources;
- More efficient use of these resources;
- Better management of external debt.

It seems that many developing borrowed countries are in need of more effective methods of debt management, as well as improved fiscal and economic management. The IMF and other international and
regional institutions should be prepared to provide such technical aid whenever called upon.

B. Specific Recommendations

Given the level of external debt carried by these countries in recent years, and given the "harsh" international economic circumstances which seem likely to prevail during the rest of the 1980s, it appears fairly appropriate that the IDCs, should exercise better management of their external debt. And this must come about as part of a general improvement in economic, monetary and fiscal policies. The improvement required in these policy areas should be designed to secure high growth during the coming years. In this endeavor, certain policy criteria should be seriously considered. Thus, these Islamic debtor countries would be well advised to do the following:

(a) Apply more effective methods of mobilizing domestic financial resources and enlarge participation of their national banking system in development financing;

(b) Ensure maximum efficiency in the allocation and utilization of all domestic resources;

(c) Economize on capital, whenever possible, through applying capital saving technologies, especially those which save foreign exchange resources;

(d) Refrain from short-term borrowing to finance long-term development;

(e) Minimize borrowing from foreign commercial banks as long as their terms of lending remain excessively hard;

(f) Borrow only what is "really" needed (that is only what can be used efficiently);

(g) Avoid excessive deficit financing, improve on economic performance and rationalize development planning and allocation of development resources in favor of dissatisfying basic home needs;

(h) Revise trade policy in favor of development and growth;

(i) Promote interregional co-operation and economic integration among the Islamic economies and readjust or co-ordinate development strategies accordingly; and

(j) provide sufficiently effective incentives for interregional flows of capital, including private direct investment.

It seems that these capital-surplus countries should continue playing their vital financial role in extending ODA to LDCs. They should enlarge their role in promoting inter-Islamic economic co-operation and integration, and they should redirect a larger part of their financial surpluses toward investment in the Islamic countries economies especially in promoting "Common Islamic Projects". In view of the depressing effect of the international debt crisis, Islamic Funds, the AMF, IDB, ADB, AFESD, and the other development-aid institutions should play a more active financial and technical role in fostering economic and social development as well as in enhancing financial co-operation and economic integration among the Islamic countries.

C. Concluding Observations

External debt of the Islamic developing countries has been rapidly accumulating during the past years, reaching "crisis" proportions since the late 1970s. The current crisis of international indebtedness has arisen because many large and small debtor countries have acing difficulties in servicing their external debt, thus exposing their foreign creditors, especially the banks, to liquidity problems and possible insolven-

Being eager to keep their economies growing, most Islamic developing countries offset the short fall of ODA inflow by enlarging their borrowing from commercial banks. By so doing, they actually were incurring short-term debts which they can then use for financing long-term development. This practice, inevitably, led to even more rapid accumulation of these countries' debts. The current debt crisis has come about as a result of causative forces that are deeply seated in the economies of both developed and developing countries, these countries have become increasingly dependent on external factors, with the latter being much more so, because of their gross reliance on foreign trade and external financing. As a result the position of developing economies has become highly
sensitive and vulnerable to external disturbances, especially those emanating from the more influential, industrially advanced countries.

The currently practiced ad hoc, case by case debt rescheduling arrangements are largely designed to ease acute cases of liquidity shortage, by stretching debt burden over a longer period and providing new loans to debtor countries facing such cases. But the conditions attached to these arrangements, in the form of austerity programs for adjustment, are often viewed by debtor countries as being devoid of due consideration the "harsh" consequences on social well-being and political stability in the debtor country, or on its economic growth in the long run. The overall aim of the policies applied in debt rescheduling arrangements is to have debtor countries generate export surpluses in order to service their external debt. The question therefore arises whether these programs of adjustment can reasonably be expected to continue and whether they will, in long run, contribute to a solution of debt problem.

In sum, there has been considerably more progress on international debt problems as a whole than is generally recognized. Reinforcement of the Baker plan with multi-year new money packages exit bonds with seniority, and the right for successful exporters to use extra earnings to repurchase debt at a discount in the secondary market, should be sufficient for most of the major debtors to achieve gradual restoration of creditworthiness along with adequate domestic growth. In contrast, for a special list of heavily indebted, low-income countries (primarily in Africa), some forgiveness of primarily official debt may be appropriate. While significant number of countries is on this list, their aggregate debt is only a small fraction of the total for developing nations. For the Islamic debtor countries, progress on debt will depend not only on arrangements on debt, but more fundamentally on appropriate domestic policies (especially on fiscal balance and the real exchange rate, and successful management of the international economy by the leading industrial countries.
### Annex Table 3-1: EXTERNAL DEBT OF DEVELOPING COUNTRIES, 1970, 1980, 1983-89
(In billions of US dollars)

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#### LONG-TERM DEBT

A. Public and publicly guaranteed debt

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<tr>
<td></td>
<td>61.9</td>
<td>420.7</td>
<td>633.2</td>
<td>674.8</td>
<td>767.3</td>
<td>867.3</td>
<td>980.5</td>
<td>959.8</td>
<td>958.8</td>
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- Official creditors: 32.2
  - 156.7
  - 218.7
  - 232.8
  - 294.4
  - 356.6
  - 433.2
  - 436.5
  - 454.0

- Private creditors: 14.1
  - 193.9
  - 310.3
  - 340.8
  - 380.2
  - 426.2
  - 470.1
  - 459.8
  - 447.9

B. Private non-guaranteed debt

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<td></td>
<td>15.6</td>
<td>70.1</td>
<td>104.3</td>
<td>101.2</td>
<td>93.2</td>
<td>84.4</td>
<td>77.2</td>
<td>63.5</td>
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#### USE OF IMF CREDIT

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<td>0.8</td>
<td>12.4</td>
<td>33.9</td>
<td>36.0</td>
<td>40.2</td>
<td>42.5</td>
<td>42.8</td>
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#### SHORT-TERM DEBT

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<td></td>
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<td>128.7</td>
<td>139.3</td>
<td>132.3</td>
<td>128.9</td>
<td>117.8</td>
<td>128.5</td>
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#### TOTAL DEBT SERVICE

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<td></td>
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<td>108.9</td>
<td>117.7</td>
<td>124.6</td>
<td>129.3</td>
<td>140.4</td>
<td>151.8</td>
<td>135.7</td>
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</table>

A. Long-term debt

B. IMF repurchases and charges

C. Short-term debt interest

### Annex Table 3-2: EXTERNAL FINANCING FOR DEVELOPING COUNTRIES, 1980-89
(In millions of US dollars)

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<tbody>
<tr>
<td>Deficit on goods, services and private transfers</td>
<td>-25.2</td>
<td>54.8</td>
<td>84.4</td>
<td>66.5</td>
<td>37.3</td>
<td>35.1</td>
<td>56.3</td>
<td>12.0</td>
<td>29.0</td>
<td>31.1</td>
</tr>
<tr>
<td><strong>Financed by:</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Non-debt-creating flows</td>
<td>11.7</td>
<td>21.4</td>
<td>26.4</td>
<td>19.2</td>
<td>21.4</td>
<td>31.8</td>
<td>27.0</td>
<td>35.5</td>
<td>28.9</td>
<td>27.3</td>
</tr>
<tr>
<td>B. Asset transactions</td>
<td>-79.3</td>
<td>-89.0</td>
<td>-48.8</td>
<td>-3.8</td>
<td>-14.7</td>
<td>-12.0</td>
<td>-16.7</td>
<td>-5.7</td>
<td>-25.4</td>
<td>-9.4</td>
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<tr>
<td>C. Net errors and omissions</td>
<td>-9.7</td>
<td>-15.0</td>
<td>-26.5</td>
<td>-17.6</td>
<td>-6.6</td>
<td>-1.3</td>
<td>2.7</td>
<td>-6.6</td>
<td>-6.4</td>
<td>1.7</td>
</tr>
<tr>
<td>D. Use of reserves</td>
<td>-49.8</td>
<td>11.7</td>
<td>35.1</td>
<td>-3.3</td>
<td>-10.3</td>
<td>-16.7</td>
<td>-3.6</td>
<td>-53.9</td>
<td>0.7</td>
<td>-20.7</td>
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<tr>
<td>E. Net external borrowing</td>
<td>102.0</td>
<td>125.7</td>
<td>98.1</td>
<td>71.9</td>
<td>47.6</td>
<td>33.3</td>
<td>46.9</td>
<td>42.7</td>
<td>31.2</td>
<td>32.2</td>
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<tr>
<td>Reserve-related liabilities</td>
<td>2.9</td>
<td>12.5</td>
<td>9.7</td>
<td>9.1</td>
<td>4.9</td>
<td>1.6</td>
<td>-2.1</td>
<td>-5.3</td>
<td>-4.0</td>
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<tr>
<td>Other net borrowing</td>
<td>99.2</td>
<td>113.3</td>
<td>88.4</td>
<td>62.8</td>
<td>42.7</td>
<td>31.7</td>
<td>48.9</td>
<td>48.0</td>
<td>35.2</td>
<td>34.5</td>
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<tr>
<td>Of which:</td>
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<tr>
<td>Official sources</td>
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<td>30.2</td>
<td>37.0</td>
<td>40.9</td>
<td>37.6</td>
<td>22.4</td>
<td>29.1</td>
<td>27.0</td>
<td>17.8</td>
<td>25.8</td>
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<td>Commercial banks (a)</td>
<td>74.6</td>
<td>83.1</td>
<td>69.4</td>
<td>38.7</td>
<td>16.8</td>
<td>-1.5</td>
<td>-0.4</td>
<td>2.7</td>
<td>-7.4</td>
<td>-3.4</td>
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(a) 1980 and 1981 figures include all non-official borrowing, calculated as a residual.
Annex Table 3-3: NET EXTERNAL BORROWING BY DEVELOPING COUNTRIES BY REGION, 1980-89
(In billions of US dollars)

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<tbody>
<tr>
<td>AFRICA</td>
<td>11.0</td>
<td>16.4</td>
<td>17.3</td>
<td>14.0</td>
<td>7.9</td>
<td>3.0</td>
<td>7.8</td>
<td>5.1</td>
<td>9.8</td>
<td>10.7</td>
</tr>
<tr>
<td>Reserve-related liabilities</td>
<td>0.3</td>
<td>2.6</td>
<td>1.4</td>
<td>2.9</td>
<td>0.7</td>
<td>0.7</td>
<td>-1.7</td>
<td>-1.6</td>
<td>0.6</td>
<td>0.8</td>
</tr>
<tr>
<td>Other external borrowing</td>
<td>10.8</td>
<td>13.8</td>
<td>15.9</td>
<td>11.1</td>
<td>7.2</td>
<td>2.2</td>
<td>9.6</td>
<td>6.8</td>
<td>9.3</td>
<td>10.0</td>
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<td>of which:</td>
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<tr>
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<td>7.9</td>
<td>4.9</td>
<td>8.5</td>
<td>7.7</td>
<td>6.6</td>
<td>6.6</td>
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<tr>
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<td>5.6</td>
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<td>1.0</td>
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<td>-1.4</td>
<td>-1.2</td>
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<td>-0.6</td>
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<td>30.2</td>
<td>33.4</td>
<td>26.3</td>
<td>25.0</td>
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<td>17.8</td>
<td>21.6</td>
<td>16.8</td>
<td>11.9</td>
<td>10.6</td>
</tr>
<tr>
<td>Reserve-related liabilities</td>
<td>2.3</td>
<td>3.6</td>
<td>2.3</td>
<td>2.4</td>
<td>0.2</td>
<td>-0.9</td>
<td>-0.8</td>
<td>-2.3</td>
<td>-2.8</td>
<td>-1.4</td>
</tr>
<tr>
<td>Other external borrowing</td>
<td>28.0</td>
<td>29.8</td>
<td>24.0</td>
<td>22.6</td>
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<td>18.7</td>
<td>22.4</td>
<td>19.2</td>
<td>14.7</td>
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<td>of which:</td>
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<tr>
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<td>4.7</td>
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<td>Commercial banks (a)</td>
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<td>16.8</td>
<td>11.7</td>
<td>6.0</td>
<td>7.5</td>
<td>2.5</td>
<td>1.6</td>
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<tr>
<td>EUROPE</td>
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<td>11.2</td>
<td>4.5</td>
<td>5.5</td>
<td>3.8</td>
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<td>4.2</td>
<td>2.6</td>
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<tr>
<td>Reserve-related liabilities</td>
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(a) 1980 and 1981 figures include all non-official borrowing, calculated as a residual.
### Annex Table 3-4: TOTAL EXTERNAL DEBT OF ISLAMIC COUNTRIES, 1980-89
(In millions of US dollars)

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<th>Burkina Faso</th>
<th>Cameroon</th>
<th>Chad *</th>
<th>Comoros *</th>
<th>Egypt</th>
<th>Gabon</th>
<th>Gambia *</th>
<th>Guinea *</th>
<th>Guinea-Bissau *</th>
<th>Indonesia</th>
<th>Jordan</th>
<th>Malaysia</th>
<th>Maldives *</th>
<th>Mali *</th>
<th>Mauritania *</th>
<th>Morocco</th>
<th>Niger</th>
<th>Nigeria</th>
<th>Oman</th>
<th>Pakistan</th>
<th>Senegal</th>
<th>Sierra Leone *</th>
<th>Somalia</th>
<th>Sudan *</th>
<th>Syria</th>
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<th>Turkey</th>
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**TOTAL IDCs** 146,902 162,121 182,433 202,751 213,634 243,896 283,453 331,858 334,055 340,670

**COMPARE:**

- Least developed countries (*) 17,569 20,630 23,460 25,437 27,332 30,816 35,339 41,903 43,878 45,772

**SOURCE:** World Bank, World Debt Tables 1990-91.
### Annex Table 3-5: TOTAL DEBT SERVICE PAYMENTS BY ISLAMIC COUNTRIES, 1980-89
(In millions of US dollars)

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* of which:
Least developed countries (*) 1,120 1,275 1,267 1,088 1,252 1,346 1,766 1,801 1,848 1,779

COMPARE:
All developing countries: 90,967 106,939 115,257 108,931 117,667 124,571 129,340 140,436 151,774 135,661
Severely indebted countries: 59,048 69,221 72,523 64,046 67,463 65,333 64,503 60,291 69,767 60,042

SOURCE: World Bank, World Debt Tables 1990-91. JC2-A15
Annex Table 3-6: RATIO OF TOTAL EXTERNAL DEBT TO EXPORTS OF GOODS AND SERVICES, 1980-89 (Percentages)

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COMPARE:

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| All developing  | 133  | 149  | 182  | 201  | 189  | 214  | 241  | 232  | 201  | 187  |
| Severely indebted | 174  | 211  | 285  | 313  | 282  | 314  | 385  | 391  | 340  | 315  |

Managing External Debt in Developing Countries

Annex Table 3-7: RATIO OF TOTAL EXTERNAL DEBT TO GROSS NATIONAL PRODUCT, 1980-89
(Percentages)

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|Severely indebted| 35.5 | 39.5 | 48.5 | 58.4 | 59.8 | 64.3 | 69.3 | 76.9 | 66.0 | 59.1 |

Annex Table 3-8: RATIO OF TOTAL DEBT SERVICE TO EXPORTS OF GOODS AND SERVICES, 1980-89
(Percentages)

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Annex Table 3-9: RATIO OF TOTAL DEBT SERVICE TO GROSS NATIONAL PRODUCT, 1980-89
(Percentages)

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**SOURCE:** World Bank, World Debt Tables 1990-91.
Annex Table 3-11: RESERVES EXPRESSED AS MONTHS OF IMPORTS, 1980-89
(End-year reserves divided by average monthly imports)

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4. The Current Debt Situation

Summary of the Discussion

Rapporteurs:

- Mr. Mohamad Reza Yousof Khan, Iran
- Mr. Saeed Ahmed, Pakistan
- Mr. Hassan J. Abozeid Al-Jehani, Saudi Arabia

The discussion of the current debt situation highlighted that, under the prevailing economic conditions, many developing countries in Latin America and Sub-Saharan Africa are facing financial and economic problems. These countries are confronted with problems of (a) large debt repayment obligations on existing debt, (b) frequent exchange rate fluctuations especially against hard currencies and thus additional requirement of local currency to pay the same amounts, (c) reduced availability of funds from private sector; and (d) worsened debt GNP and exports ratios.

The discussion focused on what to do about the debt problem. The suggested solution under "Toronto" Plan for low income countries include (a) reduction of 1/3 of the principal; (b) rescheduling of debt liability; and (c) reduction of 1/3 of the interest.

The rescheduling of debt service was not considered as a favorable proposition as it was only the postponement of the present liabilities to some future date. Most participants, however, favored either of the other two alternatives, namely reduction of 1/3 of the principal or a reduction of interest rates. However, it was pointed out that the implementation of any of these measures affects the creditworthiness of the country in case of entry into private international capital market.

The other point which was highlighted in the discussion was that, at present, the majority of the developing countries, in view of their increasing debt burden, are borrowing from official sources and financial institutions to pay back the debt servicing liabilities of the loans already obtained from different sources rather than using the borrowed amount for productive purposes.

It was suggested that developing countries may outline their borrowing policies based on the criteria of payment capacity, comparative advantages and diversification of the economy, taking into consideration of the availability of natural resources and their efficient allocation to various sub-sectors of the economy.

The Brady Initiative has been put into place to help the middle income countries that have a severe burden of commercial bank debt. As of May 1990, four countries, Mexico, Costa Rica, Philippines, and Venezuela have reached agreements with the commercial bank creditors to reduce the stock of debt or/and interest service payments. It was emphasized that the discounts under these agreements should be deep enough to allow benefits to the debtor countries. The World Bank and IMF will allow their funds to be used for the purpose of debt and debt service reduction only if the debtor country was already pursuing a strong economic reform program. Without sound economic policies and good economic management the debt reduction will not be very useful.
Part II - Finance for Development

5. Introduction

During the Seminar, much attention was focused on the debt crisis: identifying its causes and seeking remedies. In this segment, the participants looked "beyond the debt crisis". Was the type of finance available to developing countries in the 1960s, 1970s and 1980s appropriate or inappropriate to their circumstances? If not, what alternatives should be adopted in the future? Fluctuating interest rates and exchange rates in the 1970s and 1980s have added new dimensions of uncertainties to international borrowing. What can be done to reduce these risks?

I. Financial Flows

Ishrat Husain opened this segment of the seminar, describing the trends during the 1980's of financial flows to developing countries in general and to Islamic Countries in particular (Chapter 6). Mr. Husain pointed out that flows from financial institutions fell abruptly in the mid-1980's. After averaging over $20 billion per year during 1980-83 (to all developing countries), they fell to $3.4 billion in 1986. The outlook for recovery is not good. Concessional flows to low-income countries have increased in the latter part of the 1980's, but they cannot entirely offset the decline in flows from private sources.

Looking ahead, Mr. Husain said that there will be much competition for available funds. Thus, creditors will remain highly selective as to whom they will lend. However, the renewal of capital flows to developing countries is possible once underlying economic conditions become attractive.

II. Alternative Finance

In a contributed paper (Chapter 7), "Alternative Forms of External Financing for Developing Countries", Stijn Claessens examines the different forms of financing to developing countries. Following the work of Donald Lessard, he points out that the desirable characteristics of external finance, in addition to low cost, are: (a) that debt service obligations be related to a country’s capacity to repay, (b) that there be performance incentives for both the borrower and the lender - in the sense that the lender as well as the borrower have a stake in the outcome of the project being financed, (c) that there be a positive impact on domestic financial markets so as to disperse the risk of default more broadly through the economy, and (d) that international contracts be readily enforced. Claessens observes that general obligation finance has a number of shortcomings from this point of view. Foreign direct investment, on the other hand, has a number of advantages, such as the active involvement of the investor in the economy and the possibility of profit remittances to decline during economic recessions, matching debt service payments with capacity to pay.

Claessens identifies several types of financial instruments that can serve as alternatives to general obligation finance and foreign direct investment: risk capital (such as the purchase of equities in a public stock market), stand-alone finance (which links debt service payments to the performance of the project being financed) and improved general obligation finance (in the sense of incorporating better risk management). These have more desirable characteristics but have seen little use. International financial institutions can facilitate these financial instruments by providing technical advice on how to develop and use these instruments, by direct financial intermediation and by providing guarantees.

Foreign direct investment (FDI) is examined in more detail in a contributed paper by Andrea Gubitz, "Foreign Direct Investment: Recent Trends and Policy Issues". This paper (Chapter 8) draws on a study of the determinants of German direct investment in developing countries. Gubitz points out that market size and low production costs are major determinants of FDI flows. FDI flows are influenced by host countries' policies. Three important elements are: restrictions on ownership, restrictions on the repatriation of profits and capital, and approval procedures.

III. Risk Management

In another contributed paper by Bengt Rådstam, "Management of the External Debt - Approach of the Swedish National Debt Office" (Chapter 9), we learn how Sweden has dealt with risk management associated with exchange rate and interest rate fluctua-
Developing country experience in managing the currency risk inherent in general obligation finance is discussed in papers by Hadanan (Malaysia, Chapter 10) and Irgat (Turkey, Chapter 11). How Turkey gradually reestablished access to financial markets is discussed in a paper by Gülner Üçok (Chapter 12). She explains how Turkey has gradually succeeded in tapping diverse securities markets and has been able to reduce the cost of borrowing and to extend the length of maturity of new issues.

Managing External Debt in Developing Countries

6. Finance for Development: Past Trends and Future Prospects

Ishrat Husain
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The most dramatic event of the later half of the 1980s has been an unprecedented reversal of financial flows to developing countries. Real long term financial flows to developing countries are currently only 60 percent of their levels in the early 1980s. Voluntary private lending is negligible. New multilateral non-concessional lending is largely being offset by amortizations of existing loans. The current low levels of capital flows imply that developing countries must limit their investment to what can be financed with their own saving. The low levels of capital flows also mean that developing countries actually must export more goods and non-factor services than they receive, in order to service their debt.

One should not expect nor want a return of the large capital flows to developing countries on the scale of the "petrodollar" era. But that is not the danger at present, when developing countries as a whole are transferring resources to the industrialized world. If developing countries have to continue to make resource transfers to the rest of the world, limiting their investment to levels below their own saving, their long run development is likely to suffer.

The assessment of flows to the developing countries cannot be done solely at the aggregate level. Individual developing countries' receipts of capital flows and performance differ significantly. For example, the newly industrialized countries of East Asia began to run large current account surpluses in the 1980s. Korea, whose $32 billion of debt in 1981 was just below Argentina's $36 billion, has shown that it is possible to grow out of a heavy debt burden through higher domestic saving and high growth. Although the East Asian countries continue to receive commercial bank loans and foreign direct investment, the question is increasingly one of placing their net surplus. Countries such as Thailand and Malaysia continue to complement domestic saving with external finance. With low levels of distortions and rapid growth, they have had little problem in obtaining or using foreign capital. Their increasingly sophisticated financial markets may make them candidates for increased portfolio investment as well as foreign direct investment and commercial bank loans.

I. Recent Developments

Aggregate net resource flows (long-term) to developing countries, including net flows of long-term lending, foreign direct investment, and official grants, reached a projected $71.0 billion in 1990 (see Table 1). This represents a 12.2 percent increase over last year's net flows of $63.3 billion and a rise above the nominal levels of the mid-1980s. The main factor in the projected increase in 1990 was the increased net lending from official sources, mentioned above, much of which went to the Severely Indebted Middle Income Countries (SIMICs) to purchase collateral or buyback debt in Brady Initiative operations. Except for Chile and Mexico, new private lending to the SIMICs has been minimal. Total private lending, net of amortization, remains far below the levels of the mid-1980s. Official grants (29 percent), official loans net of amortization (28 percent), and foreign direct investment (35 percent) accounted for almost the whole of aggregate net resource flows in 1989, as has been the case since 1987. This composition represents a major shift from the dominance of commercial bank lending in the late 1970s and early 1980s and return to the pattern of net flows prevailing in the 1960s and early 1970s. The composition of the roughly constant amount of annual official flows during the 1980s also has shifted. Official grants and concessional lending (ODA) has grown, while nonconcessional, bilateral official lending has declined substantially, compared with the early 1980s. And the share of multilateral lending has increased relative to bilateral lending.

1 The author, at the time of the seminar, was Chief, Debt and International Finance Division, World Bank. The views expressed in this paper are the personal views of the author and do not necessarily reflect those of the World Bank.
The shift in the composition of aggregate net resource flows and private lenders' interest in supporting private projects, means that in some countries the public sector now has less access to external private funds than the private sector, a major change compared with the late 1970s and early 1980s. The shift in the composition of aggregate net resource flows also means that countries that relied on external borrowing from private sources have suffered a sharp fall in access to external resources compared with countries that can attract foreign direct investment. Thus far, foreign direct investment has been highly concentrated. For example, five major East Asian countries received nearly 25 percent of direct investment in the developing countries. In contrast, most SIMICs have been hard hit by the drop in net flows of loans. Net lending to the SIMICs declined from average of $37.3 billion in the early 1980s to an average of $4.3 billion in 1988-90. For the Severely Indebted Low Income Countries (SILICs), the net flow of resources, aside from foreign direct investment, is about $7.7 billion, a figure similar to that of recent years. Nigeria accounts for about a quarter of the total. Outside of Nigeria, foreign direct investment in Sub-Saharan Africa is minimal.

In real terms, aggregate net resource of flows have increased compared with their low point of 1987, although they remain below the levels of the early 1980s. However, the size and time pattern of the changes in real aggregate net resource flows depend significantly on whether they are deflated by the price indexes of the suppliers of net flows, the creditor countries, or the price of developing-country imports. This distinction is important because of the sharp changes in the international petroleum prices during the 1980s and the much larger weight of petroleum products in the imports of developing countries than in the economies of donors/creditors. Measured in terms of OECD prices, real net flows declined 26 percent between 1980 and 1985. Then, between 1985 and 1989, they declined a further 29 percent. However, measured in terms of import unit values, real aggregate net flows declined about 21 percent between 1980 and 1985 then remained roughly constant between 1985 and 1989, aside from 1987. In 1990, the rise in import prices, reflecting mainly the impact of the rise in oil prices after August, offset more than half of the rise in aggregate net resource flows.

In other words, during the 1980s, the drop in oil partially offset the fall in aggregate net flows to developing countries in terms of import purchasing power. Of course this offset was comfort only to the oil-importing developing countries such as Brazil, the Republic of Korea, India, the Philippines, Turkey and Yugoslavia. For the energy exporters, such as Ecuador, Egypt, Mexico and Venezuela, which account for almost 50 percent of the SIMICs' debt, and Nigeria, which accounts for about one third of the SILICs' debt, the fall in oil prices compounded the drop in net flows. In 1990, with the rebound in oil prices as a result of the Middle East crisis, the winners and losers were reversed.

Despite the gradual increase in nominal aggregate net flows since the mid-1980s, the developing countries' net import of goods and services - the financeable current account deficit - has not risen much. The developing countries' current account deficit was only $28 billion in 1989 and $40 billion in 1990 compared with an aggregate net resource flow of $6.3 billion and $71 billion respectively. Current account deficits do not fully reflect aggregate net resource flows because, to an increasing extent, these flows have been offset by the build-up of reserves, capital outflows; and, in 1990, collateral under the Brady Initiative operations. The 1989 current account deficit represented only 1.0 percent of (estimated) GNP. As a percentage of exports, the current account deficit has fallen from about 7.6 percent in 1985 to 4.6 percent in 1989.

Moreover, a substantial part of the current account deficit represents interest costs on debts and retained profits remittances on foreign investment, rather than current imports of goods and nonfactor services. Actual interest payments were $64.3 billion in 1989, and profit remittances and reinvestments are estimated at $12.5 billion, in total more than double the current account deficit. Thus, in a reversal of the pattern that prevailed up to the 1980s, developing countries now export more goods and nonfactor services to the industrial countries than they receive.

In terms of regional distribution, flows to the low income Asian countries have stagnated at about $1.5 billion p.a., barely above the levels of the early 1980s. The four major South Asian countries already have moved into the moderately indebted class and only the large share of concessional debt in the total debt stock is keeping the debt service ratio manageable. Both China and India, facing limits on the availability of concessional funds, turned to non-concessional borrowing to finance larger current account deficits and higher investment ratios and growth during the 1980s. In both
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In both countries, the short term problem will be to reduce the current account deficit to sustainable levels, while moving toward a less distortionary incentive framework. The industrial countries can make an important contribution to growth and worldwide poverty reduction by ensuring that concessional flows grow rapidly enough to support investment and growth in China and the low-income countries of South Asia and that a shift to non-concessional finance is not forced upon them too rapidly.

The countries of Sub-Saharan Africa face perhaps the most difficult development problem, coupled with a severe debt problem in many cases. Although per capita income and the numbers in absolute poverty present a better picture than South Asia, adverse external conditions and poor domestic policies have led to economic, social and environmental decline. Reversing this decline will require an acceleration in the adjustment process that has begun. Both debt and debt service relief and new money are needed. To avoid future debt service problems the new money should probably be on concessional terms, and thus from official sources, or in the form of foreign direct investment, which, just importantly, will bring with it external know-how.

Finally, as is well known, the severely indebted middle income countries represent a particular challenge for international financial markets. Once the debt crisis began, net flows to these countries dropped dramatically, reflecting the sharp dropoff in commercial bank lending and the stagnation of official flows. (Foreign direct investment has increased recently, but much of this is related to debt-equity swaps and secondary market transactions.) Higher real interest rates have increased the cost of debt service and reduced real transfers even more. Growth has fallen as a result of domestic macroeconomic instability and the debt/debt service problem. Investment rates are down sharply and price distortions encourage inefficiency in resource use.

The severely indebted middle income countries did - perforce - manage to improve their current account balance in the mid-1980s. Since then, however, their current account deficits have risen as a percentage of GDP. These deficits reflect mainly large interest payments. In terms of goods and non-factor services, these countries' exports to the rest of the world exceed their imports by the equivalent of about 2.7% of their GDP. This figure accounts for much of the developing countries' surplus on the goods and non-factor services accounts.

The international community has of course recognized the need for a new strategy to deal with debt and debt service problems in the severely indebted, middle income countries. The World Bank and the IMF are expected over the next three years to provide $20-25 billion of resources to support debt and debt service reduction operations. About half of this total represents new resources. Japan has provided its support with up to $10 billion in cofinancing.

II. Prospects

It is unlikely and undesirable that external capital flows will return to the high levels of the late 1970s and early 1980s. Even if some of the developed countries were to move to a higher current account surplus, much of the improvement probably would flow to the industrialized countries. Moreover, Eastern Europe is likely to be a much larger claimant on OECD capital exports in the 1990s than in the 1980s. Nonetheless, under a plausible, if somewhat optimistic scenario, it should be possible for the developing countries to finance a current account deficit/GDP ratio of about 1.3 percent. This would be about the same as in the 1960s and early 1970s and about 30 percent larger than today. World Bank projections suggest that the larger current account deficit would be associated with a slight rise in average growth in the developing countries, from 4.2 percent in the 1980s to about 4.5 percent per annum.

The flows of capital that do occur to developing countries are likely to resemble the composition of the 1960s and early 1970s. Commercial bank lending and the other private lending have declined and are likely to remain low for the foreseeable future. Official flows and foreign direct investment have become and are likely to remain the main source of capital flows to developing countries.

Official development assistance (ODA) rose in the mid-1980s, offsetting partially the fall in private flows. But ODA is likely to grow more slowly in the 1990s, reflecting pressures for tighter budgets and some diversion of funds to Eastern Europe. Multilateral non-concessional (net) loans are likely to rise from current low levels and become an important source of finance, one difference from the 1960s and early 1970s. This rise reflects the larger capital of the World Bank and the regional development banks and smaller net negative
transfers by the IMF. Through the World Bank and its cofinancing arrangements, at least some of the developing countries will retain a connection with private capital markets. However, the growth of lending by these institutions will have to be managed carefully, to avoid increasing risk. Also, it will be difficult for their lending to increase across the board, because of exposure limits.

Official flows typically are government to government flows. Given the growing emphasis on the private sector in development, new mechanisms will have to be developed to pass through official flows to the private sector and old mechanisms will have to be improved. Regarding private flows, foreign direct investment will grow quite rapidly and reach levels similar to the 1970s in terms of the overall balance of payments. Other private flows net are likely to be small.

What actions are necessary to achieve this scenario? A great deal will depend on the actions of the developing countries. Achieving higher growth, largely on the basis of internal resources, will require stable macroeconomic policies and reduced public sector deficits. This will stimulate private investment. The incentive framework also will have to adjust, to encourage a more efficient use of resources. The public sector will have to operate efficiently and place a minimum drain on private saving. Financial sector reforms will be necessary to mobilize domestic and foreign resources and allocate them efficiently. In other words, the process of adjustment that has been supported by the World Bank and the IMF and that has begun in some countries will have to be intensified and extended.

These same policies will encourage foreign direct investment and encourage its efficient allocation. Recent studies suggest that foreign direct investment depends heavily on the macroeconomic and political environment. If these are unstable, it is hard to offset them with specific incentives for foreign investors. Overly favorable specific incentives also are likely to draw domestic criticism and are therefore unstable.

In terms of specific incentives for foreign investors, reasonable tax and repatriation rules will be needed. In the area of natural resource investment it may be necessary to reassess and improve conditions for investors of all kinds. Programs of privatizations in the areas of natural resources and public enterprises in general need to move forward.

On the side of the developed countries a number of policies would contribute to greater resource transfer and higher growth in the developing countries:

(a) A larger surplus of saving over investment;
(b) Increased aid to adjusting countries;
(c) Progress in reducing the debt/debt service problem; and,
(d) Increased openness to trade flows.

The balance of saving over investment in the industrialized countries could be raised through tighter fiscal policy in concert with monetary policy aimed at maintaining real growth. This policy mix would involve a significant reduction in the budget deficits of the U.S. and some other industrialized countries. Japan and Germany would be able and are likely to reduce their surpluses concurrently. However, this reduction would have to be less than the increased saving in the other OECD countries, in order to increase the overall OECD surplus. Higher OECD saving also would tend to reduce the debt service burden by reducing real interest rates.

Increased development assistance will be necessary to reach a number of countries that are unlikely to attract foreign direct investment and cannot finance the costs of non-concessional multilateral loans. Increased development assistance also will be needed to help resolve the debt problems of a number of the low-income, severely-indebted countries. Such aid should be targeted to countries that adopt necessary adjustment measures.

The current debt strategy is still too new to be evaluated fully. Nonetheless, several considerations have emerged from the five operations (Mexico, Philippines, Costa Rica, Venezuela and Uruguay) and the negotiations surrounding other potential operations (Brazil, Ecuador), that need to be taken into account in future operations. They are:

(a) Available funds could reduce the debt/debt service problems of the majority of countries, particularly if attractive prices are obtained in the secondary market. The available funds would not be enough, however, to cover operations for all the major debtors, e.g. Brazil and Argentina.
More equitable burden sharing needs to be ensured between the commercial creditors, the countries and the international institutions. In particular, risks to the international institutions should not be increased unduly, to avoid hindering their basic operations. Bilateral official agencies, including export credit agencies, could be a source of additional resources, following the example of the Japanese EXIM Bank.

Ensuring participation of all creditor banks in debt reduction operations is not easy. There is a "free rider" problem that has slowed the process and which will have to be dealt with by the coordinating committees, changes in incentives, and pressures from creditor governments.

"New money" is a problem. Commercial banks that are not willing to provide new money will have to accept sufficient debt or debt service reductions to meet the country's financing requirements.

Some banks have been reluctant to participate in debt operations because of the particular tax/regulatory framework they face. Developed countries need to make an effort to reduce unneeded regulations and provide reasonable tax treatment for participants in debt reduction. At the same time, the operations need to be structured with enough options to permit individual banks to operate effectively within the particular tax/regulatory framework they face.

Mechanisms need to be developed to ensure adequate levels of external finance in the event of adverse external developments.

Most importantly, the developed countries need to ensure a favorable external environment for the developing countries. An open trading system is essential to the growth of the developing countries and to resolving the debt problem. The industrial countries have a particular responsibility to avoid protection, given their weight in international trade. In the short run the most productive policy here would be for developed countries to ensure a rapid and successful conclusion of the Uruguay Round to reduce trade restrictions.

The likelihood that private lending will remain minimal and that aid budgets will remain tight has rekindled interest in foreign direct investment. However, foreign direct investment has a number of particular features and problems that need to be understood and resolved before it can play a major role in the developing countries.

Reliance on flows of foreign direct investment would not be completely new. Foreign direct investment was an important type of external funding for developing countries in the 1960s. As late as 1970 it accounted for 50 percent of private flows to developing countries and 29 percent of total net flows. In the 1960s, some developing countries depended on foreign direct investment to finance much of their current account deficit, Brazil being an important example. While much foreign direct investment traditionally had been oriented toward natural resources in developing countries, a large part of the flows of U.S. investment in Latin America and Japanese investment in Asia in the 1960s went to manufacturing. However, some of this investment was attracted by protective barriers and questions have been raised about the benefits of foreign direct investment in a distorted incentive framework.

From the beginning of the 1970s to the mid-1980s foreign direct investment flows to developing countries stagnated. A wave of nationalizations occurred in Latin America in 1974, and net foreign direct investment actually turned negative. In many Latin American countries, internal politics took an increasingly negative view of foreign direct investment. The general feeling was that profits were too high and, sometimes, that foreign direct investors had received better treatment than domestic investors. Transfer pricing between head offices and subsidiaries was treated increasingly as an evasion of restrictions on repatriations. At the same time, low real rates of interest on commercial bank loans made them more attractive as a source of funds than foreign direct investment. In Asia, Japanese foreign direct investment, which had been growing rapidly, slowed. Both Japan and the host countries suffered from the impact of the oil price shocks on their growth.

Since the mid 1980s, world flows of foreign direct investment have grown substantially. Moreover, the data probably underestimate growth. Japan, which today is the largest single source of FDI, does not include reinvested profits of overseas operations in its...
flow figures. Also flows of small investments, particularly in real estate, which are difficult to measure, have probably increased.

Most of the recent growth in world foreign direct investment has gone to developed countries and offshore banking centers. The U.S. as a host country, for example, has received 44% of foreign direct investment flows in 1984-87, up from 35% in 1981-83. Foreign direct investment in Europe is likely to grow rapidly as a result of recent developments in Eastern Europe and the unified Common Market scheduled for 1992.

Developing countries have not participated fully in the recent foreign investment boom. Despite a sharp increase in 1988, foreign direct investment in developing countries, in real terms, is only about 25% higher than in 1970. Moreover, much of this rise in 1988 reflected debt equity swaps and other transactions associated with the secondary market.

A number of the problems that led to a slowdown of foreign direct investment in Latin America and Africa - negative political attitudes, unstable macroeconomic environments, distorted incentive structures - remain. Efforts have been directed at reducing these problems, for example by the setting-up of direct investment guarantee programs by industrialized countries and the World Bank (MIGA). Nonetheless, further efforts are needed, particularly in the host countries, if foreign direct investment is to become an important factor in resource transfer to the developing countries. This is particularly true given the current low levels of commodity prices, which depress the potential for foreign direct investments in the primary sector.

In addition to its resource transfer role, foreign direct investment has been promoted because of a number of other benefits it conveys to the host country. First, direct investment generally is agreed to transfer technology, management methods, quality control procedures, etc. to the recipient country, as well as capital. This is true not only for manufacturing, but for many of the investments in natural resources.

Second, DFI may serve as a balance of payments shock absorber, compared to external debt. Studies of U.S. foreign direct investment suggest that its returns and repatriated profits have been pro-cyclical. Compared to debt finance, with its fixed repayment schedule, foreign direct investment resembles equity.

Recent studies support the view that foreign direct investment costs more than debt, although there are a number of data problems. An IMF (1985) study of the experience of 12 countries over the period 1974-82 showed that the average rate of return paid to foreign direct investors was almost 11 percent per annum compared with an 8.5 percent per annum average interest rate on external debt. A recent study of the Chilean experience for the period 1954-1987 showed that the real rate of return repaid to the foreign investors averaged 7.8 percent per annum, versus a real LIBOR rate of 3.6 percent per annum.

The higher rate of return on foreign direct investment bears on its ability to generate net transfers to a country. For countries that open up to foreign direct investment, the initial flow of new resources will be high, as investors make stock adjustments in their portfolios. Once the adjustment is complete, however, new foreign direct investment, including reinvested profits is likely to simply keep the stock of investment growing at about the same rate as the economy. If the rates of return on foreign direct investment exceeds the economy's growth rate, then the net transfer will turn negative. (see Hanson and Neher).

Foreign direct investment thus is likely to generate net positive resource transfers only in rapidly growing countries or during an initial period of adjustment. Once adjustment is completed, foreign investment is likely to result in negative net transfers because profits are likely to exceed the desired new investment. Of course, from the balance of payments standpoint, the new investment shows up in the capital account, the repatriated profits in the current account.

This argument suggests that foreign direct investment should be looked upon mainly as a potentially important source of technology, modern business practices and, in some cases, export markets. Given the slowdown in other types of external capital flows, foreign direct investment is likely to account for a larger share of external capital flows in the 1990s than in the 1980s. Because of its technological and shock absorbing benefits, as well as the resource transfer it can provide in the short run, developing countries will wish to pursue policies that attract foreign investors. As the East Asia experience suggests, foreign direct investment can be an extremely important aid to development.
Table 6-1: NET LONG-TERM RESOURCE FLOWS TO DEVELOPING COUNTRIES, 1980-90

($ Billions)

|------|------|------|------|------|------|------|------|------|------|------|------
| Aggregate net flows | 82.8 | 99.9 | 88.4 | 68.2 | 61.9 | 56.6 | 51.2 | 46.1 | 60.9 | 63.3 | 71.0 |
| Total O.D.A. | 32.6 | 33.7 | 33.8 | 31.6 | 34.0 | 34.8 | 33.6 | 32.2 | 36.3 | 36.6 | 46.9 |
| Official grants | 12.5 | 11.4 | 10.4 | 9.9 | 11.4 | 13.2 | 14.0 | 14.9 | 18.0 | 18.6 | 19.5 |
| Official loans (etc.) | 20.1 | 22.3 | 23.4 | 21.7 | 22.6 | 18.6 | 19.6 | 17.3 | 18.3 | 18.0 | 27.4 |
| Bilateral | 12.2 | 12.9 | 11.9 | 10.6 | 10.3 | 6.4 | 6.3 | 4.9 | 6.8 | 6.1 | 10.4 |
| Multilateral | 7.8 | 9.4 | 11.5 | 11.0 | 12.4 | 12.2 | 13.3 | 12.4 | 11.5 | 11.9 | 16.9 |
| Private loans (net) | 41.1 | 53.3 | 43.6 | 28.1 | 19.6 | 14.3 | 8.1 | 0.7 | 5.5 | 4.3 | 2.3 |
| Commercial banks | 30.8 | 44.0 | 30.9 | 19.8 | 14.6 | 4.7 | 2.4 | -1.1 | 0.7 | 3.0 | |
| Bonds | 1.1 | 1.3 | 4.8 | 1.0 | 0.3 | 5.0 | 1.3 | 0.2 | 2.2 | 0.3 | |
| Other | 9.2 | 8.0 | 7.8 | 7.4 | 4.7 | 4.5 | 4.4 | 1.6 | 2.6 | 1.0 | |
| Foreign direct investment (FDI) | 9.1 | 12.9 | 11.1 | 8.5 | 8.3 | 10.5 | 9.5 | 13.2 | 19.1 | 22.4 | 21.8 |
| Net transfers | 37.0 | 45.7 | 27.4 | 10.5 | -0.9 | -7.4 | -10.0 | -16.8 | -9.5 | -1.0 | 9.3 |
| Memorandum items: | | | | | | | | | | | |
| Private grants | 2.3 | 2.0 | 2.3 | 2.3 | 2.6 | 2.9 | 3.3 | 4.0 | 4.3 | 4.2 | 4.3 |
| Net Use of IMF Credit | 3.9 | 6.9 | 6.6 | 11.1 | 4.4 | -0.2 | -2.5 | -5.8 | -5.5 | -2.3 | 2.1 |
| Real net resource flows: | | | | | | | | | | | |
| OECD deflator | 109.3 | 137.0 | 124.4 | 96.2 | 89.2 | 80.6 | 58.9 | 46.1 | 56.8 | 56.9 | 61.4 |
| Real net resource flows: import unit value index | 72.0 | 85.2 | 79.2 | 62.9 | 59.2 | 56.7 | 53.7 | 46.1 | 59.6 | 60.3 | 63.8 |
| OECD deflator | 75.7 | 72.9 | 71.1 | 70.9 | 69.4 | 70.2 | 87.0 | 100.0 | 107.1 | 111.3 | 115.7 |
| Import unit value index | 114.9 | 117.2 | 111.7 | 108.6 | 104.6 | 99.7 | 95.3 | 100.0 | 102.2 | 105.0 | 111.4 |

* Projection
* Estimate

Note and Sources: Loans: DRS; excludes short-term FDI: IMF, balance of payments figures, which include reinvested profits. Official and private grants: OECD. Aggregate net transfers equals aggregate net resource flows less interest payments (DRS basis) and reinvested and remitted profits (IMF). Figures for FDI are substantially higher than shown in last year's tables, which were based on OECD estimates of FDI from member countries only (and included reinvested profits). Profit remittances and reinvestment are included in net transfers for the first time. OECD deflator: OECD, Development Cooperation in the 1990s, Paris, 1989. Import unit value index from IMF, International Financial Statistics Yearbook 1992 and World Economic Outlook, Washington, D.C. Oct. 1990.
## Table 6-2: THE DEVELOPING COUNTRIES’ CURRENT ACCOUNT DEFICIT AND ITS FINANCING 1989 AND 1995 (PROJECTED) ($ Billions Current Prices)

<table>
<thead>
<tr>
<th></th>
<th>1989</th>
<th>1995</th>
<th>Percentage increase</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Account</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Exports (Goods &amp; NFS)</td>
<td>-4</td>
<td>21</td>
<td></td>
</tr>
<tr>
<td>Interest on Long-Term Debt</td>
<td>71</td>
<td>70</td>
<td></td>
</tr>
<tr>
<td>Deficit on Current Account *</td>
<td>28</td>
<td>64</td>
<td>128</td>
</tr>
<tr>
<td><strong>Financing (Net)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Official Grants</td>
<td>18.6</td>
<td>24.9</td>
<td>33</td>
</tr>
<tr>
<td>Official Loans</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bilateral</td>
<td>6.1</td>
<td>9.7</td>
<td>60</td>
</tr>
<tr>
<td>Multilateral</td>
<td>11.9</td>
<td>21.0</td>
<td>76</td>
</tr>
<tr>
<td>Foreign Direct Investment</td>
<td>22.4</td>
<td>31.8</td>
<td>42</td>
</tr>
<tr>
<td>Other Private Long-term</td>
<td>4.3</td>
<td>9.9</td>
<td>130</td>
</tr>
<tr>
<td><strong>Ratios</strong></td>
<td></td>
<td></td>
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<tr>
<td>Current Account Deficit/GDP</td>
<td>1.0</td>
<td>1.5</td>
<td></td>
</tr>
<tr>
<td>Surplus Goods &amp; Non Factor Services/GDP</td>
<td>0.8</td>
<td>0.5</td>
<td></td>
</tr>
</tbody>
</table>

* Excludes official transfers but includes private transfers and interest on short-term debt and direct investment income.

Source: World Bank (IECDI) projections
1. This distinction is analogous to the problem of measuring the real value of saving - should the deflator be the cost of the consumption goods foregone or the cost of investment goods that are purchased with the saving.

2. As used here, the current account excludes official transfers. The developing countries’ current account deficit was US$34 billion in 1989 excluding Korea, which ran large current account surpluses between 1986 and 1989.

3. Collateral was also purchased by Mexico in 1988, as part of a debt conversion operation.

4. The numerous recent reschedulings raise the question of just how fixed are interest and principal payments on loans. However, cost of rescheduling is certainly more than the contractual debt service on loans, perhaps even more than the cost of foreign direct investment in the sense that interest is capitalized and increases the amount of the debt. It is possible to make debt service on loans more pro-cyclical through the use of bonds linked to commodity prices, as has been done recently by Algeria and earlier Mexico, or even macroeconomic indicators.
7. Alternative Forms of External Financing for Developing Countries

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The purpose of this paper is to discuss the forms that the external finance of developing countries might take in future years in the light of recent experience. The paper begins by defining the characteristics good international finance and notes the shortcomings of the current patterns of international finance against these criteria. The paper then identifies alternative financial instruments for developing countries, discusses their benefits and drawbacks, and presents examples of their uses. In the final section, the paper outlines the role that international financial institutions (IFIs) can play in making some of these alternative instruments more accessible to developing countries and thereby increasing financial flows to indebted countries.

I. Background

Recent changes in developing countries and in international financial markets highlight the importance for many borrowers of not only an adequate volume of external finance but also of an appropriate structure of external finance:

Deregulation and liberalization efforts in the developing countries aimed at developing a more responsive economy increase the importance for developing countries of external financial arrangements which, in addition to providing external resources, are also complementary to domestic developments. An example of external finance that is not necessarily complementary to domestic developments is public and publicly-guaranteed general obligation finance. General obligation finance relies less than, for instance, portfolio equity investments on domestic financial markets for the selection and management of investments and projects. It allows the developing countries' governments to bypass domestic financial markets, since it does not rely on the allocational mechanism of domestic financial markets. Furthermore, policy measures necessary to stimulate domestic capital formation can be neglected.

The volatility in commodity prices, exchange rates and interest rates have increased over the last decade. This has made many developing countries aware of the risks resulting from external transactions and associated with external liabilities, and focussed them on the need for improved liability management. The structure of many developing countries' external liabilities often gave rise to external debt service obligations that were not keyed to the resulting fluctuations in their capacity to pay. Many developing countries were consequently adversely affected when their debt service and net income flows were perversely related, something which happened, especially in the early 1980s when commodity prices declined and interest rates (nominal as well as real) increased.

At the same time, new financial instruments have emerged in the developed countries' financial markets that allow agents to manage some of the external risks to which they are exposed. The use of short-term hedging instruments, like currency futures and interest futures, and long-term hedging instruments, like currency swaps and interest rate swaps, has been growing at an explosive pace.

1 The author is an economist with the Debt and International Finance Division, International Economics Department, World Bank. The views expressed in this paper are those of the author and do not necessarily represent official policy of the World Bank.
Furthermore, the effects of the debt crisis have led to constraints on developing countries’ access to external finance in general and have hurt a group of developing countries which would probably have had continued access otherwise to external finance in general. The needs for external finance have become much more diverse across countries.

These trends are reflected in the level and structure of resource flows to all developing countries in recent years. The amount of private finance in the form of bank lending has declined significantly since the start of the debt crisis, while official finance has remained constant. Most notably is the increase in the relative importance of foreign direct investment as a source of financing for developing countries. These trends are even more pronounced when regional or analytical sub groupings are made. [Resource flows during the 1980’s are summarized in Chapters 3 and 6 - ed.] In general, the more successful countries have diversified their external financing structure in the last decade to a much larger extent than other countries were able to. Good examples are Turkey, Malaysia, South Korea and Indonesia.

There is a clear need for many developing countries to improve and adjust the structure of their external obligations, and a number are trying to do this. Countries can either restructure existing liabilities or, over time, use new types of external finance or both. However, many developing countries have not been able to improve their liability structure significantly, since external finance and risk management instruments have limited accessibility due to institutional barriers and by perceptions of private markets regarding their creditworthiness. International financial institutions may be able to play a useful role in facilitating access to new financial (risk management) instruments and assuring adequate external finance for different groups of developing countries.

The outline of this paper is as follows. Section II analyzes the attributes which international finance needs to have an efficient international distribution of risk. These are: an appropriate distribution over time of debt service obligations; an appropriate incentive structure for borrowers and lenders; a structure which is complementary to domestic financial markets; and an adequate enforceability of contracts. Section III discusses some of the shortcomings of existing patterns of international finance, in light of the identified desirable attributes of international finance, with a focus on general obligation finance and foreign direct investment. Section IV discusses other forms of international finance that have a better structure of and which conceivably can also lead to increased financial flows to developing countries. Section V discusses the role of international financial institutions (IFIs). The ability of developing countries to better structure their external liabilities using private markets alone might be limited. In addition, many of the alternative forms of international finance are relatively new and might need to be introduced or promoted by third parties in order to become acceptable means of transferring resources to developing countries. It is therefore a possible, and worthwhile, role for the IFIs, in addition to extending finance, to facilitate such alternative instruments for developing countries.

The paper distinguishes two broad groups of developing countries: those mostly in need of financial risk management tools and those affected by their large external indebtedness. Clearly, there are a variety of forms facilitating alternative financial instruments can take and they will need to be tailored to the situations of the country.

II. Characteristics of Good International Finance

International finance can benefit a country in three ways: by enabling it to increase its income over time; by stabilizing its income over time and by stabilizing it across circumstances (see Lessard (1985) on which this section draws). International finance allows the country to undertake investments whose prospective returns are above the cost of finance and which it would have had to forego if it depended on its own savings or foreign-exchange generation. Foreign finance can thus increase the level of production and hence increase or stabilize income over time. It also allows the country to increase or postpone its absorption of resources in circumstances where additional consumption or investment has a particular high or low value compared to the future, either because of expected trends in income or because of internal or external shocks.

Many forms of external finance can serve these functions for a developing country. Some, however, are not suited for all countries. Therefore foreign capital flows need to be evaluated not only by their amounts but also by their structures. No universal rules exist regarding the appropriate structure of capital
Situations regarding internal and external factors differ from country to country making generalizations difficult. Nevertheless, a number of characteristics of foreign capital inflows have been identified which can help a country achieve its goals of increasing and stabilizing its income. (See Lessard and Williamson (1985), Lessard (1985) and the World Bank report on Korea (1988).)

In addition to low cost, the following are generally mentioned to be desirable characteristics of foreign capital inflows:

(a) a positive correlation of payments obligations with the ability to pay;
(b) performance incentives for the borrower and the lender;
(c) a positive impact on domestic financial markets;
(d) contract enforceability by creditors and investors.

Each of the above characteristics has in some sense an expected cost. The expected cost does not only include the direct costs paid on the foreign capital but as well potential indirect costs. Costs should be interpreted broadly to include not only amount to be repaid in relation to amount borrowed, but also its timing and coincidence with other circumstances affecting a country’s overall income. The expected costs of different forms of capital will differ depending on the extra payments demanded by investors or lenders for each of the characteristics included. Let us examine these characteristics in more detail.

A. Correlation Between Debt Service and Ability to Pay

In very general terms, external finance giving rise to obligations that are keyed to a country’s capacity to pay, other things being equal, contributes more to a country’s objectives. Hence a country should be willing to pay a somewhat higher expected cost for such financing. The experience of the 1980s shows that low expected costs can be disadvantageous at times. The shift toward heavy reliance on bank credit and less on equity and other forms of foreign capital in the 1970s resulted in a pattern of debt service which at times has been unrelated (or even perversely related) to the country’s ability to pay. Floating rate debt has been painful for a number of developing countries: the record high (nominal as well as real) interest rates in the early 1980s greatly increased the real burden of debt service obligations. Other forms of financing, even though more costly in financial terms on average, could have resulted in higher levels of welfare.

The objective of a high correlation between debt service and ability to pay points towards certain of the following specific desirable elements of foreign capital flows:

(a) a proper dispersal of repayments over time;
(b) a properly diversified currency composition;
(c) a sharing of risks between borrowers and lenders; and
(d) a diversity of funding sources to promote stability of supply.

A portfolio of general obligation liabilities, i.e. bank credit, floating rate notes, bonds, multilateral and bilateral obligations, etc., could be structured to possess some of these elements. However, general obligation finance (especially floating rate), provides little ex-ante sharing of external risks between borrowers and lenders. As many developing countries are more exposed to external factors than the developed world as a whole, countries should be able to contract to transfer some risks through financial arrangements to the developed world. The comparative advantage of lenders in carrying risks will be reflected in the fact that the premium demanded by world investors for carrying risks will be substantially lower than the premium countries are willing to pay to avoid these risks. The shifting of risk to parties which have a comparative advantage in bearing them leads to mutual gains not only in cases of risks arising from world macroeconomic variables, like world interest rates and world commodity prices, but also in the cases of risks arising from the success or failure of a specific enterprise or project.

Since an important objective for developing countries is to maintain a steady flow of finance, within bounds determined by creditworthiness considerations, one will also have to evaluate financial instruments and sources on their degree of continuity. This objective
relates to the general supply of funds as well as to the availability of those funds specifically in demand by the borrower in question. Avoiding an overconcentration of inflows from particular capital markets, investors or types of instruments is advisable. An optimal mix of various types of financing would probably involve, besides lending from financial institutions, a significant amount of lending from securities markets and direct forms of capital flows. This is also the pattern that many successful countries show in their external financing; a highly diversified mix of instruments, markets and investor bases.\(^3\)

**B. Performance Incentives**

A significant fraction of lending to developing countries has taken place through government financing and through financing that has been guaranteed ex-post by the debtor country’s government. Examples are most of the Latin American and African countries. Furthermore, international financing has been, to a large extent, general obligation finance. As a result of both factors, debt-service obligations have often not been directly linked to the outcomes of specific projects and undertakings, and foreign lenders or investors did not obtain a stake in the project. A more explicit linkage between capital providers and the performance of the venture financed may improve the performance incentives of both the providers as well as the recipients of finance. It may also reduce risk for both, when lenders and investors have some control over variables crucial to a project’s success and debtor’s debt service is linked to the outcome of a project. For example, if all or part of the yield on an obligation is tied to the performance of the project financed, the investor has on one hand a greater interest in seeing that the design is appropriate and its management is satisfactory. If the project is not robust financially or economically, investors are unlikely to provide finance if their yield is tied to the performance of the project to be financed. On the other hand, the debtor will have a greater interest in the outcome of a project since its debt service declines relatively as the success of the project increases.

The exact incentive effects of a financial contract depend on its specificity in terms of risk sharing. Equity financing is specific to a particular firm and gives investors incentives to promote that firms’ success. Production-share contracts may link an investor’s return to a narrower measure of project success and may thus result in focusing investors’ incentives on those dimensions. However, in some cases the project’s success or failure is largely dependent on the government policy choices. Financial participants might thus be confronted with a moral hazard problem: the risk of a self-serving government might reduce the credibility of the contract. In such a case, it can be beneficial to separate these risks in contracting through quasi-equity instruments, such as non-recourse financing, in which the return to the lender is tied solely to the project performance, and the risks of a self-serving government is dealt with separately.

**C. Impact on Domestic Financial Markets**

International finance will probably be available on the best terms and employed most usefully when it is accompanied by healthy domestic capital formation. The relatively poor record of domestic capital formation in many developing countries reflects unattractive climates for domestic savings and distortions in foreign-exchange markets that create, on one hand, arbitrage opportunities that outweigh potential domestic returns and, on the other hand, do not allocate domestic savings efficiently. International finance in the form of general obligation finance bypasses to a large extent the domestic financial markets. Some alternative forms of international finance, such as country funds of equities, depend more on domestic markets and, if designed appropriately, can therefore contribute to a further development of domestic financial markets. Flourishing domestic financial markets can contribute to a dispersal of default risks inside the economy itself and avoid the concentration of risks in the government that occurred in the 1970s and 1980s through the tying together of default risks via public guarantees and cross-default clauses.\(^4\)

**D. Contract Enforceability**

In general, financial contracts between foreign creditors investors and sovereign debtors have to strike a balance between incentive compatibility characteristics and risk-sharing characteristics. While a contract which requires the payment of a share of foreign-exchange earnings (with high risk sharing characteristics) would be ideal in matching repayments with capacity to pay, such a contract would confront serious moral hazard problems, since the country’s foreign-exchange earnings...
depend to a large extent on its own actions. In domestic finance, such contracts may still be enforced through legal mechanisms. In general, contracts across borders are harder to enforce than those between two parties within one jurisdiction. A sovereign can reject claims against itself within its own territory and a sovereign has considerable discretion over policy choices that influence its own or its citizens' ability to fulfill the contracts. In addition, lenders have limited scope for imposing legal sanctions, and moral hazard problems are much larger. However, it should be realized that it can be in the interest of debtors to enter contracts which are more enforceable ex-post as these type of contracts will increase the amounts and forms of external financing it can obtain.

Contracts across borders will thus have little economic value unless debtors perceive that it is in their long-term interest to honor their previously incurred obligations. Of course, creditors can impose sanctions if sovereign debtors do not honor their contracts. The likelihood that countries will meet their obligations will, therefore, depend on the likelihood that creditors will use particular sanctions and on the costs to the country of these sanctions.

The principal sanctions of creditors are withholding of future finance and the blocking of commercial trade transactions. Thus the costs of nonperformance for a country will depend on the importance of its access to finance, e.g., does it expect to receive positive transfers from abroad, and the importance of future trade with the countries that will honor the lenders' claims. Bank lending could differ from equity investments in this respect as potential lenders will be under moral and financial pressure from other banks not to lend in cases of default which could reduce the country's general access to finance and trade, while in the case of equity investments such a concerted response is less likely.

Limits to contract enforceability can be overcome, albeit at the cost of economic inefficiencies. Multinational companies, for example, can locate production facilities in different countries in such a way that each facility depends crucially on inputs from abroad. The debtor country's vulnerability to trade interruptions enhance the enforceability of its financial arrangement with multinational companies. The specificity of the contract, in combination with the specificities of the country or the project (or both) can be a significant factor in its enforceability. General obligations lack this specificity since they gain their credibility largely from the collective response of a cutoff of all general obligation funds. Specific contracts depend largely on the ability to impose sanctions in the form of seizure of foreign-exchange proceeds or denial of further access to critical inputs or information for a specific investment.

International financial contracts are thus exposed not only to the risks arising from factors affecting a country's ability to pay but also to its willingness to pay. Especially, financial contracts denominated in local currency are exposed to policy measures the country may adopt in managing its economy and to policy measures of other countries. There is, in many cases, no clear dividing line between commercial and non-commercial risks arising from the host country governments actions, which further complicates the enforceability of international claims.

The viability of the current system depends partly on the ability of the commercial banks to withdraw their (short-term trade) financing and the leverage of the IFIs vis-a-vis the developing countries. The leverage of the IFIs is partly derived from the fact that they are a continuing source of finance which serves as a signal to other financial institutions whether or not to lend to a particular country. The beneficial role of the multilaterals and of MIGA will be further discussed in section V.

III. Shortcomings of Existing Patterns of International Finance

Two forms of international finance have dominated the nonconcessional financing to less developed countries over the past decade: general obligation finance and direct foreign investment, with the latter one a distant second in terms of the magnitude of resources transferred. The following sections will provide an appraisal of both types of instruments in the light of the remarks made above regarding good international finance.

A. General Obligation Finance

General obligation finance - largely in the form of long term, floating rate bank loans, but also in the form of (long-term) buyers and suppliers credits - came to dominate the finance to developing countries in the 1970s (see World Bank (1985)). While borrowing from banks and suppliers and buyers has some clear advantages over other forms of finance, it also has some
clear drawbacks. Its primary advantages are its apparent low cost, the easy control over the level of financing, and the flexibility it has offered (ex-post) in restructurings and reschedulings. Its clear disadvantages are its lack of ex-ante risk shifting (e.g., interest risks, project risks, price risks) from borrowers to lenders in line with comparative advantages; the absent or perverse relationship at times between the debt service obligations and the ability of the developing country to pay; the failure to allocate part of the responsibility for the selection and management of investments to the lenders; the tendency to concentrate the risk of default in major commercial banks that represent a small part of the world financial markets and, as a result, the increase in the probability of a disruption of the international financial system; and the tendency to concentrate risk with the government of the country.

The two characteristics that have played a key role in the debt crisis of the 1980s are the nonspecific nature of bank lending and its concentration in a few lending institutions. The nonspecificity is related to the fact that a large part of bank lending is directly to the government or publicly-guaranteed (often ex-ante and in several countries after 1982 ex-post with the assumption of private claims by the government). As a result, governments have been able to have complete control over the borrowings at the expense of removing the lenders or investors from the selection and management of the projects. The concentration in a few lending institutions has, especially in the early stages of the debt crisis, meant a heightened risk to soundness of the international financial system. It has, on the other hand, been a positive factor as it allowed ex-post significant flexibility in restructuring. Even though not designed as such, bank lending has provided a reasonable effective mechanism to deal with external shocks for most developing countries. However, it has, especially in the early stages of the debt crisis, meant a heightened risks to soundness of the international financial system.

B. Foreign Direct Investment

Foreign Direct Investment (FDI) has traditionally been one of the more important mechanisms for providing risk capital to the developing countries. In the years 1980-1982 FDI represented about US$4.2 billion or 10% of the capital inflows to the severely indebted middle income countries (SMICs). In the later 1980s, the absolute amount of FDI decreased considerably. It amounted for instance in 1989 to about US$8.1 billion, or 62% of total capital inflows, for the SMICs.

The motivation for FDI is most often the return the investor expects from establishing a local facility and linking it with its existing network of production or marketing operations. Cost advantages of locating domestically or economics of scale in technology or marketing increase the attractiveness of FDI. The level and composition of FDI flows are in general more related to the production or export possibilities (or both) than to the major economic needs of the country. Exceptions are cases where investors seek returns from a highly protected domestic market. There is a tendency for profits, and for profit remittances (dividends) to decline in time of economic recessions. This shifts part of domestic (macroeconomic) risks to foreign investors and can thus benefit the country, since it can lead to a reasonable match between foreign factor service payments and capacity to pay, and benefit the foreign investor, since it lowers sovereign risk.

The direct stake of the investor in the economy has the advantage of a more active involvement with the local venture and can lead to more adequate forms of human resources investments. It can provide the country with an important source of knowledge, technology and access to international markets. At the same time, it can constitute, in the eyes of the host country, an undesired control over its economy and could even be viewed as a hampering of the domestic development process. There is, further, the possibility of an inherent conflict between the foreign investor seeking to maximize the foreign exchange value remitted and the desire of the host country to maximize the local value added. The exact magnitude of this conflict, and the credibility of FDI as a foreign contract as a result, will depend on, among others, the reliance of the local firm on foreign (parent supplied) materials and foreign knowledge, as well as on the sanctions that can, directly or indirectly, be imposed on the country.

It is clear that the debt crisis has led to a significant reduction in FDI in the developing countries with debt services difficulties. The drop in FDI is partly due to the prospects and uncertainties of the domestic economies in terms of economic growth, consumption growth, tax policies, etc., which are related to their debt servicing problems and which have depressed investment in general. In addition, the large external indebtedness of these countries have depressed the exchange rates at which profits can be converted.
thereby reducing the foreign exchange equivalent for parent companies, and casting some further doubts with investors regarding the ability to remit (sufficient) profits to the parent company. The debt crisis has thus reduced the attractiveness of FDI on one hand. On the other hand, many developing countries have over the past decade opened up their economies to foreign direct investment through liberalizing exchange controls, deregulating domestic industries, making the foreign direct investment application process transparent and less restrictive, and removing other structural barriers. The increase in FDI in countries which have moved ahead aggressively in this field, (for example, Mexico, Turkey, Philippines and Indonesia) indicates that for many developing countries the scope for increases is large.

IV. Types of Alternative Financial Instruments: Benefits and Drawbacks

There are a number of financial instruments alternative to general obligations finance and FDI that could augment the flow and improve the structure of the external borrowing of developing countries. They may be evaluated on the extent to which they constitute good international finance. We may group alternative instruments as follows: risk capital; stand-alone finance; and other forms of external finance (this classification is also used by Lessard and Williamson (1985) on which this section draws). Against the background of alternative financial instruments, we may see how general obligations finance can be better structured. Risk capital and stand-alone finance are examined below.

A. Risk Capital

In addition to foreign direct investment, the two primary mechanisms that explicitly involve a transfer of risk from borrower to lender are portfolio investment in local equities and what may be termed quasi-equity investments, where the lender is entitled to an income stream that depends in a well-defined way on the success of a project but with a narrow claim to participate in ownership or control of the project.

a. Portfolio Investment in Equities.

A major potential source of risk capital is portfolio investment in stocks (equities) quoted on public stock markets. The investor seeks a share of the profits of private enterprises but does not seek, in contrast to direct investment, the responsibility of control. Holdings are in general restricted to a small percentage of total equity to avoid entanglement with the management of the firm.

Portfolio investment among developed and developing countries has seen an increase in recent years, as a result of several factors. Firstly, the sums of money available to investment pension funds, insurance companies, and other institutional investors have grown rapidly over the last decade and in many cases faster that the domestic capital markets' capitalization. Secondly, cross-border information on foreign firms has improved very significantly. Thirdly, theories of risk diversification have become more widely accepted; it is now well understood that the overall risk of a portfolio can be reduced, and its return increased, by holding an internationally widely diversified portfolio, even if some of the securities in itself are individually quite risky.

The bulk of portfolio investment in developing countries has taken place through the medium of so called investment funds. Most of these so called country funds are closed-end funds where the portfolio is actively managed and shares of the fund are simultaneously traded on one of the major world securities markets. Investors can trade the shares of the funds among each other without necessitating the country to supply foreign exchange. Several country funds have been established over the last few years, many of them with the support of the IFC. Examples are the Korea Fund, the Malaysian Fund, the Philippines Fund, the Thai fund, the Mexico fund and the Brazil fund. The total market value of the funds introduced over the last couple years at the time of launching was roughly $5 billion.

Foreign equity investments could be an additional future source of capital inflows for developing countries. Suppose that foreign investors were to acquire a proportion of 5% of the value of developing country equities, which would be of the same order of
magnitude as the investments by OECD investors in OECD countries other than their own. This would imply a holding of around $20 billion in 18 developing countries. As market capitalization in developing countries has risen quite rapidly over the last decades, it seems far from unreasonable to expect a future increase in these holdings over the coming years. Foreign purchases of just 5% of the increases could then represent a reasonably large additional capital inflow for the developing countries. Furthermore, the flows would also tend to raise stock prices and thus feed on itself.

It is very conceivable that portfolio investment in developing countries will increase. First, returns in developing countries' equity markets tend to be high. Returns measured in terms of dollar were on average 32.9 percent a year from 1984 to 1989 for emerging securities markets (the 9 countries in IFC's emerging market index), as against the world average of 20.3 percent. Secondly, the returns tend to be lowly correlated with the returns in the major developed equity markets, thus making developing markets an attractive medium for portfolio diversification. Thirdly, information on these markets is rapidly improving, largely due to efforts by the IFC. Fourthly, obstacles for flows, such as inferior accounting, auditing and disclosure standards, are rapidly being reduced in several developing countries, including those in highest need of foreign finance.

There are some problems that must be overcome. One is the allocation of funds in developing countries' capital markets since some of these markets lack the necessary liquidity to absorb a large inflow of new capital. Another difficulty is that some governments restrict foreign equity investments on the grounds that local firms could come under foreign control. Such attitudes exist elsewhere, but they tend to be stronger in developing countries. In addition to these negative factors, equity investment is often regarded as an expensive form of international finance as the return on equity is generally higher than the expected cost of bank loans. However, given the transfer of risk to foreign investors, it might well be worth paying a higher rate of return. The internal impact on the domestic capital markets and the diversification of funding sources can also easily justify the higher costs of equity finance. Examples of successful equity funds are the funds of South East Asian countries.

Other forms of equity investments could include venture capital funds and real estate funds. Such forms of transfer of capital would also have secondary effects that would make them a useful additional source of external funds.

b. Quasi-Equity Investments

Two of the financial instruments mentioned so far, foreign direct investments and equity investments, alleviate some of the weaknesses of general obligation finance by increasing the tie of the investor to the outcome of the project for which the funds were borrowed. However, these are not the only alternatives that have been used. Other forms of international investment which are relatively new involve joint ventures, licensing agreements, management contracts, turnkey contracts, build-to-operate (and transfer) contracts, production sharing arrangements and international subcontracting. These forms of international financing contracts allow the host country to single out the particular features to be controlled by foreign enterprises that cannot be economically obtained elsewhere, and to contract these out, without allowing (full) foreign control of the project or organization. These instruments may be called "quasi-equities". They can be divided into three forms: production sharing, revenue sharing and profit sharing.

Production Sharing. A production sharing agreement entitles the lender to a specific proportion of the output of a project in return for bringing in foreign capital, technology, marketing or management skills. It has predominantly been used in developing countries for the development of mineral resources. Production sharing in cases of limited domestic resources seems a natural intermediate solution between nationalization associated with foreign borrowings by the government on one hand and full foreign direct investments with complete foreign control on the other hand.

Revenue Sharing. Under a revenue sharing agreement the investor is entitled to a fraction of the general revenues generated by the project. This type of contract could present a moral hazard problem, to the extent that revenues can be influenced by the government's domestic policies once the project is on stream. Adequate pricing formulas, combined with caps and floors on the amount to be shared, and surveillance by an international agency to ensure that the contract is respected, might avoid such moral problems.

Profit Sharing. A profit sharing arrangement gives the foreign investor a stake in the net outcome of the project, but not a share in ownership as in an equity
7. Alternative forms of External Financing for Developing Countries

claim. It provides investors with the right incentives in terms of maximizing profits, but it exposes the investor to possible distortions in the pricing of inputs and outputs. Compared to an equity claim, a profit sharing arrangement has three advantages. First, it exposes the investor to a narrower risk spectrum with which they might be more familiar. Second, it requires a less sophisticated capital market in the host country, which would otherwise be needed to price the equity claim. Third, it does not pose to the host country the risk of foreign control and might therefore be more acceptable. However, profit sharing arrangements do have some disadvantages since they require a carefully designed, mutually agreeable set of contracts terms. The legal precedent for the contracts might often not exist and existing institutional and regulatory circumstances in host and investor countries might prove to be barriers.

The potential magnitude of quasi-equity flows is quite large as demonstrated by the experience of Indonesia in its oil and gas development. Almost all of it has been financed with production shares that provide foreign investors with a fraction of output. In general, oil and gas related investments in developing countries have largely been characterized by quasi-equity types of financing. The IFC has been involved in a number of quasi-equity private sector investments in different countries and acts as a further catalyzer for these schemes.

B. Stand-Alone Finance

Stand-alone finance (non-recourse finance) links the repayment on borrowings to the outcome of particular enterprises or projects without a government guarantee. Lenders are exposed to the down-side risk of the undertaking financed, but do not share in the upside potential as the maximum payment is limited to the promised, contractual interest rate. The country (transfer) risk is often reduced through the escrowing of export proceeds. Stand-alone financing has typically been employed for large extractive projects. They require a clear understanding and commitment between both parties to the contract of provisions and to the lack of guarantee on the part of the government. Stand-alone finance can involve (implicitly) granting a seniority status to a certain class of creditors through the pledging of assets or revenues, which could affect the overall borrower’s status in financial markets and would often require waivers from existing creditors on certain clauses. At the same time, some guarantees by the government, or say in the project or firm for the investor, might be necessary to insure that the stand-alone financing does not become junior to new claims.

C. General Obligation Finance

There will always be an important role for general obligation finance, important as risk capital and stand-alone finance may become. Even though general obligation finance cannot, by definition, shift the risks of particular projects or enterprises to foreign investors, it can, nevertheless, be structured to reduce certain risks that affect the economy as a whole. In particular, the risks inherent in general obligation finance can be reduced by using international financial markets to improve the match between the borrowing country’s contractual debt service and its ability to pay. Alternative instruments can improve and sustain bank finance; capital markets can help in providing finance.

a. Improved Risk Management

Volatile exchange rates and interest rates during the 1980s has affected adversely many developing countries and has highlighted the need for improved management of liability structures. Fortunately, also during the 1980s, financial markets developed novel techniques that allow borrowers in developed countries to hedge some of the external risks to which they are exposed, currency, commodity and interest risks, in particular. As yet, developing countries have not been able to use many of these hedging techniques due to institutional barriers, lack of familiarity, and market considerations regarding their creditworthiness. Support of the international institutions, in the form of credit enhancement and technical assistance, could play a vital role in allowing developing countries more access to these instruments.

The objective of risk management should be to match more closely the terms of loans with the needs of the borrowing country. The objective of a country in risk management will have to be the minimization of both the level and the variability of its cost of funds relative to its ability to pay. But, a reduction in the variability in the costs of funds relative to its ability to pay can sometimes only be achieved at the expenses of a higher cost of funds relative to its ability to pay, and vice versa. The country will, therefore, sometimes have to choose risk and cost combination for its liabilities that match its other economic objectives. Further,
risk management depends on the country's ability to pay, which is influenced by the behavior at basic macroeconomic variables.

Developing countries can potentially use both short-term and long term risk management instruments. Several types of short term instruments are traded on organized financial markets: commodity futures and options; currency futures, forwards, and options; and interest rate futures and options. Most of these instruments are also traded in over-the-counter markets between financial institutions. In addition, many financial institutions in developed countries offer their clients their own hedging products which are either standardized or specifically tailored to the needs of their clients. On the long date side of risk management tools, interest rate and currency swaps are the most liquid instruments intermediated by banks. (See Masuoka (1990)).

Commodity futures and options can be used either to lock in the price of a commodity or to insure a minimum (or maximum) price for a commodity. They can be used effectively to cap/or floor a future commodity price, and subsequently lead to a form of risk-sharing. Similarly, currency futures, forwards and options can be used to ensure that a known stream of export earnings or debt service denominated in one currency is converted into another currency at a known or minimum (or maximum) exchange rate. Interest rate futures have been actively used to fix, beforehand, the floating interest rate at a future point in time, while interest rate options have been used to set bounds for the interest effectively paid at a point in the future. Chile has used these instruments extensively to fix the costs on its floating-rate commercial bank debt. However, futures and options markets have short maturities (the longest maturities are 24 to 36 months and are illiquidi traded) and require considerable margins or premiums to be paid by the buyers.

The interest and currency swap markets offer the greatest potential for risk management for developing countries since they offer the longest maturities. In essence, two parties agree in an interest swap to service each other obligations, one of them being a fixed-interest rate obligation, the other a floating-interest rate obligation. As a result, both parties end up with their preferred interest rate exposure. Similarly, in a currency swap parties agree to service each other obligations which are denominated in different currencies. Most of these instruments (short-term as well as long-term) involve the risk of default of a partner, since a default leaves the intermediating bank with an open financial position or, in case of a swap, obliges the other party to service the original obligation standing in its own name. Clearing houses for certain futures and options contracts avoid to some extent the default problem by way of (daily-adjusted) margins. Recently, market-to-market swaps have been used as a hedging tool which overcomes some of the creditworthiness considerations involved with swaps.

So far most developing countries have made little use of these instruments to hedge their exposures related to commodity price, exchange rate and interest rate uncertainty. There is a general unfamiliarity on the part of the developing countries regarding these types of instruments and their exact properties in terms of risk management. Secondly, there does not exist a general agreed upon framework with which to evaluate the usefulness and appropriateness of these instruments. In particular, there is no clear concept of the ability of a country to pay, which is crucial for the objective of risk management. Thirdly, banks have been reluctant to enter into arrangements with developing countries as they resist taking on a counterparty whose creditworthiness is at issue.

More recently, several developing countries have expanded their use of risk management tools and have actively used financial techniques for liability management and capital markets access. Approximately 25% of their external financing from private sources for this group of developing countries was obtained with the use of sophisticated risk management tools.

b. Continued Access to Funds

An important characteristic of good international finance is a steady flow of finance. Traditionally, instruments such as commercial bank lines of credit have served this purpose and will continue to be an important factor. In addition, a series of instruments have been introduced in recent years in the international financial markets which are designed to assure the longer term access of funds for corporate and public borrowers. Note issuance facilities, revolving underwriting facilities, and similar arrangements have become widely used over the last few years. The essence of these facilities is that the underwriting banks will provide the borrower with assured access of short-term notes by guaranteeing during a determined medium-term period to take up unsold short term notes at
each rollover date. So far, the availability of these facilities has been limited to the most creditworthy developing countries (e.g., Korea, Turkey, Malaysia) as banks did not want to be left with unsaleable notes.

Another form that has emerged recently has been the transferable loan instrument, which has facilitated the transfer of lending commitments from one private lender to another. Other forms of assuring a steady flow of external finance could take place through a private insurance scheme, which would permit banks to pass the sovereign risk to an insurance facility or company in exchange for a premium.

c. Expanded Use of the Capital Markets

International finance in the 1930s and 1950s took place predominantly through the international bond markets. In contrast, in the 1970s and 1980s market finance to developing countries consisted almost entirely of lending. However, there appears to be some room for developing countries to rely more on international capital markets as an alternative and complement to bank lending. This can take place in part through traditional instruments, such as floating-rate notes, fixed-interest rate bonds and debentures. These, in some sense, would represent securitization of bank lending. Alternatively, finance can be in the form of instruments that explicitly provide a better match between debt service obligations and borrowers' capacity to pay. Many high income developing countries have moved in this direction.

Expanded use of securitized forms of international lending has the advantages of broadening the scope of investors providing funds, reducing the debtors' exposure to developments in the banking sector, and enlarging the set of types of investors providing funds. On the negative side, it reduces the implicit flexibility that has been associated with bank lending through the rescheduling process; a mechanism for a collective response to debt servicing problems does not exist in security market.

d. Indexed Instruments

Instruments which are indexed to borrowers' capacity to pay are currently largely absent in the international capital markets. Examples are commodity-indexed bonds, trade index-linked bonds, export-indexed bonds and constant real interest rate bonds. The principal advantage of linking debt service to ability to pay as a risk-sharing mechanism should be clear. There are important secondary benefits as well. The reduced vulnerability of the country to external factors will decrease the risk of overall debt servicing difficulties, increase its overall creditworthiness, facilitate easier access to funds and reduce the overall cost of funds when risks are shifted to world capital markets in line with comparative advantage.

For instance, an oil-exporting country might be able to obtain more financing when it relies on oil-price linked financing than when it relies on conventional types of financing, as the former debt service obligations are more in line with the country's expected ability to pay. In addition, these types of instruments can give creditors a stake in the developing country access to exports markets and its general economic performance. The disadvantages of indexed instruments are the moral hazards that arise by relating the payments to a variable that is under partial control of the debtor. To date, the demand for this type of instruments is still very small. Only the markets for gold and oil-price indexed loans have developed considerably in recent years (see Provolos and Duncan (1990)). This may represent in part, the reluctance of developing countries themselves to consider such instruments and also the hesitancy of financial markets to accept innovations other than those introduced by the names with the highest credit standing. Intermediation by international financial institutions could correct these deficiencies.

V. Role of International Financial Institutions

Conceivably, developing countries might be able to achieve their desired external liability structure over time either through new financing using alternative forms of financing or through a restructuring of their existing external liabilities or both. However, with few exceptions, most of the alternative forms of financing and the instruments designed for risk management are only available in limited amounts from the financial and capital markets or they are available at inappropriate financial conditions. Furthermore, the debt crisis has resulted in a lower volume of new finance to developing countries and financial institutions are reluctant to take on counterparty risks in restructuring arrangements or risk management arrangements with developing countries.
In these circumstances, the role of the international financial institutions (IFIs) in facilitating alternative forms of financial instruments for financing, restructuring or risk management purposes could be very important. IFIs can assist in five ways: (1) technical and institutional advice; (2) direct financial intermediation; (3) guarantees on a variety of instruments; (4) design of their own lending program and conditionality; and (5) the World Bank’s MIGA. When examining the potential role of IFIs, we should distinguish between the countries heavily affected by the debt crisis and constrained in their new access to external finance and those countries that still have access to external finance and that are potential beneficiaries of risk management instruments.

A. Technical and Institutional Advice

There is no doubt that the IFIs can play a large role in providing technical and institutional advice to developing countries as it relates to their external (asset and) liability management. The needs of many borrowers for this kind of advice are large. Some borrowers, especially those with higher per capita income, are diversifying and undergoing structural shifts and are interested in more sophisticated liability management and non-traditional means of finance, while other borrowers are faced with large risks arising from external factors and are in desperate need of financial methods to hedge these exposures. At the same time, many of these borrowers do not have the institutional framework and the necessary qualified human resources to tackle the issues of liability management. Even though many commercial and investment banks have filled this gap and have provided useful advice on liability management to developing countries in the past, the IFIs could still play a useful role because of their neutral status and cooperative nature and their broad cross-country experiences.

IFIs are probably best suited to advise countries on: the appropriate institutional setup for liability management; the necessary data collecting, processing and reporting systems; and the necessary staffing and technical training of the people involved with the various aspects of liability management. In addition, the IFIs could devote resources to the development of a conceptual and practical integrated liability management model, with related risk versus costs tradeoffs, that could be applied to developing countries. At this point in time, there does not exist such a model to relate a country’s characteristics, in terms of ability to pay, domestic opportunities, etc., to a corresponding optimal liability structure. One needs to have a clear objective function in order to evaluate the usefulness of different hedging instruments. For some work in this direction see Claessens (1989) and Priovolos and Duncan (1990).

B. Direct Financial Intermediation

Apart from financial intermediation of developing countries’ general obligation finance (and the World Bank’s direct participation in co-financing), the IFIs have not been involved in the intermediation of alternative forms of contingent financing. As discussed above, developing countries could conceivably benefit from contingent forms of financing, such as commodity-linked bonds, as they would provide a better match between debt service obligations and ability to pay. However, developing countries have been unable, so far, to obtain substantial financing in this way on their own accord. To overcome this, the World Bank could, for instance, conceivably change its own borrowing terms and intermediate in an efficient manner, using its credit standing in the international markets, appropriate forms of contingent finance by issuing and on lending such instruments. As an example, the World Bank could issue a commodity-price linked bond in order to provide a particular borrower or group of borrowers with the debt obligations of its or their choice.

C. Guarantees on a Variety of Instruments

The IFIs could provide credit enhancement for either specific contracts between specific borrowers and investors or for a general group of contracts through guaranteeing in effect the performance of the contracts. These guarantees could be either unconditional guarantees of fixed payments or guarantees of (variable) payments which would be dependent on specific events. The former includes some forms of the co-financing scheme as it currently exists, where the Bank guarantees repayment of the longer maturities. The latter includes the contingency liability financing part of the co-financing scheme where the payments by the Bank are dependent on other factors and which can serve as a means to assure access to external funds. The latter would fall under an Expanded Cofinancing Facility (ECO) of the World Bank approved in July 1989.
The Bank could also use guarantees in its negotiations with other creditors about a financing package for a country as leverage to achieve not only an appropriate amount of financing but also an appropriate structure of the financing. The Bank could, for instance, engage in co-financing schemes only if it deems the claims held by other parties to be appropriate both in amount and forms. More specifically, the Bank might only co-finance (using its normal lending tools) an infrastructure project when other investors provide financing whose claims are dependent on the revenues (or the profit) of the project. Many other type of guarantees are feasible, such as guarantees on the specific performance of a project against transfers risk. Many of these guarantees, particularly those related to instruments linked to commodity prices or indexes of world economic activity, should be in the interest of borrowers as well as investors.

D. Design of IFIs’ Lending Programs and Conditionality

The IFIs have been able to achieve significant changes in many developing countries’ domestic financial policies which will, over time, broaden domestic financial markets and increase the set of opportunities which are attractive to foreign investors as far as risk, expected return and liquidity are concerned. The IFIs will have to intensify their efforts in this direction as many developing countries still have underdeveloped, undercapitalized and illiquid financial intermediation services and thin financial markets. However, an increase in the amounts and an altering of the forms of external finance will depend largely on policy changes within individual developing countries.

The IFIs have played an important monitoring role for other creditors in the implementation of certain types of policies by countries, as for instance agreed upon in rescheduling and debt reduction operations. They could further expand on this role and encourage and promote alternative financial instruments using an appropriate design of their own general lending programs and the specific conditionality that underlies certain lending programs in the case of Sector and Structural Adjustment Loans of the World Bank and the Use of Resource Arrangements of the IMF. The IFIs have so far used their policy dialogues and the strengths that they derive from their continued lending programs to accomplish beneficial general policy changes within borrowing countries. The IFIs have not extended their leverage over countries encouraging specific types of private contracts, but could conceivably do so.

In addition to their structural lending operations and other lending, the IFIs could in project lending introduce and negotiate specific features and performance requirements that private lenders require. The IFIs could devote more resources to designing projects and project financing in a fashion that would be conducive to, for instance, parallel financing. Similarly, sectoral lending operations could be structured in such a fashion which is as complementary as possible to appropriate forms of private financing. The World Bank could also support financial activities that have a specific risk-sharing (or other beneficial) aspect which it cannot finance directly itself. It could, for example, make loans whose only purpose is to back private financing schemes that have these characteristics.

E. Special Role of the Multilateral Investment Guarantee Agency (MIGA)

MIGA is becoming a powerful instrument for promoting not only the level of private flows to developing countries but also for enhancing the structure of those flows. MIGA has been designed to focus primarily on promoting international investments, but it could also serve to broaden the support for other forms of finance as well. MIGA is able to issue guarantees, including coinsurance with and reinsurance of, existing political-risk insurers, against non-commercial risks, and MIGA is able to extend a broad array of technical and advisory services to investors and countries. MIGA might also be able to play a role in enhancing the security of commercial loans to developing countries through acting as an umbrella organization for publicly or privately sponsored guarantees or acting as an administrator for funds that would guarantee bank loans.

MIGA can further broaden the range of creditors providing flows to developing countries: pension funds, insurance companies, and other institutional portfolio investors that have largely avoided cross border assets due to their general unfamiliarity with international finance, their institutional and regulatory constraints and the perceived risks. Most of these investors are, however, better suited than many financial intermediaries to provide financing across countries as they are in a better position to share the inherent risks because of their greater scope for diversification, their specific knowledge and their longer investments.
horizons. As long as returns in developing countries are attractive compared to the returns in developed countries, these groups of investors could conceivably provide substantial amounts and appropriate forms of capital inflows.
References


2. The occurrence of high interest rates and low commodity prices might, in the minds of many, not have been a very likely scenario and the experience in the early 1980s might therefore just be due to "bad luck". Ex-ante, however, the relationship between debt service on floating rate debt and a country's ability to pay is unclear, but the two are not likely to be highly correlated. See Lessard (1989).

3. The South-Asian and Pacific countries have, for instance, a much diversified mix of external financing. See Herman (1991).

4. Most forms of non-guaranteed (or also called non-recourse) financing requires a clear understanding and commitment from both parties regarding the respective obligations. Governments have to be committed not to bail any failed projects and lenders have to realize that they can not resolve to the government.

5. Especially the withdrawal of short-term trade linked finance can be disruptive to a country.

6. However, the relative amount of FDI increased due to the drastic decline in other sources of external financing.

7. Legislation could, however, be introduced (similar to, say, the Security and Exchange Commission regulations in the United States) which would limit the stakes of foreigners to certain percentages. Alternatively, separate classes of shares could be introduced, one with full and one with limited voting rights.

8. This group includes, among others, India, Thailand, Turkey, China, South Korea and Algeria.

9. In this case, centers can reassign their loan to a different borrower and thus limit the balance of payments efforts of repayment. Brazil and Mexico have used this relending option in the context of their debt restructurings.

10. The World Bank is currently providing such financial technical assistance through units in its Treasury Department, Cofinancing and Financial Advisory Department and International Economics Department.

11. The World Bank's objective is to adapt its commercial cofinancing program, begun in 1983 with the "B-Loan" program, to the changes in capital markets, that have resulted in a broader range of instruments for creditworthy borrowers. The first ECO operation, approved in June 1990, authorized the Bank to guarantee principal payments on the private placement of bonds in the U.S. capital markets by the Housing Development Finance Corporation Limited of India. See: World Bank, Annual Report 1990, p.56.
8. Foreign Direct Investment: Recent Trends and Policy Issues

Andrea Gubitz
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The issue of foreign direct investment (FDI) in developing countries attracted a lot of interest in recent years, especially so in the context of the debt crisis with FDI mainly seen as a potential substitute for commercial bank lending, which declined rapidly to less than US$5.0 billion in 1988. According to the OECD, FDI accounted for about 58 percent of total private and 19 percent of total resource flows to developing countries (including off-shore banking centers). Furthermore, FDI flows from OECD to developing countries gained in importance not only in relative but also in absolute terms: it almost doubled on average over the years 1986-1988 compared to 1983-1985. At the same time, however, FDI in the industrialized world has grown much faster, especially so in the United States and within the EC, where favorable expected rates of return and the market size gave rise to unusually high FDI inflows in recent years.

I. Benefits of FDI

For the developing countries the main benefit of FDI is not so much the substitution of private lending, but the gain in technological knowledge and managerial skills, which leads to a higher labor productivity and an easier access to export markets. FDI is usually a long-term commitment for the foreign investor as well as for the host country. Furthermore there are no contractual payments involved, i.e. the repatriation of earnings occurs only, if the invested funds are profitable. All these advantages are appreciated by the developing countries. The hostility of host countries to foreign investors is over; expropriations almost vanished in the eighties. Many countries are eager to improve their investment climate by easing their investment restrictions and offering all kinds of special incentives to attract FDI capital.

The benefits of direct investment capital, however, do not come free of charge. Although data on earnings from FDI are notoriously unreliable, recent studies showed that the rate of return on FDI stocks tends to be higher than the costs of debt finance. The IMF, for example, estimated that the average rate of return on FDI in twelve countries over the years 1974-1982 was almost 2 1/2 percentage points higher than the interest rate on debt. Nevertheless, FDI is considered to be advantageous for the host countries and to play a crucial role in the process of development.

As foreign direct investment is one way of financing the activities of the private business sector in the host countries, macroeconomic performance plays a key role in attracting FDI. For many countries however the empirical relation between the economic determinants and the actual stock and/or inflows of FDI is difficult to verify. While a major part of this problem is related to the nature and the rather poor quality of the data, investment restrictions and promotions often play a crucial role in determining FDI inflows to a developing country.

Section II of the paper summarizes the recent trends of FDI inflows to developing countries, especially some regional aspects, and discusses the economic

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1The author is an economist at the Deutsche Bundesbank. This essay was written when she was a consultant at the World Bank. Some major portions of the paper were drawn from a research project on an empirical investigation of the determinants of German direct investment in developing countries, conducted at the World Bank in cooperation with the Kiel Institute for World Economics, and on a project on the outflow of private direct investment to developing countries at MIGA. The views expressed are those of the author and not necessarily those of the Bundesbank or of the World Bank.
factors driving FDI. Section III addresses the issue of investment policies, a topic that has been well covered as far as host countries' policies are concerned, but source countries' policies received less attention.

II. Recent Trends in FDI Flows to Developing Countries

As mentioned before, the two different data sources for FDI flows somewhat disagree on the development of inflows to developing countries. Both the IMF and OECD data bases show an increase of FDI flows to developing countries until 1981/1982, which then was reversed until 1986, when FDI started to rise again to about $19 billion in 1988. Two qualifications to this rising trend have to be made. First, according to the OECD a large amount of total FDI flows was received by off-shore banking centers. These, however, play a significant role as intermediaries for investments directed to other developing countries. The "net effect" of the off-shore centers is, of course, unknown. Stocks statistics on FDI in developing countries, as for example compiled in Germany, indicate that this effect is substantial in some of the major recipient countries such as Brazil. Second, FDI flows to the 17 highly indebted-middle income countries (HICs), which roughly halved after the outburst of the debt crisis, started to rise again in 1985 and amounted to $6.1 billion in 1987. This increase is partly associated with the implementation of debt/equity swap programs, especially so in 1987.*

A. Regional Trends

Along the lines of a general surge of FDI in recent years there is also a shift between regions, both as with respect to recipient and with respect to source countries. As can be seen from the table below, Asia gained in importance over the last few years. Also the distribution within this region has changed, as China developed very quickly into the most important single recipient country in the world. Nearly 85 percent of FDI flows to China have come from Hong Kong. The other two major recipients in the region are Singapore (with a declining portion) and Korea, which developed into a major recipient within only a few years. Latin America's share, which used to be the highest until the early eighties and still is in terms of stocks, declined in the recent past although this process came to halt in 1985-1987. The leading role as a recipient within Latin America is taken over by Mexico (from Brazil), which received about 50 percent of total inflows to Latin America in 1986/87.

Table 8-1: FDI INFLOWS OF THE DEVELOPING COUNTRIES: REGIONAL SHARES (percent)

<table>
<thead>
<tr>
<th>Region</th>
<th>1982</th>
<th>1984</th>
<th>1986</th>
<th>1987</th>
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</thead>
<tbody>
<tr>
<td>Latin America</td>
<td>24.5</td>
<td>20.4</td>
<td>24.6</td>
<td>46.4</td>
</tr>
<tr>
<td>Africa</td>
<td>6.9</td>
<td>6.7</td>
<td>5.6</td>
<td>5.6</td>
</tr>
<tr>
<td>Asia</td>
<td>17.6</td>
<td>28.8</td>
<td>32.8</td>
<td>51.6</td>
</tr>
<tr>
<td>Middle East</td>
<td>48.1</td>
<td>38.5</td>
<td>30.8</td>
<td>-13.8</td>
</tr>
<tr>
<td>Europe</td>
<td>3.0</td>
<td>5.7</td>
<td>6.2</td>
<td>10.3</td>
</tr>
</tbody>
</table>

Source: IMF, BOP

The above mentioned shifts in the regional distribution of FDI inflows of the developing countries have their counterparts in a rather pronounced shift in the regional distribution of FDI outflows from OECD countries to developing countries. The United States used to be by far the most important source of direct capital for the developing countries. They still are, but
their share has significantly declined. At the same time Japan became a major foreign direct capital exporter to the developing countries (see table below). Investors from major source countries in Europe (UK, France and West Germany) showed a relatively reduced interest in the developing countries in recent years.

Table 8-2.: FDI OUTFLOWS FROM MAJOR SOURCE COUNTRIES TO DEVELOPING COUNTRIES

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>United States</td>
<td>60.5</td>
<td>44.1</td>
<td>14.4</td>
<td>27.9</td>
<td>40.3</td>
</tr>
<tr>
<td>Japan</td>
<td>10.4</td>
<td>18.9</td>
<td>15.5</td>
<td>27.8</td>
<td>32.7</td>
</tr>
<tr>
<td>West Germany</td>
<td>6.2</td>
<td>8.0</td>
<td>-2.2</td>
<td>3.7</td>
<td>3.4</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>5.2</td>
<td>10.5</td>
<td>32.6</td>
<td>17.1</td>
<td>9.5</td>
</tr>
<tr>
<td>France</td>
<td>5.1</td>
<td>7.6</td>
<td>9.0</td>
<td>5.5</td>
<td>3.5</td>
</tr>
</tbody>
</table>

Source: OECD

The changing regional pattern of the source countries is to some extent due to the preference of the MNEs to invest in countries geographically and culturally close to them. As Asia in general has been the more promising area for economic development than Latin America in recent years, Japanese companies got relatively more involved than those from other industrial countries. The same kind of argument applies to US investment in Mexico and also explains the declining share of the European countries.

B. Sectoral Trends

Aggregate numbers on the sectoral distribution of FDI in developing countries are even more unreliable and outdated as those on the regional pattern. Nevertheless, a few major observations can be drawn from the data published by the major source countries. Historically, i.e. until the sixties, most foreign direct investment was devoted to the extractive and primary sectors. The seventies were characterized by particularly buoyant investment activities in manufacturing. This development is related to two different phenomena occurring in two different regions. FDI in Latin America was attracted by big domestic markets, while FDI in Asia, most notably in the NICs, has been oriented towards exports. With a growing product differentiation in manufacturing more and more exports markets are characterized by monopolistic competition, which supports export-oriented globalization of production. Many developing countries realizing this try to attract investment by establishing export processing and free trade zones. To some extent the upswing of FDI in Mexico since 1985 can be explained by the new regulations that significantly extended in bond production in the whole country.

C. Determinants of FDI Flows

The description of the regional and sectorial pattern of FDI flows to developing countries already gave some indication of what the major determinants of FDI are. The most well established result in the empirical research on FDI is that market-size is the most important single argument to acquire production facilities in developing countries. The classical example is Brazil, a more recent one is China. The large size of a country (measured by its GDP) becomes even more attractive, if the domestic market is protected. Smaller countries, on the other hand, cannot afford trade barriers, as foreign direct investors tend to "explore" their markets by exporting first. Market size is not restricted to national boarders, but refers to a whole area as for example in the case of FDI in electrical engineering in Singapore. Another important factor is hypothesized to be low production costs, which is in most cases associated with low labor costs. Empirical evidence is difficult to
obtain, as one needs comparable labor cost data in absolute levels. There are a few countries for which estimated time series exists.\textsuperscript{6}

This data was used in a study on German FDI in developing countries to investigate the hypothesis.\textsuperscript{7} Based on the data of a limited number of countries a significant positive impact on foreign labor costs on the change in FDI stocks in manufacturing was found. The change of FDI stocks can on an aggregate level be considered as a proxy for the adjustment of an existing capital stock abroad to its optimal level, which increases with rising foreign labor costs due to a substitution effect between capital and labor. If the data could be disaggregated into new projects and extension of existing ones, the results would probably look quite differently. Labor productivity which changed little over the relatively short sample period had no significant impact in the case of German FDI.

FDI can, however, in itself be an important driving force to increase labor productivity not only in the foreign but also in the locally owned companies in the developing countries. This is the result of a recent study on US American FDI in Mexico, which found out that not only do US companies contribute to increase the labor productivity in Mexico, but also that the productivity gap in manufacturing between the two countries diminishes.\textsuperscript{8} According to a study of the UNCTC foreign affiliates in Latin America played the key role in the surge of exports of the region.\textsuperscript{9} FDI however is not a necessary condition for export growth. In fact in the Asian NICs The increase of manufacturing exports was driven by locally owned companies.

Another crucial element in attracting FDI is considered to be economic stability as it is reflected in low inflation, positive real interest rates, stable exchange rates, and stable expected growth rates.\textsuperscript{10} Although it is obvious that long term investment commitments are not feasible in an unstable environment, it is very difficult to assess this issue quantitatively. Aggregate FDI data is compiled in value terms only; thus valuation and volume effects cannot be properly separated. In general, countries which failed to stabilize their economies, have a high debt overhang and consequently a low credit rating also faced a decline in FDI inflows. The same applies to countries that are perceived to be politically unstable, measured by the number of changes in the government, strikes and lockouts, etc.. There are however differences in the risk behavior of foreign direct investors from different source countries as will be discussed below.

### III. Policy Issues

Although FDI flows roughly follow the relative economic performance among countries, there are countries with similar characteristics but different levels of FDI inflows. As mentioned before market size is the single most important determinant of FDI inflows. The ratio of FDI to GDP for the two largest economies in the developing world, Brazil and India, however deviate substantially from each other (considered on the basis of an 18 years average): 0.93 percent for Brazil and 0.04 percent for India.\textsuperscript{11} A major cause for this discrepancy is host countries policy; India has traditionally been rather restrictive with respect to FDI. Brazil’s mix of investment and trade policy on the other hand attracted import substituting FDI. However it is not only host countries’ policy that influences FDI but also source countries’ policy. Brazil, for example, is well known for having attracted a lot of German FDI in the past; gross FDI outflows from Germany to Brazil have been 0.15 percent in relation to Brazil’s GDP on average between 1976 and 1988. What is less well known is that a country attracting even more gross FDI flows from Germany, 0.21 percent in relation to GDP, is Egypt. Both countries have roughly the same degree of openness with respect to their investment regulations, and Egypt has been rated on average less creditworthy than Brazil in the past. On the other hand an unusually high amount of federal guarantees has been approved for German projects in Egypt. Thus source countries’ policy can substantially alter the general risk behavior of foreign investors from different countries.

### A. Host Countries’ Policies

The regulations and policies of the developing countries to influence the inflow of foreign capital can be quite complex and are often inconsistent. When relating the actual size of FDI stocks or inflows of single countries to the countries’ regulatory frameworks one has to keep in mind that in many cases FDI is the result of decisions of a few companies only, for which a particular component of the regulatory framework might have - at that particular point in time - outweighed all the others. On an aggregate level, however, there are a few components of the rules and regulations that are generally considered to be crucial and will be described below.

A major obstacle to FDI is the restriction on ownership. Companies have a strong preference for 100
percent ownerships, as it eases the decision process inside the company and allows for better control over intangible assets such as technology, product quality and credibility.\textsuperscript{12} It has to be mentioned, however, that joint ventures have their particular advantages too. Country specific aspects of production and distribution can be more easily handled with a local partner sharing the risk burden. Especially small and medium-size companies appreciate these advantages of joint ventures.

Some countries have codified limits varying from sector to sector with complete foreign ownership being the exception, often approved particularly to export-orientated companies (for example in Malaysia). Other countries decide on a discretionary basis (like Thailand), and others require a gradual increase in national participation (for example Peru). An important qualification to the above described regional pattern of shares has however to be made: most developing countries, especially in Asia, liberalized their investment policies substantially. In 1988 and 1989 in particular many countries eased their ownership restrictions allowing a 100 percent participation in many sectors (Argentina, Mexico, and Indonesia).

Another important factor influencing the investment climate of a developing country concerns restrictions on the repatriation of profits and capital. This issue also involves the access to foreign exchange.\textsuperscript{13} Even if the repatriation of profits and capital is granted under the investment code of the country or by a bilateral investment treaty, this is not of much use, if access to foreign exchange is restricted. This is especially true for companies which mainly operate in the domestic market. Most countries with severe debt problems restrict repatriation of profits and capital. In Argentina, for example, emergency legislation used to prohibit the repatriation of capital, and capital acquired under the debt/equity conversion program cannot be repatriated for ten years. Other countries, for example Kenya, restrict the repatriation of capital gains.

Although no country completely prohibits the repatriation of profits, many countries have restrictions that distort optimal financing conditions. Many countries restrict, for example, the repatriation of profits to a certain percentage of the registered capital. Earnings repatriated above that amount are highly taxed. Brazil restricts the repatriation of profits to 12% of the registered capital (in foreign currency) calculated over a three year average. Although this regulation might appear harmless at first sight, it turns out to be a major source of difficulty because registered capital is usually not allowed to be adjusted for inflation. As much of the FDI stock was registered many years ago, often only a small proportion of the actual profit can be remitted. This gives an additional strong incentive to invest in form of a loan rather than in form of equity capital, because remittance of interest earnings on foreign loans is geared to market rates.\textsuperscript{14}

According to an older survey on German firms' investment behavior in developing countries "the most important individual factor for German investors is the difficulties in dealing with the state authorities (bureaucracy) in developing countries."\textsuperscript{15} Obtaining a complete picture of this issue is, of course, beyond the scope of this paper. There are countries which are known to have a particular tedious approval procedure, for example Nigeria and Kenya. On the other hand there are a few countries which have a codified, straight forward approval process; in Korea for example many investment projects are approved automatically. Some countries which used to have a very bureaucratic administration shortened their approval procedure, for example Kenya and Indonesia. In the discussion on improving the investment climate in developing countries some emphasis was given to the establishment of "one stop" agencies, which would be the only institutions the foreign investor has to deal with. Whether this will help to actually reduce the implementation costs of the investor depends more on how the approval is handled in practice than on the way the procedure is formally institutionalized.

Apart from the three issues discussed above there are other disincentives which are crucial for the investment climate in a developing country such as quotas mandating employment of host countries' nationals (as for example in Malaysia) and performance requirements like local content requirements (as for example in Venezuela). On the other hand most countries offer at least some special FDI incentives such as tax concessions, duty free imports or inputs, protection against local and foreign competition, and export processing zones. Highly indebted countries subsidize investments via debt/equity swap programs. Some countries, like Chile and Korea, rather opt for a more even treatment of local and foreign investors. Joint ventures often receive preferential treatment and the pattern of incentives and disincentives often varies substantially between different sectors. Multinational Enterprises (MNEs) nowadays take some special treatment, at least some tax exemptions, in all the developing countries for granted; this reduces the impact of FDI inflows to single countries or makes them rather costly.
B. Source Countries Policy

Instead of asking the developing countries to put up with foregone tax revenues in order to subsidize private companies from abroad (which will at least in the short run lead to an increasing need of other foreign funds), it might be more effective to support the foreign direct investor in the source country. In the recent discussion on how to attract more FDI in the developing countries it is often concluded that it is mainly the host countries which can create favorable investment conditions, while source countries' policy instruments have only a marginal effect. The reasoning is that there is nothing to deregulate in most industrial countries as there are no restrictions to invest abroad. Promoting investment in developing countries is rather a matter of subsidizing projects; most industrialized countries do that, although the actual amount of funds spent is rather low. This however does not mean that their effect is negligible. In fact as will be argued below this conclusion has to be modified.

Most industrial countries have a set of policy instruments to promote FDI in the developing world on a national level as well as they support similar instruments on the international level. The direct ingredients of this set are usually bilateral investment treaties,\textsuperscript{16} public insurance against non-commercial risk,\textsuperscript{17} financial participation of official or publicly owned institutions,\textsuperscript{18} and information and consultant services.\textsuperscript{19} Several industrial countries have other measures that indirectly support FDI, most notably subsidized credits for exports of investments goods to developing countries and export credit insurance. To assess the overall effect of these instruments is very difficult, as many of them are complementary.\textsuperscript{20}

The most important single instrument, however, is a public guarantee. Roughly 50 percent of Japan's FDI and about 20 percent of Germany's FDI is covered by public guarantees. Although the amount covered is high, the amount of public funds actually used may be very low. In the case of Germany, for example, final defaults are very rare (about one percent of the total amount covered).

The purpose of a guarantee scheme is to drive a wedge between the general perceived country risk and the individual investor's risk. If this objective can be successfully reached, public guarantees would be a rather efficient instrument to promote FDI in developing countries. The case of German FDI in developing countries was recently investigated in more detail.\textsuperscript{21} In a regression equation estimated with pooled time series and country data explaining FDI gross outflows it was found that the amount of acquisitions in developing countries is significantly positively influenced by the amount of new approved guarantees (corrected for country risk and country size), but it is not significantly negatively influenced by the country risk (measured by countries' credit rating). This result supports the view that public guarantees can indeed play an important role in promoting FDI in developing countries. It also contrast earlier findings that a decline in the creditworthiness of a country also lowers its FDI inflows.

IV. Summary

Although the sluggishness of FDI flows to developing countries has ended and might even have been reversed, increases have been lower than in the industrialized world leaving the developing countries with a reduced share of the cake. Along with this development there have been major shifts in the regional distribution with an increasing weight of Asia, both with respect to inflows to host countries as well as with respect to outflows from source countries. Many host countries took major steps to reduce restrictions in their investment regulations and implemented special incentives to attract more FDI. However, some of these measures were taken only recently and will need more time to be fully perceived by the investors, before they will generate additional inflows. Debt/equity swap programs helped to increase FDI in certain highly indebted countries, even in some of those, which have otherwise not managed to improve their general investment climate, for example Argentina. One problem is that the special incentives granted by the host countries' governments can be quite costly, and developing countries might end up in entering into a rather expensive competition among each other in order to attract FDI. On the other hand, governments of the industrialized countries can help to enhance FDI outflows to developing countries by establishing public guarantee schemes, assuming that there is a need for some subsidized support for FDI in developing countries in the first place.
8. Foreign Direct Investment: Recent Trends and Policy Issues

1. FDI in the context of this paper is defined as an investment involving ownership in a local company high enough to have an effective voice in the management. Other types of "FDI" like quasi-equity arrangements such as licensing, franchising, etc. are gaining importance, especially so for small and medium-size investors. Nevertheless, ownership participation is still by far the single most important form of FDI.

2. Numbers on aggregated FDI flows give only a rough indicator of the underlying development. Data from OECD is compiled by aggregating FDI outflows from OECD countries to single countries (sometimes these numbers are even based on stock values, i.e. are distorted by capital gains and losses), while the Balance of Payments Statistics of the IMF aggregates FDI inflows as reported by the recipient countries. The numbers from the two sources depart substantially from each other, especially so with respect to single countries.

3. IMF: "Foreign Private Investment in Developing Countries", Occasional Paper No. 33, 1985

4. Authorized conversions, however, do not translate directly into FDI inflows, as only a fraction is equity investment and there is a lag between authorization and realized investment. According to the UNCTC more than half of Latin America's inflows in 1988 involved debt/equity conversions.

5. Some decline of FDI flows to countries that have built up an FDI stock over a longer period of time is, of course, "natural" due to the dynamics of investment behavior.


11. In recent years India gained importance as a recipient country. FDI numbers for India are based on the OECD statistic, i.e. they cover only FDI from the OECD countries and thus probably underestimate the actual amounts.

12. Studies investigating the behavior of US American and German MNEs in developing countries strongly support this proposition; see C.D. Wallace (ed.): "Foreign Direct Investment in the 1990s: A New Climate in the Third World", Nijhoff, 1989, and H.-E. Scharrer and H. Krägenau: "Die Finanzierung deutscher Direktinvestitionen in Ausland", study conducted for the German Ministry of Economic Affairs, 1988

13. For detailed information on single countries see IMF: "Exchange Rate Arrangements and Exchange Restrictions".


16. The Federal Republic of Germany, for example, has 63 bilateral investment treaties, the United States 10.

17. Public programs are, for example, in the USA: OPIC, GRIP, in Germany: the federal guarantee scheme, in Japan: MITI, and on the international level: MIGA.

18. These are, for example, in the USA: OPIC, in Japan: JAIOD, JICA, in Germany: the DEG and KiW, and on the international level: the EIB and IFC.

19. These are, for example, in the USA: Bureau of Private Enterprise (within the AID) and TDP, in Japan: same institutions that provide financial support also offer technical assistance, in Germany: DEG, the Agency for Foreign Trade and the BK-Program, and on the international level: the Center for Industrial Cooperation of the EC, UNCTC, UNIDO, and FIAS.

20. For example, to obtain financial support from a public financial institution, it is often required to cover the project by a public guarantee.

21. A. Guebitz, "Impact of Investment Policies on German Direct Investment in Developing Countries: An Empirical Investigation," (paper presented at the seventh conference of the EARIE, Lisbon, September 1990)
9. Sweden’s Approach to External Debt Management

9. The Management of the External Debt - The Approach Taken by the Swedish National Debt Office

Bengt Rödstam
Swedish National Debt Office

With borrowing requirements declining, the Swedish National Debt Office (SNDO) has shifted its attention from raising new money to an active management of the outstanding debt. In the following, I will give a brief description of how the SNDO manages its external debt portfolio in order to achieve the lowest possible cost, subject to an acceptable level of risk.

I. A Framework For Performance Evaluation

An active management of a large multicurrency debt portfolio would not make sense without a framework for performance evaluation in terms of a cost measure, planning horizon and a benchmark portfolio that conveys the notion of risk. Who should be responsible for the establishment of such a framework? Here we distinguish between the sovereign, represented the Ministry of Finance or a similar high-level Government office, on the one hand, and his agent, the debt manager (DM), on the other hand. Clearly, it is the MOF that should define the cost measure, the planning horizon and the benchmark portfolio. (In practice, the MOF might require a lot of assistance from the DM in this process.) Using these definitions, it is then up to the DM to try to optimize performance within the framework provided and to report to the MOF on a regular basis the performance of the debt portfolio relative to the benchmark portfolio.

A. The Cost Measure

With the external debt consisting of public issues trades daily on the secondary market, the SNDO uses a cost measure which corresponds to the concept of total return used by a global fund manager. For a given period of time, the total cost of the debt portfolio is defined as the sum of three different cost components:

(a) periodized interest payments
(b) change in the market value of the debt due to currency movements
(c) change in the market value of the debt due to interest rate movements.

B. The Planning Horizon

Even if the MOF views its debt as an ongoing concern and thus has a long horizon, it usually reviews the performance of the DM on a frequent basis. The performance of the SNDO is reviewed as often as quarterly. From the DM’s perspective, this review period is the relevant horizon. The MOF’s dilemma of conveying its long-term perspective in the context of a short review period can be resolved by measuring performance relative to a benchmark portfolio.

C. The Benchmark Portfolio

Choosing an appropriate benchmark portfolio is not an easy task. Should the benchmark portfolio contain only domestic only foreign currency denominated instruments or a mix between the two? As long as the DM has the option of substituting domestic financings for foreign financings, it would seem logical to let the benchmark portfolio contain only domestic instruments. When the DM does not have that option, the benchmark portfolio should presumably contain only foreign currency denominated instruments. In the latter case a decision on the currency composition of the benchmark portfolio has to be taken.

Then, there is the question of whether the benchmark portfolio should be weighted towards short-term instruments, medium-term instruments or long-term instruments. Clearly, the benchmark portfolio must reflect MOF’s strategic objectives. A possible objective may be debt service stability, because it facilitates internal planning and budgetary efforts. If the MOF perceives risk as debt service fluctuation and thus views floating rate exposure unfavorably, the appropriate benchmark would logically be a portfolio of long-term, fixed-rate bonds. If instead of debt service certainty, the MOF is primarily concerned with stabilizing market value of the outstanding debt, the bench-
Managing External Debt in Developing Countries

mark should be short-term funds. In that case, floating-rate instruments which, experience minimal market price fluctuation, are riskless, while long-term bonds are risky.

The key in each case is to specify the appropriate benchmark and to measure cost in terms of the deviation from the cost of the benchmark. Within this framework, "risk" refers to the probability that the actual debt portfolio will underperform the benchmark, making the benchmark, by definition, risk free. Portfolios that deviate from the benchmark in terms of currency or interest rate risk introduce exchange rate and interest rate risk, respectively.

II. Minimizing Currency Risk

As already stated, the SNDO periodically reports to the MOF the actual performance of the Government’s foreign currency denominated debt both in absolute terms and relative to a multicurrency benchmark portfolio. What is the rationale behind the currency composition of the benchmark portfolio?

A. Actual and Benchmark Portfolios

Ideally, the weight for a currency of a certain country should reflect that country’s importance as a competitor to Sweden both bilaterally and in third markets. To try to construct a weighing scheme that really fulfills that requirement is certainly not an easy undertaking. Fortunately, it has been shown that, as far as Sweden is concerned, a weighing scheme along these lines will not be significantly different from a much simpler and easier-to-calculate scheme based Sweden’s total trade with different countries. Furthermore, the Swedish Krona is tied to a basket of 15 currencies, with each currency having a weight based on the total trade between Sweden and the country in question. Clearly, by letting the actual debt have the same currency composition as the Krona basket, one can minimize the scope for fluctuations in the value of the debt caused by alterations in exchange rates. Under these circumstances it was not difficult to decide that the SNDO’s benchmark portfolio should have the same currency composition as the Krona basket. (Actually, at the outset, it was decided that the currency composition of the Government’s external debt should be based on two factors, viz. the Central Bank’s currency composition identical to that of the currency reserves. The remainder of the debt, i.e. the net external debt of the Government and the Central Bank taken together, then to be given a currency composition close to the Krona basket. Subsequently, the monetary authorities have decided that the currency reserves should have a currency composition close to the Krona basket. Consequently, the currency composition of the SNDO’s benchmark portfolio is now the same as that of the Krona basket).

To what extent should the currency composition of the actual debt portfolio be allowed to deviate from the composition of the benchmark portfolio? The SNDO has divided the 15 currencies in the Krona basket into five currency groups, each group consisting of currencies whose movements are perceived to be reasonably closely correlated. (The SNDO may have limited access to some of the currencies in the Krona basket. The currencies where the problem of limited access is most acute are the Finnish Markka and the Norwegian Krone. However, since those two currencies are managed on a basket basis, the Swedish Krona can be expressed without explicitly referring to the Finnish Markka and the Norwegian Krone.) The Swedish Krona basket-weighings for the individual currencies within each currency group are then added together to give the benchmark weighings for the five currency groups on an aggregated basis. These benchmark weighings could be thought of as the normal positions to be held in the various currency groups. The SNDO also faces binding restrictions as to how far the actual positions may deviate from these normal positions. The purpose of the restrictions is to underscore the desire for diversification, to insure that underperformance risk is limited, and to provide ample scope for superior performance via active management of the debt portfolio. The latitude to take on more or less currency risk relative to the benchmark norm is set out in Table 9-1 at the end of this paper.

As shown in Table 9-1, the currency composition within a particular currency group is not subject to any explicit restrictions. A net asset position in an individual currency would, however, probably be regarded as unacceptable.

To what extent, then is the SNDO making use of its relative freedom in managing the currency composition of the external debt portfolio?
B. Managing Currency Composition

Before looking at some examples of how the SNDO manages foreign exchange risk, it may be useful to consider the merits of managing foreign exchange risk at all. The traditional argument against managing risk is that markets are efficient and that liabilities in other currencies because these currencies are expected to appreciate in value over the life of the liability. The amount of the appreciation should be just about equal to the difference in interest rates. Very long term studies have supported this theory. These studies have tracked the levels of inflation differentials eventually show up in foreign exchange rates. Strict adherence to this view of management would leave one with nothing to do from one quarter century to the next. These studies also suffer from the common use of inflation differentials rather than yield differentials. While there is a large degree of correlation between real rates of return across bond markets, real returns are influenced significantly by economic policies and short term currency problems. These aberrations in real rates of return certainly create opportunities to trade foreign currencies. Let us now look at some examples of how the SNDO tries to exploit these opportunities.

The SNDO tries to identify currencies that could be viewed as either grossly undervalued or grossly overvalued. The identification of such currencies is primarily based on an analysis of the underlying fundamentals, but there is also some use of technical analysis in order to capture long-term trends. For example, when the 1-week moving average of the Deutschemark/U.S. Dollar exchange rate went through the 52-week moving average from above in the second quarter of 1985 (see Figure 9-1), that was perceived as a significant piece of evidence that the long, overdue correction of the U.S. dollar was going to occur. At that time the SNDO decided that a high exposure in U.S. dollar should be maintained until there was evidence of a change in the long-term trend of the U.S. dollar. As shown in Figure 9-1, no such evidence was visible until the second quarter of 1988. Since then the SNDO has gradually reduced its exposure in U.S. dollar.

Another example of the value of disciplines use of this kind of technical analysis is shown in Figure 9-2. Evidently, there was a pronounced, downward trend in the Deutschemark/Pound Sterling exchange rate from the third quarter of 1985 to the second quarter of 1987. After the second quarter of 1987 the trend was consistently upwards until the first quarter of 1989 when the present downtrend, still in full swing, began.

The SNDO could of course decide to maintain either a low or a high exposure (relative to the normal position) in a certain currency without that currency necessarily having to be identified as either undervalued or overvalued. For example, the SNDO has tried to profit from the following, characteristic feature of the European Monetary System (EMS): The interest rate differential between a country with a high rate of inflation and a country with a low rate of inflation has tended to be wider than the inflation differential between the two countries, i.e. the interest rate differential has tended to be wider than the expected rate of depreciation of the former country's currency vis-a-vis the latter country's currency. In other words, international investors have required a risk premium, on top of the expected rate of depreciation, in order to invest in a more inflation-prone currency. (By investing in such a currency, an investor with a short- to intermediate-term time horizon is of course running a risk that the next realignment will take place sooner that expected and/or that the realignment will be more sizeable than expected.)

Accordingly, for a borrower, borrowing in a weak currency has tended to be more expensive than borrowing in a strong currency (provided that both currencies were reasonably valued at the outset). Consequently, the SNDO has for long time maintained a relatively low exposure in the more inflation-prone EMS-currencies and a relatively high exposure in the stronger ones. However, the continued presence of this feature of the EMS during the 1990s should certainly not be taken for granted. As already stated, the currency composition within a particular currency group is not subject to any explicit restrictions (see Table 9-1).

Consequently, the reward from identifying the cheapest currency (form a borrower's point of view) within each currency group could be quite substantial. With long-term interest rates significantly lower in Switzerland than in Germany (or Holland) and with the scope for an appreciation of the Swiss Franc vis-a-vis the Deutschemark seen as very limited, the SNDO has for a long time regarded the Swiss Franc as the cheapest currency among the strong European currencies. Obviously, the SNDO has tried to take advantage of this perceived anomaly by opting for an overweight Swiss Franc position and an underweight Deutschemark position. In the same way, the Belgian Franc has been identified as the cheapest currency within the group.
"Other European currencies". Clearly, anomalies like these are not going to last forever.

III. Minimizing Interest Rate Risk

A commonly used measure of interest rate sensitivity of a debt portfolio is the proportion of the debt held at floating rates. A problem with that measure is that it does not take the average maturity of the fixed rate debt into account. Clearly, a 3-year bond does not carry the same interest rate risk as a 10-year bond. A more comprehensive and more accurate measure of a debtor’s exposure to interest rate volatility is the duration or modified duration of the portfolio.

A. Basic Concepts

Duration is a measure of the average remaining life of a loan’s present valued cash flows. It differs from the maturity of the loan in that it also takes into account the interest rate payments and amortisations made during the life of the loan. Modified duration is linked to the concept of duration and shows the percentage change in the market value of the debt when the prevailing interest rate alters by one percentage point.

Consider the cash flows of a bond:

<table>
<thead>
<tr>
<th>Payment</th>
<th>P.V.</th>
</tr>
</thead>
<tbody>
<tr>
<td>End-Year 1</td>
<td>10</td>
</tr>
<tr>
<td>2</td>
<td>10</td>
</tr>
<tr>
<td>3</td>
<td>10</td>
</tr>
<tr>
<td>4</td>
<td>10</td>
</tr>
<tr>
<td>5</td>
<td>110</td>
</tr>
</tbody>
</table>

The bond has a PV (present-value) of 100 based on a discount rate of 10%. The PV is of course the sum of the PV’s of all the flows:

\[
\text{modified duration} = \frac{\text{duration}}{1 + \text{yield}}
\]

In the above example:

\[
\text{modified duration} = \frac{4.17}{1.10} = 3.79
\]

In effect there are 5 zero coupons bonds all packaged together. The present value weighted average maturity of these 5 zero coupons bonds is:

\[
\frac{9.1 \times 1 + 8.3 \times 2 + 7.5 \times 3 + 6.8 \times 4 + 68.3 \times 5}{100}
\]

= 4.17 per year

This is the duration of the bond.

Now, the concept of duration has certain properties:

- longer the final maturity of a bond, the longer the duration;
- the higher the coupon, the shorter the duration (an investor gets his money back sooner on average
- the higher the yield, (discount rate) the shorter the duration (later payments are less important).

Without going into more numbers, modified duration is:

\[
\text{modified duration} = \frac{\text{duration}}{1 + \text{yield}}
\]

In the above example:

\[
\text{modified duration} = \frac{4.17}{1.10} = 3.79
\]

i.e. for a 1 percentage point movement in yields, the bond price will move 3.79%.

Let’s now return to the composition of the benchmark portfolio. What could be said about the modified duration of the benchmark portfolio?

If the modified duration of a debt portfolio is low, the market value of the debt will not be very sensitive to alterations in interest rates. At the same time, with short intervals between interest rate resets, the borrower faces a high repricing risk. (If the debt has a modified duration close to 0%, the impact of higher interest rates will be felt almost immediately by the borrower.) On the other hand, if the modified duration of the debt is high, the repricing risk will be low but the market value of the debt is high, the repricing risk will be low but the market value of the debt will be quite sensitive to interest rate fluctuations.

To strike the right balance between the repricing risk and the market value risk is obviously a very delicate problem. However, as far as the benchmark
portfolio is concerned, this balancing of risks should not be the concern of the debt manager. As stated before, the benchmark portfolio should reflect the MOF's strategic objectives. In Sweden, the most important objective is that the total cost of the external debt should be as low as possible in the long run. Should the modified duration of SNDO's benchmark portfolio be low, high or in between to be consistent with the objective?

In retrospect, the best performing debt portfolio during the 1980s is easily calculated. With a falling trend in interest rates during the 1980s, a portfolio with a low modified duration has obviously performed much better than a portfolio with a high modified duration. Looking ten years ahead is a different matter. Long-term projections of interest rates are highly uncertain. If the MOF either lacks or does not want to express a firm view about the most likely trend in interest rates during the next ten years or so, the benchmark for the modified duration of the debt portfolio should be compatible with that posture. (The MOF could of course ask the debt manager to provide long-term projections of interest rates. However, if the benchmark portfolio is based on the interest rate view of the debt manager, to what extent should the accuracy of the debt manager's forecast be taken into account when his performance is evaluated?)

With total uncertainty, about the future trend in interest rates, the debt manager should adopt a strategy of risk minimization. Clearly, a debt portfolio with half of the loans at floating rates and half at fixed rates will always show an average performance regardless of the trend in interest rates. In other words, the risk of underperformance will be minimized.

Let's now try to calculate the modified duration of such a portfolio, beginning with the floating rate component. If, on an average, the next interest rate reset will take place in 3 months, the duration of the floating rate debt will be 3 months and the modified duration just below 1/4%. The fixed rate debt can be considered as consisting of a series of 10-year financings, which have been executed on a regular basis during the last 10 years. (In some markets it might have been possible to obtain maturities beyond 10 years. In other markets, however, the maximum maturity might have been limited to 5 years.) The average remaining maturity of the fixed rate loans will then be 5 years and the modified duration approximately 3 3/4%, as shown in the above example. The whole portfolio will then have a modified duration of about 2%. Consequently, the modified duration of the SNDO's benchmark portfolio has been set at 2%. At the same time, to insure that underperformance risk is limited and to provide ample scope for superior performance via active management of the debt portfolio, it has been decided that the modified duration of the debt should never be lower than 1% or higher than 3%.

There is, however, an argument to the effect that the modified duration of the SNDO's benchmark portfolio should be set at a lower level than 2%. The argument is based on an assumption that they yield curves will be upward-sloping for most of the time in most of the markets. The assumption certainly seems reasonable from a theoretical point of view. Furthermore, it is supported by empirical evidence. For a borrower, the optimal long-term strategy should then be to borrow at floating rates with the shortest possible interval between interest rate resets. By actively using different debt management instruments it would certainly be possible to keep the modified duration of the debt at 0% (or lower still). However, as already stated, such a strategy could easily give rise to excessive fluctuations in the cost of servicing the debt. In Sweden, such a development would be seen as unacceptable by the MOF.

To insure that underperformance risk is limited, the interval 2 + 1% applies not only to the total debt but also to each of the five currency groups shown in Table 9-1. (Since it is highly unlikely that the modified duration of the debt will be kept at the minimum [maximum] allowable level in all currency groups at one and the same time, the effective interval for the whole portfolio could be thought of as somewhat more limited than 2 + 1%.) However, for an individual currency group, the interval will be adjusted upward or downwards depending on the currency exposure in that currency group relative to the currency benchmark. Thus if the SNDO's currency position in an individual currency group is smaller (larger) than the normal position in that currency group (see Table 9-1), the interval for the modified duration of the debt in that currency group will simply be scaled up (down) by the ratio between the normal position and the actual position. That is, if the actual currency position in Japanese yen is 5.2% of the total debt (currently the minimum allowable currency position in yen) and the normal position is 8.2% of the total debt, the maximum allowable modified duration of the debt in yen will be set at $(8.2/5.2) \times 3\% = 4.7\%$. In the same way, the minimum allowable modified duration will be set at 1.6%. Clearly, this adjustment will have no effect on the minimum and maximum allowable modified dura-
tion in Swedish Krona terms. The minimum (maximum) allowable modified duration in Swedish Krona terms will still be 1% (3%) of the normal currency position (also measured in Swedish Krona terms) in the currency group in question.

B. Dynamic Management of Interest Rate Risk

Since it is impossible to catch the bottom or top of the interest rate cycle on a consistent basis, the approach taken by the SNDO is to set target rate levels over a range of rate movements, rather than attempting to catch one level. Although the target rates are meant to foster a necessary discipline, they must be used cautiously, since the SNDO must be ready to quickly change the strategy if rates move in the opposite direction. Normally, however, once targets are set, the SNDO waits on the sidelines until either the markets reach the targets or the targets are revised.

To illustrate this, let's assume that with the 10-year U.S. Treasury at 8%, the SNDO has come to the conclusion that U.S. interest rates are now low relative to the most likely, average level during the next couple of years and that although rates may continue to creep downwards for another quarter or two, the next significant change (1 percentage point or more) will be upwards. Under these circumstances the SNDO may decide to start increasing the modified duration in U.S. Dollars by entering into interest rate swap agreements paying the fixed rate (receiving the floating rate). With one such swap done with the 10-year U.S. Treasury at 8% the next target rate may be set at 7.85%, then at 7.70%, 7.55% and so forth. If rates eventually reach a bottom at 7%, the average level of the 10-year U.S. Treasury captured by the SNDO will be close to 7.5%, which, though not as favorable as 7%, certainly is better than 8%. In order to preserve flexibility the SNDO may also decide to buy a swaption (an option on a swap) giving the SNDO the right but not the obligation to enter into a let's say 5-year interest rate swap within let's say 3 months (the exercise period) as a payer of a predetermined fixed rate. Obviously, the higher the fixed rate is set, the lower the (premium) cost of such an option will be.

Interest rate swaps are but one instrument used to change the modified duration of the debt. For example, if the SNDO had decided to lower the modified duration of the debt, an alternative to an interest rate swap (receiving the fixed rate) would be to issue new floating rate debt and then use the proceeds to repurchase outstanding fixed rate debt. Another alternative would be to buy interest rate futures (call options on Government bonds) either on a futures exchange like LIFFE in London or over-the-counter. However, the choice of instrument is of minor importance in comparison with the decision to increase or decrease the modified duration of the debt.

IV. Performance Measurement

The SNDO's management of the debt portfolio during both the last 3 months and the last 12 months is reviewed at the beginning of each quarter. To start with, the total cost in Swedish Krona terms of the actual debt portfolio has to be calculated. The total cost has to be set against the average (time-weighted) market value of the debt portfolio during the review period in order to arrive at the total cost in percentage terms. When the total cost of the benchmark portfolio has been calculated along the same lines, the performance of the actual portfolio vis-a-vis the benchmark portfolio can be assessed. Obviously, if the debt portfolio consistently outperforms (underperforms) the benchmark portfolio, the SNDO's latitude to take on risk relative to the benchmark portfolio could be increased (decreased).
### Table 9-1: The Currency Composition of the SNDO's Multicurrency Benchmark Portfolio, 30th November, 1989. (Percentages)

<table>
<thead>
<tr>
<th>Currency Bloc</th>
<th>Minimum Position</th>
<th>Normal Position</th>
<th>Maximum Position</th>
</tr>
</thead>
<tbody>
<tr>
<td>North American</td>
<td>19.6</td>
<td>24.6</td>
<td>29.6</td>
</tr>
<tr>
<td>of which: USD</td>
<td>23.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>CAD</td>
<td>1.4</td>
<td></td>
</tr>
<tr>
<td>Strong European</td>
<td>30.7</td>
<td>35.7</td>
<td>40.7</td>
</tr>
<tr>
<td>of which: DEM</td>
<td>24.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>NLG</td>
<td>3.5</td>
<td></td>
</tr>
<tr>
<td></td>
<td>CHF</td>
<td>6.3</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ATS</td>
<td>1.8</td>
<td></td>
</tr>
<tr>
<td>UK pounds (GBP)</td>
<td>8.6</td>
<td>11.6</td>
<td>14.6</td>
</tr>
<tr>
<td>Other European</td>
<td>14.9</td>
<td>19.9</td>
<td>24.9</td>
</tr>
<tr>
<td>of which: FRF</td>
<td>5.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>BEC</td>
<td>3.8</td>
<td></td>
</tr>
<tr>
<td></td>
<td>DKR</td>
<td>7.1</td>
<td></td>
</tr>
<tr>
<td></td>
<td>ITL</td>
<td>2.9</td>
<td></td>
</tr>
<tr>
<td></td>
<td>PTA</td>
<td>1.1</td>
<td></td>
</tr>
<tr>
<td>Japanese Yen (JPY)</td>
<td>5.2</td>
<td>8.2</td>
<td>11.2</td>
</tr>
</tbody>
</table>
Figure 9-1

Deutschemark/U.S. Dollar

DM/US$ 52-Week Moving Average

Figure 9-2

Deutschemark/Pound Sterling

DM/SGP 52-Week Moving Average
10. Management of Currency Composition of Debt: Malaysian Experience

Hadenan Abd Jalil
Malaysia

The purpose of this presentation is to share Malaysia's experience in managing its foreign debt, especially in terms of currency composition. A full description of Malaysia's debt management system is given in Chapter 21.

I. Borrowing Policy Parameters

An appreciation of Malaysia's ability to manage its foreign debt must be seen in the light of its political, legal, economic and monetary policies working closely together. The Malaysian Government has financed development in part through foreign borrowing. The main reason being that the excess of Government current revenue over current expenditure (e.g. salaries, pensions, etc.) leaves only a small balance for development expenditure.

The amount of borrowing is planned over a period of five years, and is related to the Government's 5-year plan. The Sixth Malaysian Plan is now being prepared. Development programs and projects must be given allocation in the Plan before they can be implemented.

A total loan ceiling (both Domestic and Foreign) of the Federal Government is set by an Act of Parliament. The current level is set at M$30 billion for foreign loans and M$60 billion for domestic loans. At the end of 1989, outstanding foreign loan's were only M$25.3 billion. However, the ceiling may be changed if needed. The major proportion of borrowings by Malaysia is from domestic sources. At the end of 1989, 72.6% of Federal Government outstanding debt was from domestic sources, i.e. Government Securities and Treasury Bills.

The currency profile of Malaysia's external debt has changed over the years. (See Table 10-1). Between 1984 and 1987, yen-denominated debt increased from 13 to 35 percent of the total, and US dollar-denominated debt fell from 66 to 41 percent of the total. To reduce the impact of the appreciation in the value of the yen, an effort has been made to reduce the total volume of yen-debt, with some result evident at the end of 1989. In March 1990, Malaysia prepaid 30 billion of yen debt to further reduce the share of yen debt in total external debt.

Table 10-1: CURRENCY COMPOSITION OF MALAYSIA'S EXTERNAL DEBT (Percentages; end-year values)

<table>
<thead>
<tr>
<th>Currency</th>
<th>1984</th>
<th>1987</th>
<th>1989</th>
</tr>
</thead>
<tbody>
<tr>
<td>US dollars</td>
<td>66</td>
<td>41</td>
<td>42</td>
</tr>
<tr>
<td>Yen</td>
<td>13</td>
<td>35</td>
<td>33</td>
</tr>
<tr>
<td>All other</td>
<td>21</td>
<td>24</td>
<td>25</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Malaysia feels the following factors make it necessary for managing the currency composition:

(a) Not to be exposed solely to certain currencies especially "hard currencies";
(b) To enable the country to balance its obligations and debt service requirements;
(c) To balance off any drastic movement of one currency against another.

II. The Possibility of Currency Management

It is possible to control the currency composition of loans from financial markets. For example, the government may have the option of either issuing bonds in the form of "Samurai bonds" in Yen, "Yankee Bonds" in US dollars or "Bulldog issues" for Pounds Sterling. Alternatively, a syndicated loan in currency
Managing External Debt in Developing Countries

of choice can be raised. [Malaysia had used these approaches in the past. We have issued Samurai bonds last year, and we are planning to issue Yankee Bond this year].

However, it is not possible to control the currency composition of loans from official sources. Project loans provided by multilateral institution such as World Bank and ADB have the amount of the loan stated in agreement as US dollars equivalent. The actual currency exposure will only be known once the loan is fully disbursed.

Bilateral loans, i.e., loans provided on a government-to-government basis either in the form of soft loans or export/suppliers credits are normally contracted in the currency of the donor country. Thus, we have Japanese OECF loans in Yen, British ODA in Pound Sterling and even India providing suppliers credit in Indian Rupees. IDB members such as Kuwait and Saudi Arabia provide soft loans in their currencies. However, some countries are now willing to provide other currencies for their loans.

A. Determinants of Selected Currencies

It is worthwhile noting that foreign borrowing brings along with it an exchange risk. Nobody can predict the movement in the exchange rate and as such borrowings from the financial market are based on the best assessment of future value of currency in question. In the case of Malaysia, the Central Bank [Bank Negara Malaysia], being the government’s banker and institution that monitor and analyse movement of exchange rates, works closely with the Treasury in drawing up the loan program for the government.

However, it is generally true to say that choice of currency may be determined by the following:

(a) Currency composition of government reserves. A viable proposal will be to have the debt profile linked closely to the reserve composition. Any increase in the debt service due to appreciation of a currency may then be offset by corresponding increase in the reserves.

(b) Trading partners of the country. With trade being conducted with a country, it is natural that we should try to borrow in the currency with which our products had been sold. Malaysia is an oil producing and exporting country, especially to Japan. However, price of most commodities including oil is priced in U.S. dollars while imports for Japan is in Yen. Thus, we have a mismatch that needs to be constantly watched.

(c) Interest rates related to specific currencies may provide the reason for choosing that currency.

(d) Historical/past relationship especially for bilateral loans.

B. Methods of Management

The Malaysian government has been able to manage its external debt effectively due to a combination of factors. However, it needs to be highlighted that the commitment and prudent financial policies adopted by the government over the past few years has significantly contributed towards the objective. Furthermore, the economic performance over the last two years has made it easier for government to manage its foreign debt.

The management of the currency composition of external debt in Malaysia is made possible through the following methods:

(a) To prepay the existing loans. From 1987-1989, the government has prepaid M$6 billion of its external debt with a major proportion involving debt denominated in Yen;

(b) To refinance some of the existing loans;

(c) To begin using currency swap arrangements.

All the above methods have been possible due to the following factors:

(a) Availability of domestic funds. The size of funds from domestic sources especially that of the Employees’ Provident Fund is sufficient not only to finance current need for development expenditure but also to prepay the foreign loans. Funds in the form of domestic loan has been used to purchase foreign currency of prepay outstanding external debt.

(b) Malaysia’s financial credibility has made it possible for the government to carry out refi-
nancing activities in terms of improving interest rate and currency profile.

(c) Terms and Conditions of loans that allow prepayment and refinancing.

(d) Changes in the international financial market in terms of decline in interest rates of some currencies has been taken advantage of by Malaysian government.

III. Conclusion

The issue of managing the foreign debt will remain critical in 1990s. With an open economy and exports that are subjected to fluctuations and declines in price, the Malaysian government needs to manage its debt make it more sensible for funds to be generated internally for purposes of implementing development programs and projects.
11. Managing Currency Composition of Turkey’s External Debt

Yücel Irgat
Turkey

As a developing country, Turkey has been, since the early 1960’s, an important user of foreign funds that until recently were provided by international organizations and governments on concessional terms. These funds, mostly from member countries of the OECD Consortium for Turkey, and from the World Bank, the International Development Association, and the European Investment Bank, had the basic objective of assisting development, coping with balance-of-payments difficulties and enhancing investments. Later, during the 1970’s, both the sources and the types of loans were diversified. Weak access to international markets went along with short-term borrowings essentially from commercial banks.

Official rescheduling operations were repeated in the consecutive years 1978-1980. A stabilization program was instituted in early 1980, and some positive results were already achieved at the beginning of 1981; higher exports and workers’ remittances and slower growth of imports resulted in a reduction of the current account deficit. These improvements allowed Turkey to enter the international capital markets in 1981-1982.

In line with these improvements, the Turkish Government has started to implement a program beginning from 1984 aimed at reducing the rate of inflation and improving external performance by emphasis on export growth by improving balance of payments performance and regaining international creditworthiness. One aspect of this program has been managing the currency composition of the foreign debt.

I. Background

After the reschedulings in 1981, Turkey’s debt service was projected to be small until 1986, but to jump in 1986 due to the expiration of grace periods. Also, with the increase in total amount of external debt due to the new borrowing to cover principal payments and the gradual replacement of concessional credits by normal market borrowing, Turkey’s debt burden has increased substantially in the past few years. Nevertheless, Turkey was able to meet its debt service obligations on a timely basis.

The characteristics of Turkey’s foreign debt are:

(a) The total external debt of Turkey was $41 billion as end of 1989. Of this, 86% consisted of medium-and long-term debt.

(b) In the period of 1984-1989, the share of concessional bilateral credits and of OECD Loans decreased to 24 percent and to 23 percent from 29 percent respectively. At the same time, the share of borrowings from commercial banks and financial markets increased to 24 percent from 17 percent.

(c) The currency composition of external debt changed as follows from 1984 to 1989: The share of US dollar decreased to 34.5 percent from 42.7, mainly due to the adjustment of IBRD’s Currency Pool, and the share of Japanese Yen increased to 14.1 from 6.6. The share of DM shows increased from 22 percent to 34.4 percent.

Regarding the currency composition of new borrowings, dollar denominated borrowings constituted 52 percent in 1986 and 44 percent in 1987, while dollar denominated borrowings were about 60 percent and non-dollar borrowings about 40 percent 8 of total 1988 and 1989 borrowings to change the currency composition of funds away from yen-denominated towards US dollar and other currency-denominated funds. In contrast to this, the proportion of Yen borrowings declined between these two years, as did borrowings in Deutsche mark.

The shift from Yen and DM loans to US-dollar loans contracted in 1988 and 1989 which was 8.9 percent pushed up the average interest rate on outstanding debt. At the end of 1989, the average interest rate was 6.5 percent and the average maturity was 15 years as compared with 5.3 percent and 18.8 years in 1984.

The percentage of floating rate debt in total medium-and long-long-term external debt reached 37.3 percent in 1989 and 38.2 percent in 1988. Turkey’s
A. Objectives of External Liability Management

The Government intends to manage its external liabilities with respect to Turkey’s overall economic and financial exposure and thus the non-interest current deficit. The currency composition of Turkey’s capacity to generate foreign exchange will be related to the following four factors:

(a) the composition of the currency basket with respect to which the Government manages the domestic currency;
(b) the country’s external trading pattern, exports, and imports, as well as the pattern of other goods and services flows including workers’ remittances but excluding interest payments;
(c) the currency composition of the country’s non-interest current account flows;
(d) the relation between the country’s term of trade movements and cross-currency exchange rate changes.

Within the framework of these factors, Turkey has some imbalances with respect to the US dollar, the Japanese yen in her currency composition of external debt stock. For this reason, Turkey intends to limit or reduce the share of Japanese yen liabilities and increase the share of US dollar liabilities. Taking into account the slightly high US dollar share of medium-and long-term debt service compared with the US dollar share in the medium-and long-term debt stock Turkey has a currency mis-match over the long term.

Beyond 1990, the currency mis-match in debt service increases as yen and other non-US dollar debt service payments will be coming due. Thus, it becomes important for Turkey to pursue one or more of these objectives: (a) achieve a better diversified trading pattern and currency composition of non-interest current account flows, (b) improve the net trade position with Japan or (c) limit, and possibly reduce, the share of Japanese yen in medium-to long-term borrowings.

Turkey’s gross foreign exchange earnings from merchandise exports and workers’ remittances, is largely with the EC and the Middle East, the economies of which are predominantly based on the US dollar.
The balance of Turkey’s trade and other goods and service flows with the EC (as a whole) and German individually is in surplus, while the balance with Japan and the United States is in deficit. On the other hand, the shares of US dollar and Japanese yen in the external debt stock are relatively large. Therefore, Turkey wants to offset her currency composition according to her trade pattern.

B. Achievements

In order to hedge or limit its exposure, the Treasury tends to structure its external liabilities to match that of its external assets. Therefore, the Treasury aims at accomplishing the management of external debt as focusing on the following topics:

(a) a more detailed annual borrowing plan, taking into account expectations regarding debt service payments, pipeline disbursements, trade and other flows, market opportunities, export and import trends within the harmony of the five year plan and its annual program;

(b) new borrowings designed to adjust the existing stock of debt toward a wider diversification and expansion of markets and instruments;

(c) training to enhance the technical capacity of staff;

(e) swap transactions.

To support these objectives a new computerized system debt management system was introduced in 1984 to monitor medium and long-term loans. This system, the "External Debt Information System", is capable of computing exact debt-service payments, collecting data, and providing projections on medium-term and long-term liabilities. It also provides analysis on such topics as the impact of new borrowing on the structure of debt-service obligations, on foreign exchange rate changes, or a comparison of borrowing costs. The data base is now regularly updated. The quality and also coverage of data have been advanced continuously. A description of this system is given in Chapter 26.
Over the past three years Turkey has successfully pursued a borrowing policy directed to diversifying its sources of funds in international capital markets and to improving the terms of borrowing.

Throughout the 1980's Turkey had, on a number of occasions, made use of traditional syndicated loans for both balance of payments purposes and project finance. It was only in 1987 that fixed rate DM bonds were issued in Frankfurt. Since then, another seven issues totalling DM 2.3 billion were completed in Frankfurt while seven further issues amounting in total to $1.4 billion were done in the London Euromarket. Concurrently, dollar and Yen syndication markets also made the borrowing of approximately $350 million possible.

In addition to the continuing goal of maintaining and enlarging the sources of financing, Turkey sought to reduce its cost of funding and to extend maturities. At present, every loan offer submitted to the Treasury is assessed in the light of the following criteria:

(a) improvement of the spread (over LIBOR or US Treasury rate) over previous transactions;
(b) improvement of the maturity (longer maturity, longer grace period or absence of put option);
(c) the amount of the transaction;
(d) improvement in other terms and conditions (e.g., prepayment, reduction in expenses);
(e) the entry to a new market; and
(f) the establishment of a new instrument.

It is obviously not possible to meet all of these criteria for each transaction. However, in most cases, one or two of these goals will be given priority over the others; and, perhaps, some other goals will be disregarded for the better attainment of one particular target.

The borrowing program is designed at the beginning of the year taking into consideration the availability of the markets for Turkey. A typical program for $1 billion would include two bond issues in the London Eurobond market, one bond issue in the DM market, one dollar syndication and one public placement in either the US or Japanese market. The program is not disclosed to the lenders except for the annual global amount. With the degree of volatility present in the markets, it is essential to remain flexible in the selection of the instruments and markets throughout the implementation of the borrowing program. A good example of the changes in the borrowing environment has been the effects of the political factors in Japan this year and the announcement of the unification of Germany. It was totally unpredictable that such events would take place only a few months before they did.

Bond issues are likely to remain in Turkey's borrowing program for a number of years. This is not only because of the advantages of having a large investor base but also because bond markets usually require the recurrent presence of the issuer in the market to maintain a minimum level of liquidity. The absence of the issuer from the market for two consecutive years may narrow down the investor base.

In addition to the above criteria, due consideration is given to keeping the market clear for one another among the borrowing entities of the Republic, i.e. the Treasury guaranteed parastatal transaction or the Central Bank. Similarly, development banks do private placements in the Tokyo market one at a time to avoid competing with one another.

As the result of the determined observance of these targets. Turkey was able to go a long way in a relatively short period of time. In the DM market,
maturities went up from 5 to 7 years while the issue amount increased from DM 125 million on the first issue to DM 400 million on the 4th issue. Also, while the spread over LIBOR was 300 basis points on the first 5 year issue, and 320 basis points on the first 6 year issue in 1988, in 1989 a 7 year issue could be concluded at LIBOR plus 140 and yet another at 65 b.p.

To date, Turkey has concluded seven issues in the London Eurobond market. A similar pattern occurred in this market, i.e. Turkey had to pay higher spreads for lower amounts and shorter maturities at first but gradually improved its status. The first issue in 1988 was for a 10 year maturity which had put options on the 3rd and 6th years. On subsequent issues the put option was extended to the 5th year and a reduction of 5 basis points were achieved each time. At the end of 1989, Turkey paid 150 b.p. over LIBOR for a 7-year issue which had no puts at all. By March 1990, it was possible to do a 7-year bond, this time at a price of 135 b.p. over LIBOR.

Two exogenous factors supported the Turkish team’s efforts to achieve these targets. First, the creditworthiness of Turkey was improving in the light of indications that the economy was strengthening. In particular, Turkey registered a current account surplus both in 1988 and 1989 after long years of continuous deficits. Secondly, after a sizeable increase in fresh borrowing in 1987, this trend was reversed; and Turkey reduced its annual borrowings both in 1988 and 1989.

While Turkey was asserting its place in the Eurobond market, other alternatives were studied. Particular emphasis was given to public placements (i.e., the Yankee market in the US and the Samurai market in Japan). Floating rate notes, ECU bonds, Euro yen’s, options and swaps were studied and evaluated in terms of their appropriateness for Turkey. Acquaintance with these markets made it evident that Turkey needed credit assessments from the US rating companies. Standard and Poor’s was invited to Turkey in October 1989 and Moody’s in early February 1990.
13. Finance for Development

Summary of the Discussion

Rapporteurs:
- Mr. Abdul Hameed Zakariyya, Maldives
- Mr. Said Mahmoud Hammoud, Palestine
- Mr. Jameel Abdulla Mukashaf, Yemen (PDR)
- Mr. Alaa Mohie Eldin Abdo, Sudan

A presentation was made by Dr. Ishrat Husain of the World Bank on "External Loan Financing Sources, Terms, Direction and Prospects". It was noted with emphasis in the presentation that the available external financing in the 1990s would be insufficient to meet the financing requirements of the developing countries. The gap would be mainly due to contractions in commercial bank lending as compared to levels that existed in the 1970s. It was underlined that the 1970s was an exceptional period, as the commercial banks then had extraordinary deposits which were created by increases in oil prices. Unserviceable huge foreign debts of the developing countries had eroded their creditworthiness which adversely affected the flow of finance from the multilateral institutions and contributed to the financing gap.

The aggregate net transfers to the developing countries had been negative since 1985, and at the end of 1988 stood around $9 billion. It was revealed that at the beginning of the 1980s private flows had exceeded the ODA, with private flows accounting for 59 per cent and ODA for 41 per cent of the total finance flows. The private flows, however, continued to decrease until 1988 when a new trend with ODA flows in the lead set in. ODA has, however, remained stagnant and is expected to increase by an insignificant 2 per cent during the period 1990-1995.

A resumption of finance flows to the original volumes, it was argued, would require policy changes by the developing countries. Several countries have rescheduled their debts and have instituted austerity measures in order to buy time, revitalize their growth and restore creditworthiness.

The change in the origin, amount and type of capital flows continues, nonetheless, to impede the economic growth of these countries thus dragging them into a vicious circle. Excessive borrowing has created an environment which has made growth more difficult, while growth is essential to service debts and regain creditworthiness.

Although several countries have successfully sought rescheduling of their debts, the World Bank has not rescheduled any of its debts fearing that its role as an intermediary in borrowing would be affected adversely. World Bank rescheduling, it was argued, would push up costs and affect amount of its borrowing from other institutions.

Donor countries and international financial institutions are, at present, more inclined to offer financial resources to those countries exhibiting policy changes and potential for accelerated growth. In this context, it was recognized that there exists severe competition of the limited resources. Lenders have become selective, it was acknowledged. Thus, the need for a certain set of policies to attract funds was underscored. The argument was illustrated by the allocation of Japan's ODA mainly to India, China, Turkey, Philippines and Indonesia. This concentration on preferred countries, it was maintained, had led to the call by some developing countries for disbursement of ODA through multilateral channels.

Countries need to spend their borrowings wisely and in projects with quick and high rates of return.

It was pointed out that the financing gap would, in the short run, be adjusted by reducing imports, or through import substitution measures and increasing exports. These measures, it was expressed, should, however, be complemented by seeking alternative forms of financing such as direct investments, portfolio investments or project finance. Domestic borrowing and privatization were also noted as measures providing resources and relieving pressure on government financing respectively.

The financial crunch, it was recognized, has awakened the developing countries, which, until recently were inclined to look at direct private foreign invest-
ment with suspicious eyes. They are now vying for such investment as well. With the emergence of Eastern European countries as potentially attractive candidates for foreign investment recipients, the competition among the developing countries has become more acute. The prospects for increased financing appear dim, and in the wake of enhanced competition, several references to the contribution to growth by the private sector were made.

Discussions among the participants noted that Turkey had been able to make timely repayments of its loans after rescheduling, thus maintaining its creditworthiness unharmed. Turkey has also successfully penetrated international financial markets, offering a variety of instruments. The borrowing strategy of Turkey at present is diversification of markets and instruments so as to open up the way to as many alternatives as possible. At present the focus is to prolong maturities while narrowing down the spreads and improving the terms. The first issues in the Euromarkets had been for relatively small amounts, and Turkey had to pay higher margins. Gradually the spreads were cut by half while maturities were extended from 5 to 10 years. Turkey has diversified its economy, and borrowing takes place with due attention to the currency composition of existing debts.

Malaysia's policy, it was stated, is to borrow for development. Its revenue, it was disclosed, sufficed only for operation. Much of the borrowing is domestic with a considerable portion coming from the Employees Provident Fund for which borrowing a variable interest rate is applied. There are ceilings for internal and external borrowings, but the ceilings have not been reached yet. Borrowing is sought seriously for implementation of projects in the Malaysian Development Plan, which is a 5-year Plan the budget of which is reviewed annually.

It was concluded that the problem of debt is huge. It cannot be solved by technical measures alone. In the view of some participants, the debt problem has to be tackled at political levels in the framework of a serious specialized international conference, because real development seems to be impossible under the current circumstances.
Part III - Organization for Debt Management

14. Introduction

The problem of debt management is largely one of effective organization. While the precise institutional arrangements for debt management differ between countries, all countries face similar problems. Ishrat Husain presented his paper, "Functions and Organization of a Debt Office" (Chapter 15), pointing out that there are five elements of debt management and that explicit arrangements must be made for carrying out each of them. This includes coordination, a task that is often neglected. During the discussion period, representatives of Yemen, the Maldives, Kuwait, Sierra Leone and Turkey explained what arrangements were made for debt management in their respective countries.

The seminar examined in detail problems in the administration of foreign borrowing. Thomas Klein led this session, basing his remarks on a paper contributed by Lars Kalderen, former Director of the Swedish National Debt Office. In this paper (Chapter 16), Kalderen pointed out that governments must establish separate groups to arrange for borrowing from bilateral and multilateral aid agencies (for concessional loans), from export credit agencies and from financial markets. To use diverse sources of finance most effectively, the ministries of finance and plan, and the beneficiary agencies, must be able to evaluate the benefits of alternative financial packages, to negotiate effectively with lenders and to execute and service loans after they have been signed. Accordingly, for each type of credit, there must be a staff and a review process appropriate for each major type of external finance. In addition, and most importantly, there must be a central unit - a foreign finance committee - that establishes overall debt management policy and coordinates its execution.

The rapporteurs for this section of the seminar emphasized the importance of recognizing each of the various elements of debt management and emphasized the significance of the classification scheme presented to the seminar (Chapter 17). They noted that it provided an useful tool for evaluating the effectiveness of national debt management systems.
15. Organizing for Efficient Debt Management

Ishrat Husain
World Bank

External Debt Management refers to the technical and institutional aspects of organizing the external liabilities. The technical aspects focus on the need to determine the level of external resources required and to ensure that terms and conditions of those borrowings are commensurate with the future debt service capacity of the country. The institutional aspects deal with the administrative, organizational, legislative, accounting and monitoring of new borrowers as well as the total stock of debt.

I. Operational Units

The assessment of level of external borrowing, its composition and the terms and conditions at which new resources are borrowed is usually related to the macroeconomic goals and balance of payments projections. In the session today, we would talk about the institutional aspects of external debt management, i.e. the current practices as to how the national debt office is organized vary from country to country and are a function of historical precedent, constitutional division of responsibility between various tiers of governments, the relative role and limits of decision-making provided to the private sector, the internal organization of the government itself and the importance of external debt in the overall economic management. Thus, to argue as if one particular model of organizing a national debt office is superior to others would be tantamount to fanciful thinking. But there are a number of known functions and processes in the management of debt that have to be performed irrespective of the particular mode of organization. For example, there should at least be several units with clear and distinct terms of reference, manned by personnel with different types of skills. These units should also be able to interact or feedback into each other’s work in a coherent manner.

The exact manner of such units or a combination of each unit may also vary but there are a few units that are a "must". The inter-relationship of these units is shown in Chart 15-1 at the end of this chapter.

The first unit is the policy making and approving body that not only coordinates the activities of different government agencies dealing with external debt. This body, comprising of heads of economic ministries, such as Finance, Planning, and Central Bank decides how much should be borrowed in a particular year, indicates broad parameters about the type of borrowing, gives general guidelines about foreign borrowing policy to other borrowing entities, including private borrowing if this function is decentralized, and approves the annual borrowing program of the government and/or public enterprises.

Private debt is not subject to prior approval in a few developing countries which only require ex-post registration with the Central Bank or the Ministry of Finance. In most other countries, it has to be approved by the Central Bank on a loan-by-loan basis. In some instances, approval may be automatic if the loan meets conditions of minimum maturity and size, and/or if it is for certain types of projects.

The second unit is a control unit that usually performs staff function or the secretariat for the policy body. It usually approves the direct government borrowing or delegates the powers up to certain limits or for certain projects to other tiers of the government, chosen public enterprises financial intermediaries or other specified entities. This unit carries out analysis and makes recommendations about the sustainable level of debt servicing burden and the composition of the foreign borrowing appropriate to that level.

The control unit also ensures that guidelines and instructions issued by the Policy Committee to the Operational Units (to whom the powers to borrow are

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1 The author, at the time of the seminar, was Chief, Debt and International Finance Division, World Bank. The views expressed in this paper are th personal views of the author and do not necessarily reflect those of the World Bank.
delegated) regarding negotiations of loans or guarantee agreements, on-lending terms etc. are carried out and implemented.

The control unit also continually assesses the impact of new borrowing on overall debt structure, makes projections of payment obligations so as to coordinate the draw-down of loans with reserve management, and also the risk of private capital outflows and guarantees being invoked. It may decide to prepay or refinance to take advantage of new loans at better terms or in more desirable currencies, or avoid accumulation or bunching of debt servicing by altering the commitment and disbursements patterns of various types and from various sources e.g. delaying certain public sector commitments, slowing down private sector approvals or regulating short-term borrowing in an effort to extend average maturities.

The third unit is an advisory unit which acts as a central focal point that follows trends in international financial markets, interest rate and currency developments and analyzes and appraises different types of financial instruments and their relevance, applicability and use by the country. The unit monitors the market access and capacity, lender characteristics, volume, cost of borrowing, time to enter the market and advises the government on the best available borrowing opportunities at most favorable and acceptable terms. This unit is particularly useful for the market borrowers who float bonds, syndicated loans and other commercial papers in the international financial markets.

The operational unit, i.e., either the financial intermediary that borrows abroad, the parastatal, the State Government or other authorized borrowing entities, should appraise all proposals concerning external debt to be raised with respect to the type of lenders, interest rate, currency of disbursement and repayments, maturity, grace period, fees and commissions, prepayment options, default options and other characteristics of the loan. On the basis of this appraisal, it either makes recommendation to the control unit for approval by the Policy Committee if the amount is beyond its ceiling or approves the proposal if it falls within its purview. The unit then either selects the lead manager for commercial floatation or directly participates in the negotiations of all loan contracts. It reports all transactions, drawdowns, interest and repayments of principal to the Statistical Unit.

The important functions of registration of all agreements and contracts negotiated by each authorized borrower, collection of detailed loan-by-loan information and providing for the timely payment of amortization and interest due are entrusted to the fifth unit i.e. the Statistical and Accounting Unit. The Unit also keeps track of all government guarantees provided for private debt.

The unit establishes a loan working sheet for each loan negotiated, and signed by the Operational Unit and registered with the Statistical Unit. Transactions against each loan are recorded as they take place and for planning purposes, projected disbursements against undrawn balances and repayment of principal and interest as due are made.

At the disbursement stage, evidence from lenders such as statement of account, debit advice, withdrawal authorization or notice of disbursement is recorded. The repayment schedule for the loan is drawn up and recorded on the loan working sheet. After the operational unit the Ministry of Finance (MOF) or the Central Bank makes the repayments according to the schedule, these are recorded on the loan working sheet and the outstanding balance of each loan calculated.

The Statistical and Accounting Unit then prepares a monthly or quarterly status report on the overall debt situation of the country and projections for the near term. The report usually contains the following summary information:

(a) Outstanding debt at the end of the preceding fiscal year and at the end of the preceding quarter (by currency debt instrument, interest rate, maturity, type of borrower, type of creditor).
(b) Cumulated interest payments in the current fiscal year through the preceding quarter.
(c) Cumulated gross borrowings and debt repayments in the current fiscal year through the preceding quarter.

II. Location of Debt Office

The location of a debt office in the appropriate Ministry or the Central Bank of a country is an important issue but for which no general satisfactory answer can be found. This will be determined on a case-by-case basis depending upon the distribution of functions, delegation of authority and the configuration of responsibilities among various government ministries and agencies. In essence, there are two parallel sets of considerations. The first one is how the various functions relating to management of debt are allocated.
The general pattern that can be discerned is that at least four entities are involved in varying degrees. The power to negotiate, approve the amount of new debt incurred and identifying the sources of external finances usually rests with the Ministry of Finance. The allocation of foreign resources among various development projects and investments and monitoring of its utilization are performed by the Planning Ministry. The integration with balance of payments and reserve management, foreign exchange approvals and remittances for servicing the debt fall within the domain of the Central Bank. Among countries with access to international markets, the Central Bank also manages the amount, timing, currency, instruments and modalities of participation in the markets. The actual transactions, i.e., receipts and payments in local currency on obligations due on loans to public sector, are handled by the Accountant General. Finally, the statistical function is either centralized or fragmented among the various agencies.

Besides the functional divisions, there is the division of responsibilities across the types of external financial flows. In some countries, the flows from multilateral development banks are handled by the MOF; the Central Bank deals with the IMF, private non-guaranteed and short-term debt; the Ministry of Economic Cooperation or Planning is responsible for bilateral grants and loans while commercial bank lending is restricted to a select group of borrowers. This can be illustrated with the example of China. The MOF has the responsibility for the World Bank; the Peoples’ Bank of China for the Asian Development Bank and the IMF; the Ministry of Foreign Relations and Trade for bilateral loans and grants; the Bank of China, CITIC and a few provincial Investment and trust companies for commercial bank loans, international bond flotations and private placements. The State Administration of Exchange Control records, maintains, compiles and publishes comprehensive data on the country’s external debt situation.

The diversity in assignment of responsibilities across functions as well as types of borrowing do not make it easy to provide an unambiguous answer to the appropriate location for the debt office. In practice, it may not be feasible to combine all these functions and responsibilities and centralize them in one debt office. The more pragmatic approach is to establish a centralized statistical unit that coordinates and integrates the data gathered by the various decentralized participants of the system and prepares a comprehensive report for the high-level policy committee. If this unit has the analytical capacity, it would be an added advantage but the same data can be analyzed from different perspectives and viewpoints for different purposes by the MOF, Planning and the Central Bank and their findings presented to the policymakers.

However, if a country concludes that the balance of convenience lies in the creation of a centralized debt management then it should be ensured that sufficient legal and administrative powers are vested in the office to carry out its functions. If the debt office is to be held ultimately accountable for the accuracy, timeliness and comprehensiveness of the data and efficient management of the country’s debt it should have the commensurate authority, status and powers. The ready access to the higher echelons of the government can reinforce the perception among the concerned agencies that the debt office has the support of the authorities in eliciting and enforcing compliance of the reporting requirements.

To summarize, effective debt management requires that several important functions are performed. In some countries, where the debt is limited to official concessional sources it is quite conceivable that one or two units can combine the above described functions. In other cases, where a whole array of borrowing is carried out, all the five units may be needed. The choices of the particular organization is determined by the peculiar circumstances of each country.

The functions and appropriate organization are a necessary but not a sufficient condition for good debt management. The quality and skill mix of personnel manning these units and the procedures and methods adopted are equally important. Also the status of the debt office in the bureaucratic hierarchy and thus its access to the policymakers are also important ingredients.
Organizing for Efficient Debt Management

Chart 15.1: THE ORGANIZATION OF DEBT MANAGEMENT

- **Policy Committee/Unit**
  - (how much to borrow)

- **Control Unit**
  - (who should borrow)
  - (how much control)

- **Advisory Unit**
  - (where to borrow)
  - (at what terms)

- **Statistical/Accounting Unit**
  - (who should monitor)

- **Operational Unit**
  - (who applies, negotiates, utilizes and reports)
16. Institutional Aspects of External Debt Management

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The present paper aims to sketch out the demands of effective management of a country's external debt on the organization and staffing of the government units involved, and on the relationship between them. It assumes that the government has the ambition not only to conduct proper debt management policies at the macro-economic level, but also to be informed of and control the details of debt owed by the government and - to a greater or lesser extent - by the private sector. This will enable the government to project future debt levels and debt service payments with accuracy, and to work with and improve debt portfolios in order to smooth out amortization profiles, reduce costs and spread exchange and interest risks.1

Obviously, there is no universally accepted textbook model for the institutional arrangements most suitable for external debt management. Each country will have its own set-up, determined by historical evolution and the circumstances of today. But some factors are common to all countries that have been reasonably successful in managing their debt.

First, the main agencies concerned should all have a clear idea what the government's debt management policies aim to achieve and their own role in this endeavor. To understand and execute that role requires staff units of high competence in each agency. But successful debt management also entails developing and maintaining well-defined and smoothly functioning relationships between the agencies. The more plentiful the players are, the more difficult this will be; and the complexity of the system will also depend on the kind and volume of debt contracted and its rate of turnover and increase. When these are low, debt management can be fairly simple and unsophisticated because the costs of faulty decisions based on insufficient information and minimal staff work are also low.

Most developing countries have obtained credits on concessional terms from governments and multilateral development institutions for many years, and have set up units in their government to manage such debt. They have also contracted export credits and developed ways to negotiate and administer such debt. In recent years, and particularly during the two oil-price increases of the 1970s, many countries have borrowed extensively on commercial terms from international banks and capital markets. This has added a new dimension to their debt management responsibilities, and put new demands on a number of government agencies and on the coordination of their activities.

In the following paragraphs, to simplify presentation, we shall consider the three kinds of finance - concessional aid, export credits and market loans - and their institutional demands as successive stages of development in debt management.

I. Concessional Loans

Most developing countries are clients of multilateral development institutions such as the World Bank and the regional banks, and they also contract grants and bilateral loans on soft terms from governments in other countries. Development loans are of many kinds, from largely untied balance of payments finance (IMF credits, structural adjustment loans, etc.) to loans that are closely tied to major projects included in a long-term plan for the country's economy, or to the execution of a sector program. Special variants are commodity credits, tied to purchases in the country of the lender, and institutional credits to local development banks for on-lending to many small borrowers. Major project loans are often made not to the government itself but to independent public or private corporations.

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1 This paper was originally published as World Bank, External Debt Division. Division Working Paper No. 1986-03, October 1986.

2 The author was Director General, Swedish National Debt Office, 1977-86.
16. Institutional Aspects of External Debt Management

and companies, with a state guarantee. Different types of finance require different administrative set-ups and procedures for borrowers, and a variety of techniques are applied in most borrowing countries. The following remarks and suggestions are therefore neither comprehensive nor universally applicable.

A common characteristic of concessional loans is that the preparation and disbursement stages are often very long and laborious, whereas the repayment phase is generally rather uneventful and gives little scope for deftness on the part of the debt manager. The financial terms of concessional loans are more applicable to developing countries than straight commercial finance, and loan procedures associated with concessional borrowing encourage a more thorough initial assessment of their usefulness for the national economy than is true for straight commercial finance. Loan offers must thus be judged against the expected return on projects that they are intended to finance, or against the financing needs of a particular sector of high priority. Ideally, whatever commercial finance from banks and the international credit and capital markets is required and is available as an addition, should be attached as co-finance to the concessional loans.

A. Preparing the Ground

As with other types of finance, a concessional loan is easier to manage - particularly in the drawing stage - if the agreement has been carefully thought through and negotiated, emphasizing flexibility in drawdown procedures as well as in repayment so as to keep financial flows in line with the actual development of the project. The borrower will need good lawyers, capable of preparing a first draft of the loan agreements and related documents (notwithstanding the fact that the lender probably wants to base the negotiation on his draft), drawn up according to the laws of his country. Commodity credits should be treated with special caution by the borrower; if tied not only to sources of procurement but to projects as well, they may turn out to be difficult, costly and time-consuming to use. Loans to local development banks need carefully drafted agreements to avoid being encumbered with on-lending restrictions. Borrowers should also try to avoid restrictions on the use of amount generated by differences between the terms of the loan to the country (which should be soft) and those of the loan from the government to the bank or from the bank to the ultimate user of the funds. These should be on commercial terms, to promote the development of local financial markets.

Debt service schedules on concessional loans should be designed to ensure, as far as possible, smooth repayment curves for the country's total debt in future years, and an even spread of interest payment dates for public sector credits throughout the year. This will avoid peaks in the outflow of funds and in the workload of Ministry of Finance and Central Bank staff. Concessional loans may not leave much choice to the borrower with regard to the currency in which they are paid and must be serviced, but if some flexibility can be negotiated, particular attention should be paid to matching loan service with the currency streams that the project is expected to generate, in order to minimize foreign exchange exposure.

B. Who Participates?

Concessional loans should stem from close collaboration between the Ministry of Development Planning, a spending agency, the Ministry of Finance and the Central Bank. In the planning process, a spending agency will propose new projects and programs to the Ministry of Development Planning, which will assign priorities and decide on the size, timing and cost of new activities. These will be determined within the limits set by the projected growth of real resources and the amount of imported capital likely to be available (according to the Ministry of Finance and the Central Bank). The Ministry of Finance should advise the Ministry of Development Planning on the financial aspects of projects and programs - are they likely to attract external finance and how should they be presented? - while reserving contacts with lenders to itself. The advice of the Central Bank should normally be channeled through the Ministry of Finance rather than brought to bear directly on projects. Once properly prepared and included in a plan, a project will be submitted to the Ministry of Finance for final approval, with a request for financing, part of which could be external while part will be domestic budget funds. After the loan agreements have been signed (and documents distributed as widely as necessary to reach all concerned), disbursement will be watched by the Ministry of Finance and progress in project implementation discussed with the spending agency. The Ministry of Finance will retain strong control over the use of funds, and the budget process should release foreign
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Loan money at the rate at which projects are actually implemented.

Many countries have found it useful to have an external finance unit in the Ministry of Finance, as liaison between foreign lender and national spending agencies. Staff of that unit must be familiar with their own planning process and a number of spending agencies, so they can present their financial needs to the lenders. They must also - as their main specialty - know the policies and procedures of major lenders of concessional finance. Their tasks are to maximize the volume and optimize the use of each lender’s agreed volume of lending, by mastering the peculiarities and constraints of individual lending agencies. Their knowledge (largely derived from personal contacts with lending country officials) will be used to advise the Ministry of Development Planning on the amount of external finance available and for what kind of projects or programs, and to assist the spending agencies to prepare projects for concessional borrowing. Their advice will also be of use to the budget department of the Ministry of Finance whose task it is to allocate and release domestic and foreign funds to individual budget items, and which therefore needs to know precisely how much loan money will be available for a particular period.³

C. Other Tasks

The loan provisions for accounting and reporting must create a system which allows the Ministry of Finance, the spending agency and Ministry of Development Planning to follow the progress of project execution and loan disbursement. Accurate reporting will help the government determine its budget, and also prepare new projects, extend ongoing programs, and canvass for additional funds. This is important because concessional funds can be made available by the lender either as advance payments, as reimbursement of expenditures made, or as direct payments by the lender to a supplier. Since the difference between an early advance and a delayed reimbursement for a particular item of expenditure can be a matter of years, the accuracy of bookkeeping and accounting is crucial for proper budget management whenever external loan finance is involved. Good records will be needed for making adequate projections, preparing timely requests and checking the actual disbursement of loan funds.

The external finance unit should help the accountant general of the Ministry of Finance reconcile the government accounts with the streams of payment from the three kinds of external finance referred to in the previous paragraph. For prepayment, the external finance unit may have to check that receipt of foreign funds - normally by the Central Bank - leads to a quick release of domestic funds to spending agencies and does not delay progress in project execution. For reimbursement, the problem may be the slowness of the spending agencies to prepare requests for foreign exchange to the lender, after they have spent the local currency.

During the life of the loan, the lender wants to receive reports on how funds are spent and on the progress of any project financed by the loan. Such reporting requirements, which often vary from lender to lender, can be quite onerous and the borrower should encourage the lender to accept standard government agency reports. Accurate and timely reporting is, however, important to the lender and should be equally so to the borrower, since it will inspire confidence among the lenders and encourage them to increase the volume of finance they are prepared to offer on concessional terms. It is, therefore, particularly important that the external finance unit makes every effort to have spending agencies fulfill their reporting obligations without delay.

Procurement of goods and services for projects and programs can affect the way foreign loan funds are used and the ability of the project to generate debt service. This is a science in itself and is not dealt with in this paper.

Increasingly, debtor countries are registering debt data in computer systems. Again, this is a science in itself and will not be further dealt with here, except to make one point.⁴ Computers can process an enormous amount of data, but it is still worthwhile for borrowers servicing many smallish loans with long maturities to consolidate their debts from the same lender into one big loan. The savings in administrative effort can be substantial and will also facilitate debt management by speeding up various processes such as simulations, etc. An opportunity to streamline often arises during rescheduling when there is a dialogue with each lender about the full range of bilateral financial relations, but need not be limited to such an extraordinary state of affairs.

II. Export Credits

Although the distinction between concessional loans and export credits is not always clear, since the
mixed credit is becoming more common, export credits are a well-defined concept that has evolved over the past fifty years. Public or officially recognized lending and/or insuring agencies exist in all major exporting countries, with networks of international cooperation among them: the Berne Union for guarantors and the Arrangement of Guidelines for Officially Supported Export Credits (the Consensus) supervised by the OECD, for subsidized finance. The importance of export credit flows, and the behavior and attitudes of ten major official export credit agencies and their national authorities, have been described in a study by Brau and Pukachtikom (1985). A similar study of borrowers of export credits would be most welcome; in its absence, the following remarks are somewhat impressionistic.

Generally speaking, export credits should be an attractive form of finance to borrowers who are able to negotiate and handle them properly. They provide fixed interest funds (if the borrower so wishes, but floating interest rates can also be arranged), diversification of currencies, longer maturities, and lower cost than direct capital market financing (because of the element of government support, which is particularly attractive when it takes the form of a subsidy of financing costs). They are an additional source of funds to concessional loans as well as to commercial banks and the bond markets, and are normally available as long as the borrower is prepared to buy goods and services from the country of the lender and the borrower maintains its creditworthiness.

Like concessional loans with a project or commodity content, export credits involve spending agencies in borrowing countries as well as central government authorities like the Ministry of Finance and the Central Bank. In addition, ministries of Commerce and Industry may be involved for a number of reasons; perhaps because export credits are used to finance imports of industrial inputs or consumer goods against licenses, or because such credits are the concern of offices responsible for the country's own export lending. The "peripheral forces" against which the central financial authorities (Ministry of Finance and Central Bank) have to struggle are usually stronger than in the case of concessional loans, particularly because the spending agencies concerned are likely to be either private companies or public corporations, which are more sophisticated financially and may be less inclined to accept Ministry of Finance/Central Bank "meddling" than the regular spenders of concessional funds. However, the guarantor may require a transfer guarantee from the Ministry of Finance or the Central Bank in order to provide cover for a particular transaction. In such cases cooperation is more easily achieved.

A. Shopping Around

Raising export credits often involves a tradeoff between the best buy and the best credit terms. Purchasers of imported goods should shop around for goods that suit their needs at the lowest possible prices. But, because of the strong competition between export credit agencies (ECA's), they should try at the same time to evaluate the various credit terms being offered by the supplier, its bank, or the ECA. This is particularly true when the seller is the resident of a non-OECD member country which, not being bound by the Consensus, is free to promote its export industries and favor borrowers with lower interest rates and other benefits. On the other hand, the buyer must beware of accepting attractive financial terms offered for goods and projects of no long-term value. While export credits have enabled developing countries to achieve striking progress in many areas (notably industry), many white elephants testify to a lack of resistance to such promotional efforts.

B. Who Participates?

The argument so far speaks in favor of a strong central authority with good current knowledge of ECA policies and practices being involved in negotiating a country's major export credits. This is especially true in light of the opportunities that have been shown to exist for borrowers to negotiate individual deals. Those opportunities include stretching the Berne Union rules or the OECD Consensus, for example, by including local costs, front-end fees, even insurance premiums, in the contract; and substituting soft-term government credit or other "side-financing" for the 15 percent share of the financing that the buyer is supposed to contribute. Success in credit negotiations is thus based on intimate knowledge of the policies and modus operandi of individual ECAs - and not least of their funding costs.

But most countries imports are the concern of many firms and public sector agencies that must take the decision to assume an export credit and carry the exchange risk and the risk of a rise in interest rates. If the government requires importers to arrange their own
financing and carry the risks entailed, then the ministries concerned should encourage and assist them to tap the best sources of export credits. The ministries can provide transfer guarantees to the lender, and assure a lender that the project concerned has government support - for instance by being included in a development plan. Also, these authorities can help present the importers as good commercial credit risks to the lenders. Sometimes these interests are best accommodated if export credits are handled mainly by a few major development banks, import agencies, or project administrations able to give additional guarantees or security to the lenders, and to build up financial departments with substantial expertise and negotiating capacity for export credits.

Export credits will still often require the active participation - and not just advice, registration and control - of central authorities. Thus the overall national relationship with each ECA, and their share in the country's portfolio of export credits, is clearly a concern of those authorities. They usually have good reason to communicate freely with ECAs, just as they do with multilateral development institutions and major commercial lenders, because it gives them access to inside information and can be used in enhancing the country's credit rating.

Moreover, the central authorities may see opportunities to arrange financial packages with contributions from several ECAs that add up to longer average maturity and lower total cost than the individual parts if those had been negotiated by a number of project managers. Some countries have established special project groups with the mandate to find use for export credits - particularly from new sources - and to integrate them with other types of funds.

Finally, the growing business of currency and interest swaps with regard to export credits is best handled by, or in close collaboration with, the Central Bank and the Ministry of Finance (particularly the department or agency responsible for state borrowing). Borrowers are increasingly attracted into raising export credits denominated in high-interest, depreciating currencies from ECAs that provide heavy government subsidy, and then swapping such liabilities, to the extent possible, for debt denominated in stable, low-interest currencies such as Swiss Francs or other currencies to match their exchange flows. Transactions of this kind can be made at a floating or fixed rate of interest and can be "defensive" or opportunistic. This sort of business, which can be quite profitable, or even of strategic importance obviously requires the greatest expertise that the country can muster and a total overview that is seldom found outside the Ministry of Finance and the Central Bank.

C. Setting Up a Specialized Unit

The growing prominence of export credit financing, its increasing complexity, and the delicacy with which such finance must be handled by central authorities in countries engaged in rescheduling, all speak in favor of having units of competent staff, specializing in export finance, in the Ministry of Finance and the Central Bank (in addition to local development institutions such as industrial banks, etc.). An obvious place to find the required expertise would be within the external finance unit of the Ministry of Finance, since such a unit is already justified by the country's concessional borrowing; additional competence in commerce and banking - and especially in export lending - should be centered there. Maintaining good contacts with the authorities in charge of providing export finance to other countries is clearly an important task of the section. It will also have a direct relationship with a number of spending agencies in addition to those with which the concessional loans staff are dealing, and with different parts of the Central Bank. The staff should also maintain contacts with private sector banking, trade and industry. Like the concessional loans staff, they will interact with economic planners, and generally will have good reason to participate in the interagency planning and control system already outlined and further elaborated in the final section of this paper.

III. Market Finance

A government experiencing - or headed toward - a growing balance of payments deficit beyond that covered by direct investment flows, concessional grants and loans, and government-guaranteed export credits, will need to determine the size and duration of the deficit before it can take appropriate steps such as promotion of export earnings or restrictive action on imports to reduce it. This analysis will indicate the amount and kind of borrowing activity required. A first step should be a review of the analytical capacity of the Ministry of Development Planning and the Central Bank: are they able to do balance-of-payments forecasts adequately? The review might lead to a
strengthening of the capacity to make judgements on interest and exchange rate developments for major international currencies, or to undertake more sophisticated analysis of demand trends for the country’s export commodities, for instance.  

A. Who Participates?

In many countries, private sector capital flows - both long-term investment and short-term trade credits - will initially play a crucial role in bridging a growing balance-of-payments gap. The government will then have to devise policy measures to increase private sector activity in raising funds abroad. This may require improvement in the technical competence of the Central Bank to carry out comprehensive macro-policies, in cooperation with the Ministry of Development Planning and other parts of the government that have responsibility for sectoral development (especially industry). It may also require a greater ability on the part of the Central Bank to orchestrate a comprehensive borrowing program involving private sector companies, parastatals and municipalities, using a blend of incentives and coercion, including exchange control and other similar measures.

Already in this model there is need for regular contact between the Ministry of Development Planning, which is concerned with growth-oriented, medium- to long-term perspectives, and the monetary authority, which is naturally more inclined toward solving short-term problems that threaten the external and internal stability of the economy. Most likely the Ministry of Finance, too, will be an active partner in the process because of the effects of private sector foreign borrowing on tax revenues and on the domestic financing needs of parastatals, which may have to be at least partly covered through the budget to the extend that external funds are not available.

All in all, the agencies concerned - including perhaps the ministries of Commerce and Industry - will need new staff resources with an awareness of, and even a flair for handling, financial matters at the firm level (exchange exposure problems, for instance). They will also need some understanding of international financial markets, particularly the Euromarkets, and of how the banking system works in other countries.

The units responsible for operating the system in each agency must organize an adequate chain of decision-making within the agency so as to be able to process loan applications expeditiously. They must also set about building channels of communication with the other agencies concerned. The output of papers will steadily increase - statistics, reports, policy memoranda, etc., - and it is essential that all such material reach the other parts of the system and be available for their decision-making. This is not a plea for collective decision-making with all agencies agreeing on everything being done by any one of them. It is making the point that it is far easier to develop a policy involving several agencies working in reasonable harmony if they not only share the same values (as laid down in general government policy) but also the same information. To facilitate this process there should be machinery set up for consultations on borrowing policies and programs for the private sector. This point is further elaborated below.

B. The State as a Borrower

Another dimension will be added if the state itself enters the international markets as a borrower. Constitutionally, it may do so without much legal preparation but it will always be concerned with the constitutional and legal aspect of its loans. It will therefore keep in close touch with the highest legal authority in the country - for instance, the Solicitor-General’s Office - and may even see fit to put some of the Solicitor-General’s lawyers into the borrowing agency.

The state will have the choice of raising funds in its own name or guaranteeing other public or private sector borrowers. In the latter case, the agency’s function is fairly limited, but it must still have financial competence to negotiate the guarantees and to review the underlying financing so that it would be acceptable to the state, should the guarantee ever have to be made good. The agency - normally the Ministry of Finance - must inform the planning agency and the Central Bank of its actions, distribute statistics on its activities regularly, and be prepared to report not only on guarantees issued and outstanding but also on the amount of liabilities against those guarantees at any particular time.

Should the state decide to enter international markets as a full-fledged borrower, external debt on commercial terms will become a new preoccupation of the agency or unit serving as the government debt manager. The government may have prior experience only in selling domestic, internal debt. Some management functions are common to domestic and to foreign
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debt. Both kinds of debt provide funds to the state budget and they share certain common technical features (a bond is a bond, whether denominated in local currency or in US dollars). Familiarity with domestic debt and domestic financial markets therefore is a good starting point for handling foreign debt, and experience with the latter can in turn lead to improvement in the government’s handling of its domestic debt. The attitude and approach of debt managers should be the same in both fields, because the characteristics of good debt management, and the instruments available, are similar. It is thus a clear advantage if the top decision-makers at the ministry are responsible for both kinds of debt, and if the staff managing the foreign debt include on or two people with experience of domestic debt management. It is also useful to set up a number of common services such as economic research, information systems, and computer hardware. But unless the domestic debt is fairly small and borrowing abroad is sporadic, the same staff should not handle both foreign and domestic debt at the operational level; they should specialize in their respective fields.

C. What Skills are Needed?

The size and composition of the government’s unit for managing external debt on commercial terms will depend on the volume and diversity of foreign borrowings, including loans raised to refinance old debt. Provided the government is active in most markets open to a sovereign borrower the unit will need a good macro-economist to follow international capital markets, particularly developments and projections of interest and exchange rates, from a borrower’s point of view.

Ideally, this officer should have at least a master’s degree in economics and fairly extensive experience in analyzing financial market trends and in assessing the effect of major disturbances such as the global debt crises, changes in US monetary policy, etc. It is important that the economist be given the opportunity to relate to and communicate with the many excellent bank economists who freely offer their advice to clients (actual or potential), and who between them exert a significant influence on market sentiment and expectations.

Keeping in touch may require visits every second year or so to chief financial centers like London, New York and Tokyo, in order to get a full briefing on economic trends. The economist should also be “plugged in” to bank economists at home, research institutes, government and private libraries, universities, etc. The knowledge thus gained will be used in advising the debt manager on the choice of borrowing currency, maturity, method of calculating interest, timing of loans, etc.

Another macro-economist is equally necessary, in the proper conduct of external debt management, for the presentation of the borrower to the international financial community, that is, banks, investors and possibly rating agencies. This economist should be well-versed in the economic data and projections produced on the country, at home and abroad, and also in the policy issues concerning the government and in the current public debate. He or she should build up good working relationships with desk officers of lending institutions covering the country, and the other government agencies who will assist in the preparation of presentation memoranda. This economist should be close to the debt manager in order to give support as necessary in the daily contacts with inquisitive bankers, questioning rating agencies and regulatory authorities who demand status reports on the economy from time to time. This economist will also be very useful when IMF and World Bank missions visit to gather materials for their economic reports.

A central function is performed by what might be called the market group. These officers correspond to the loan officers of banks and other lending agencies. They will work closely with the macro-economist for the international markets, whose judgement will point to which markets will be profitable to tap, in terms of likely movements in exchange or interest rates. Each will follow a particular market or group of markets day by day, watching for trends in interest rates and fluctuation in lender preferences so as to be able to advise on the exact timing and other characteristics of particular operations. They will take note of new borrowing devices, changes in government regulations and the fortunes of banks and individual bankers.

One of their tasks will be to meet with visiting bankers and communicate with bank offices by letter, telex and telephone. Once a preliminary decision has been taken to borrow in a certain market, the group will analyze and evaluate the loan offers that may come in, in order to judge and compare their true cost, their likely reception in the market, and what a particular mandate would mean in terms of “banking diplomacy”, etc.
The market officers will carry important responsibilities in the negotiations with lenders, and represent the debt manager on working committees consisting of economists, lawyers and treasury people from their own side as well as "loan officers" from the bankers' team. The market officer will see the transaction through to the point where, after the contract has been signed, the treasury people take over the task of drawing on the loan and of paying debt service. The market officer will continue to be involved in debt management decisions during the life of the loan; for instance, in choosing interest periods under roll-over credits and deciding whether or not to buy bonds for sinking funds, or prepay old loans that appear expensive compared to what is currently available in the market.

Staff for this kind of job should ideally have a background either in domestic debt management or in banking. While international experience and excellent language ability are necessary, an extroverted personality may be more of an asset than high academic degrees. An ability to listen well, to sift through massive quantities of information and to take quick, well-balanced decisions is essential.

A Treasury Group is needed to be in charge of the payments to and from the debt agency under loan contracts - withdrawals of funds, and payments of interest, amortization and fees of all kinds. Its staff should be in touch with paying agencies - and daily with the Central Bank - to sell foreign exchange obtained as loan proceeds and to arrange for outgoing payments. The group's participation in loan negotiations is valuable because they will know the problems involved in treasury operations and can make sure that loan agreements take them into considerations.

Good administrative officers with some economic and financial training as well as experience in handling accounts are needed to do the job. Fluency in English will be necessary, as much of the work consists of reacting to signals from banks interpreting loan agreements and other documentation. This group must be able to move quickly to avoid any failure in observing due payment dates, etc. Their speedy reporting of debt data and projections is also crucial to good decisions on new loans and debt restructuring.

A Senior Debt Manager is needed to coordinate the team and to negotiate loan transactions. He or she should possess a good background in government finance and have - or be able to acquire - a thorough understanding of how international markets work. The manager must be devoted to cost-cutting on the government debt portfolio, and always on the lookout for opportunities to arrange favorable transactions without jeopardizing the good standing of the country in the marketplace. The task is demanding. It requires stamina, self-discipline and excellent judgement. It requires the ability to be original and creative on the one hand, and a stickler for financial detail and verbal precision on the other.

The manager will need the full confidence and support of his or her superiors in order to act directly and decisively, especially because the business conducted can be quite risky (but also rewarding) to the government. Therefore, the debt manager must be sufficiently high in rank to report directly to the head of the agency. Clearly, the ability to relate well and to cooperate with senior levels of the Central Bank and other government entities is essential.

IV. Coordinating Arrangements

Where should the Government put the unit for the management of external market debt and what role should it play in coordinating interagency arrangements? Most countries who are major borrowers have put the external debt management unit in the Ministry of Finance and combined it with staff resources already engaged in the management of concessional loans and export credits. The head of the external finance unit, or the senior officer to which he or she reports, acts as the government debt manager. Certain functions, such as the banking contacts of the market group, or monitoring the international markets, may be performed by the Central Bank.

A. Setting up a Forum

The main players in the area of external debt management are therefore the Ministry of Finance, the Central Bank, the Ministry of Development Planning, and other ministries or agencies with a special interest in particular kinds of finance like export credits. It is among them that the state's - and indeed the country's - foreign debt policy will be hammered out. The experience of many countries strongly suggests that a forum should be established in which they all contribute their special knowledge derived from their own unique circles of contacts, and where policy guidelines as well as major financial ventures are agreed.
This body, which we may call the foreign finance committee, should meet about once a month, in order to determine for the 6-12 months ahead the external financial needs of the economy as a whole; by how much the private sector will increase or reduce its foreign debt (medium- to long-term, as well as short-term trade credits); what amounts will be available from loans already arranged and being drawn down; the size of scheduled repayments; the scope for favorable prepayment of older, more expensive loans; and the possible need of the central bank or other parts of the government to replenish their foreign exchange holdings.

From the committee’s discussion, the Ministry of Development Planning will receive indications of factors that will influence the size of the external deficit in future years (partly the effect of interest costs) and the ease with which it can be financed. The Central Bank will get guidance on the need for policy changes to induce a higher or lower level of borrowing by the private sector. The Ministry of Finance will be informed, among other things, of the local currency effect of foreign borrowing and will contribute information on its guarantee business (if any). And the external finance unit will receive endorsement of its ongoing borrowing program and an opportunity to discuss debts characteristics such as currency composition, maturity structure, and the floating/fixed rate mix with the macro-economic experts of the Ministry of Development Planning and the Central Bank’s financial and currency experts.

Some countries have found it useful to attach to the foreign finance committee representatives of the banking sector to advise on technical aspects of markets and transactions, particularly when new instruments are introduced in the world’s financial markets. The foreign finance committee may also make it a practice to consult from time to time - say, once or twice a year - with other national, public or private sector borrowers, with whom experience and ideas could be exchanged and who could be given guidance from the foreign finance committee about government policy and practices.

The foreign finance committee need not, and probably should not, take and put on record formal decisions, for instance, about raising a particular loan, as this might encroach on the prerogatives of one or the other of the participating agencies. Rather, it should function as an advisory group whose consensus recommendations could be relied upon as the best possible foundation for formal decisions by all the agencies concerned, and in particular the external finance unit. The work of the committee should thus be concentrated on the broad aspect of debt management, such as composition of the debt in terms of currencies, fixed/floating interest rate and maturity structure, etc.

In order for its recommendations to carry weight, the foreign finance committee should be the forum to which each participating agency submits its policy papers on subject matters bearing on external debt management. These should be discussed before they go to ministers, governors, or boards. The committee should be the place where the Central Bank gives monthly accounts of how the trade balances and currency reserves have performed and are expected to perform in the coming months; and where the external finance unit presents its past accomplishments and future plans.

B. Running the Foreign Finance Committee

To run properly, the foreign finance committee needs a chairman and a secretary from the same agency. There should also be a deputy chairman so that meetings can be held as scheduled even if the chairman is called away at the last minute by the minister. From each participating agency there should be two or three officers as permanent representatives. The level of representation should be high; in many countries a deputy minister of finance is chairman with the deputy governor of the Central Bank, the head of the Ministry of Development Planning and the head of the external finance unit as members. Other ministries or agencies can sit in as the need arises.

As so many key people with tight schedules are likely to be involved, meetings of the foreign committee must be called well in advance, and dates for future meetings should be set at the end of each meeting. The secretary should be responsible for distributing all documents and for keeping minutes, which should be cleared by all participants before being finalized for the official record. But, apart from this central function, the secretariat services to the foreign finance committee should ideally come from the agencies concerned and from the group’s own members, who between them would have most of the expertise available. Many minor issues can be settled, and major ones better prepared for high-level discussion, in small working committees consisting of a middle-level officer from each agency.
C. Sharing Ideas

In this context it is worth mentioning that a UN-ECA meeting of African debt managers in June, 1984 concluded that in each country there ought to be a "national body for external debt management" consisting of senior officials with experience in development economics, banking and finance, legal matters, etc. to exert some quality control in defining the purpose of foreign loans, to assess debt service issues, and to contribute to strengthening the government machinery for external debt management. They should also promote new policies for borrowing, and try to incorporate external debt management in the country's long-term development strategy. This would ensure that appropriate debt servicing capacity is created through sound investment projects. Finally, this body should exchange information with similar bodies in other countries and with regional development banks on the current state of the markets, on terms of rescheduling, and other common problems.

Chart 16-1: COMPOSITION OF FOREIGN FINANCE COMMITTEE

A. Ministry of Finance
   Minister or Deputy Minister, Chairman
   Director of External Finance Unit
   (will also provide secretariat services)

B. Central Bank
   Governor or Deputy Governor
   Director of Foreign Department
   Director of Research

C. Ministry of Development Plan
   Director of Plan

D. Ministry of Commerce and Industry
References


1. For a survey of techniques in this area, see Mehran (1985, Chapter 6 in particular).

2. For the role of the lawyer in debt management, see Kalderen and Siddiqi (1984).

3. In some countries the Ministry of Finance is assisted by a "cash flow committee" based in the Ministry with the Central Bank as a member, to make sure that the budget is financed even if there are temporary shortfalls in concessional finance, for instance. General coordinating arrangements for external finance are discussed in the final section of this paper.

4. For a review of the state of the art, see The World Bank (1985). [Since this paper has been prepared, a second Systems Conference was held in 1989. - ed.]

5. This becomes overwhelmingly clear if and when the country has to go to the Paris Club for rescheduling; then all foreign debt, public and private, becomes a concern of the Ministry of Finance/Central Bank.

6. In particular, estimates of future interest costs and external loans, under various assumptions, will take on added importance in the balance-of-payments projections.

7. This point is further developed in Kalderen and Siddiqi, op.cit.

8. For a full description of government management of domestic debt, see OECD (Paris 1982 and 1983).
17. Organization for Debt Management

Summary of the Discussion

Rapporteurs:

- Mr. Mamat Bin Ali, Malaysia
- Mrs. Gülınur Üçok, Turkey
- Dr. Jawad Naji, Palestine

This segment of the seminar was based on two presentations. The first, by Dr. Ishrat Husain of the World Bank, set forth a model of debt office organization. The second, led by Dr. Thomas Klein of the World Bank, explained Mr. Lars Kalderen’s approach to the administration of foreign borrowing. Following this, several participants explained various aspects of debt management in their respective countries.

I. The Organization of Debt Management

In an idealized model of debt management, we can identify five discreet functions. Each can be visualized as being performed by a separate unit:

(a) A Policy unit decides on the needs of public and private sectors. It coordinates the activities of different government agencies dealing with external debt.

(b) A Control unit analyzes the impact of borrowing.
   - It provides guarantees when required.
   - It decides on repayment and refinancing.
   - It also ensures that guidelines and instructions issued by the policy committee to the operational units regarding negotiations of loans or guarantee agreements, on-lending terms.
   - It also acts to avoid the accumulation of debt service over sustainable levels is to control the commitments and disbursements of various types and from various sources.

(c) An Advisory unit has a central function by following trends in international financial markets.
   - It monitors interest rates and currency developments, and analyzes and appraises different types of financial instruments and their relevance applicability and use by the country.

(d) An Operational unit negotiates loans with the creditors and oversees debt servicing. It could be located in the Ministry of Finance.

(e) A Statistical (Accounting) unit registers agreements and contracts negotiated by each authorized borrower, collects detailed loan-by-loan information and provides for the timely payment of amortization and interest due.

   - This unit keeps track of all direct government guarantees as well as contingent guarantees provided for private debt. In short the statistical unit continuously monitors the debt situations of the country for all types of debt.

This model can vary from country to country according to the decision making structure of each country.
II. The Administration of Foreign Loans

The model suggested by Lars Kalderen for the achievement of efficient management was summarized.

It was pointed out that Kalderen is advocating in administration model based on the types of loans rather than the functions within the process of debt management.

Loans are classified basically as:

- Concessional loans
- Export credits
- Market finance.

There should be specialized agencies dealing with those particular types of loans, particularly in the case of export credits.

In order to pursue effective commercial bank borrowing, the Market Finance Unit should have advisors well trained in macroeconomics. For contacts with the banking community and rating agencies there should be one advisor who knows the market and a second advisor who knows the country economy.

The coordination between the Ministry of Finance, Planning Department and the Central Bank is very important, Kalderen suggests that a Foreign Finance Committee meet each month to carry out this coordination function.

III. Debt Management in Selected Countries

Yemen (PDR). Yemen has a standing resolution to accept only soft loans. It is the decision of the present cabinet that no commercial (hard loans) will be accepted.

The present borrowings on concessional terms are typically of 20 years maturity with 5-10 years grace period and at the most 3%.

The Ministry of Planning has the authority to appraise the project for which the loan is requested and, if approved, direct it to a fund (Abu Dhabi Fund, Saudi Fund, Kuwait Fund, etc.) or to a concessional bilateral source.

Maldives. The policy is to accept only loans on concessional terms. The Ministry of Foreign Affairs is responsible for negotiating the loans. However, loan requirements of Maldives are determined by the Ministry of Finance. The President has to give permission for borrowing. The private sector in Maldives is not allowed to raise its own loans, except for a few parastatals. As an example the shipping industry is allowed to negotiate for market financing.

The parastatals report to the debt management office which keeps a tab on their borrowing levels.

Kuwait. The Kuwait representative from the Kuwait Investment Bank explained that as a creditor country Kuwait was facing problems of collecting bad debts issued by the Government, but the number of such loans are not many. Besides this, Kuwait administers the Kuwait Fund which is responsible for loans.

Malaysia. Malaysia is actively involved in market financing. It has a special unit for handling every type of loan. The authority to negotiate loans is with the Ministry of Finance, in cooperation with the Central Bank and the Economic Planning Unit of the Prime Minister's Dept.

Sierra Leone. It is the Ministry of Planning that has the responsibility for decisions on borrowing. However, the Ministry of Finance has to give approval for repayments and the Central Bank has to give approval for release of foreign exchange. Only loans on concessional terms are presently accepted.

Turkey. The authority to negotiate and conclude new borrowings is with the Treasury (under the State Minister). Reporting on loans in the public sector has to be ex-ante, while that of the private sector is only ex-post.

The Treasury has given its guarantee to State Economic Enterprises (parastatals) in the past; but, presently, guarantees are accorded less frequently. The data base system also allows the control of the borrowing methods.

Coordination exists between the Treasury, the Central Bank and the Planning Department. All project loans have to have the initial approval of the Planning Department.

In addition to country presentations it was underlined during the course of the discussion that concessional assistance should be readily accepted.
Part IV - Debt Information Systems

18. Introduction

To manage external debt, one must know the debt. A government must keep detailed records of its own foreign borrowings so that debt service obligations are paid when they fall due. The national debt office must also collect summary data on the debt of public corporations, state and local governments and of the private sector so as to have comprehensive information on the external debt of the nation as a whole. These entities manage their own debts; the national debt office does not need transaction-by-transaction records. From the government’s accounting records and reports from other borrowers, the national debt office must be able to produce timely and malleable statistics in order to support debt management decision-making functions.

In this segment of the seminar, the participants from six countries explained how their respective debt information systems worked and what problems they encountered. Thomas Klein introduced the discussion by presenting his paper, "External Debt Information Systems" (see chapter 19). It described how data are collected on government, public enterprise and private debt. An important feature of the paper was a diagnostic framework that showed how one can identify the underlying problems behind deficient national debt statistics. Mr. Klein went on to describe efforts by the IMF and the OECD and the BIS to develop creditor-source debt information systems, but concluded that they can serve only as a proxy and not a substitute for debtor-country data.

Turning to the descriptions of national debt management systems, Messrs Essa and Hassan of Bahrain pointed out that their country has large balance-of-payments surpluses and limited need for foreign borrowing (see Chapter 20). The Government obtains long-term loans from Arab development institutions to finance infrastructure. There is some external borrowing by the Bahrain Monetary Authority, by commercial banks and by private enterprises. The Ministry of Finance limits its supervision to direct government borrowings. At this time, there are no comprehensive statistics on external borrowing, but this is being contemplated so as to have a better understanding of development trends.

In the Maldives, responsibility for debt management is divided between the Ministries of Plan, Foreign Affairs and Finance and the Maldives Monetary Authority, as was explained by Mr. Mohamed Ahmed Didi. Information on external debt, in all its aspects, is centralized in the Maldives Monetary Authority. Data are compiled using the Commonwealth Secretariat's computerized debt management system. (See Chapter 22).

Mr. Saeed Ahmad described Pakistan's debt monitoring system, which was established in 1960 in response to the need to monitor large foreign aid receipts. Debt management has evolved into a cooperative arrangement between three agencies: the External Finance Wing of the Ministry of Finance, the State Bank of Pakistan and the Economic Affairs Department (see Chapter 23). External debt monitoring is carried out by the Debt Management Unit of the Economic Affairs Department. The work is largely computerized, using the UNCTAD system as its core. (See Chapter 30 by S. S. Hussain Zaidi below.)

Mr. Ernestus Coker described the debt monitoring system of Sierra Leone (see Chapter 24). There, record keeping is split between the Ministry of Finance and two units of the Bank of Sierra Leone (the Public Debt Section and the Foreign Department). Debt monitoring is done manually, using record cards. The Ministry of Finance must keep track of all government loans and see that debt service payments are monitored; the Bank of Sierra Leone must execute payments. Because it must forecast the balance-of-payments, it must maintain detailed records of external debt.

There is little new foreign borrowing taking place now. In view of the continued adverse balance-of-payments situation, the major problem today is deciding what debt service payments can be made with the limited foreign exchange resources available. With three separate operational centers for debt monitoring, a national debt office would be desirable.

At the time of the seminar, the Government of Sudan had just created a new Debt Monitoring Unit that combined functions being performed by several different units in the Ministry of Finance and Economic Planning. It is expected that debt monitoring within these governmental units will be centralized. The Bank
Planning. It is expected that debt monitoring within these governmental units will be centralized. The Bank of Sudan monitors short-term debt and assembles information on total debt using a computer. Mr. Eltahir explained the work of the Bank of Sudan and Mr. Alaa Abdo the work of the Government (see Chapter 25).

In Turkey, the control of debt resides with the Undersecretariat of the Treasury and Foreign Trade (UTFT). How this system works was explained by Ms. Yücel Irgat (see Chapter 26). The Treasury coordinates borrowing by the central government. In principle, it also must approve long-term borrowing by public and private enterprises, but in practice enterprises are free to obtain long-term financing abroad.

Debt transactions of the government and public sector entities is monitored by the General Directorate for Public Finance of the UTFT. Private sector debt and all short-term debt is monitored by the Central Bank. The UTFT has developed a computer system for external debt monitoring.

In the discussion, the participants concluded that it is important that there be a single office with responsibility for recording comprehensive information on external loans, disbursements received and debt service paid. However, it is still necessary that various functions of debt management be allocated to different government agencies within the Ministry of Finance, the Treasury and the Central Bank. Careful coordination of their respective individual responsibilities is essential for effective debt management.
19. External Debt Information Systems in Developing Countries

Thomas M. Klein

World Bank

Developing countries face serious debt management problems for many reasons. One common cause of difficulty is that countries, when faced with the decision whether or not to take on substantial new debts, are not aware of the amounts of existing debts and of the debt service obligations entailed. Timely and accurate knowledge of external debts is an essential feature of debt management.

This paper provides a diagnostic framework that managers can use to evaluate the quality of their country’s external debt information system. It also explains what is the role of the World Bank and other international agencies in developing internationally comparable statistics on external debt, and it describes technical assistance programs available to developing countries designed to help them improve their control of external debt. We begin by examining the structure of developing country debt, then go on to examine the institutional framework for debt management, the sources of external debt data and the problems in assembling this information.

I. Structure of External Debt

Table 19-1 shows the structure of developing country external debt by creditor type and by debtor institution. Looking at debt by creditor source, we can see that the distribution of debt between official and private lenders is just about equal. However, this proportion varies considerably between countries. For low-income countries, the share of private-source debt is relatively low, and the share official-source debt higher. South Asian and Sub-Saharan African countries (other than Nigeria) owe the 75% of their debts to official creditors and only 22% to financial institutions. In Latin America, almost 60% of external debt is owed to commercial banks and only 30% to official lenders.

It is important to know who are the borrowers. For developing countries as a whole, it is the central government that is the major debtor, and the importance of central governments as debtors has risen despite the growth of private sector activity in East Asia and Latin America. In the 1970s, central governments held less than one-half the debt of developing countries, but their share rose to 65% by 1987. There are two reasons for this development. First, during the early 1980s, many governments, particularly in Latin America, borrowed heavily from commercial banks for balance of payments support. Secondly, during the debt rescheduling process in the late 1970s and 1980s, liability for rescheduled foreign debt was transferred from public enterprises and private firms to the central government.

The share of private sector debt in total developing country debt has declined from about 25% in 1970 to about 10% in 1987, although the absolute size of private sector debt has grown. In a few Latin American countries private sector debt remains a large percentage of total debt. With the privatization of public enterprises taking place throughout the developing world, we can expect the share of private sector debt to rise during the early 1990s.

Public enterprise debt continues to remain significant: 22.5% of total debt in 1987, not much below the 1970 share. Much of public enterprise debt is guaranteed by the central government.

Not shown in Table 19-1 is the growth of debt that has been affected by debt restructuring. For countries that have had to seek debt relief in the 1970s and 1980s, a very high proportion of debts to foreign governments (OECD countries in particular) and of debts to commercial banks represent obligations resulting from rescheduling agreements. Original debts eligible for rescheduling are subject to special accounting treatment and occupy a significant part of the stock of government, public enterprise and private sector obligations.

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1 The views expressed in this paper are those of the author and are not necessarily those of the World Bank.
II. Monitoring External Debt

A. Institutional Arrangements for Debt Monitoring

There are several alternative institutional arrangements for monitoring external debt in developing countries, but all have many common features. Since central government debt is the largest component of external debt for virtually all developing countries, a debt monitoring system must be built around the work of the agency that has day-to-day responsibility for managing the government’s debt. Thus, in some countries, the agency in the ministry of finance that manages the government’s debt evolves into a national debt office. A national debt office situated in the ministry of finance, accordingly, must develop channels for obtaining information on non-government debt so as to have comprehensive information on the totality of the country’s external liabilities.

However, in many countries, the national debt office is located in the central bank rather than in the ministry of finance. The central bank of a country is in a position to record and classify external remittances, particularly if exchange control is in effect. Also, central banks usually have better staffs and physical facilities, because their administrative costs are met out of the central bank’s earnings rather than through the national budget. National debt offices located in central banks must make arrangements for the regular transmission of information from finance ministries of data on government direct debt.

In the Franc Zone, the most common institution for monitoring external debt is the "Caisse Autonome d'Amortissement", a quasi-independent agency charged with repaying government obligations. However, Caisses Autonomes generally restrict their attention to central government direct and guaranteed debt.

Irrespective of where the national debt office is located, there must be inter-agency coordination with respect to the use of external debt data. Otherwise, information on debt-related flows (disbursements received and debt service paid) produced by the national debt office will not be consistent with information used in the balance-of-payments and in budget documents (more of a problem with respect to monitoring the execution of the budget than with preparing budget estimates). Timely reviews of data must be made to avoid inconsistencies. This coordinating function is rarely performed well in developing countries.

B. Sources of Debt Data

The source of information for government direct debt is invariably the ministry of finance, because it is this agency that initiates the instructions to make payments on the obligations of the government. When the national debt office is located in the central bank, it must obtain information on government debt from the ministry of finance.

Next in importance is the debt of public enterprises. A few national debt offices monitor the transactions of public enterprises in detail and thus have continuous knowledge of this category of debt. But, for most countries, the national debt office must request periodic reports from the individual enterprises on new loans contracted, disbursements received, debt service paid and amounts outstanding. Semi-annual surveys are most common, although some countries require quarterly reports.

Private sector debt is significant for many Latin American countries and elsewhere where private economic activity is significant. A few private sector debts are guaranteed by the central government, and the national debt office can require periodic reports on their status. However, the bulk of private sector obligations consists of relatively small export credits that are not guaranteed by the government. There also may be financial credits of considerable size to countries with large individual borrowers. When the debtor country has exchange controls, the national debt office can use the exchange control data as a source of information.

The above categories of debt are long-term debt (with a maturity of more than one year). Short-term debt is compiled by only a few developing countries. It is done invariably by the central bank, and it requires close cooperation between the central bank and commercial banks.

III. Debt Rescheduling Issues

Since 1975, more than 50 countries have had to restructure their debts through multilateral debt relief agreements. Because of the persistence of balance-of-payments difficulties, many countries have had to reschedule their debts several times through a series of agreements.
1-2 year accords. This has had major consequences for the monitoring of external debt.

**A. Identification of Eligible Debts**

The first problem is to identify debts eligible for rescheduling. Only debts meeting specified criteria can be rescheduled. They are either loans from those creditor country governments or they are export credits which are guaranteed by an export credit guarantee agency in the creditor country. The loans or credits must be committed prior to a specified date (the "cut-off date").

Some loans covered by rescheduling agreements are easily known to the national debt office, such as loans from foreign governments. But export credits from private lenders pose problems. That an export credit may have been insured by an export guarantee agency in the creditor country is a fact that is not always known; some export credit guarantee agencies keep the guarantee confidential. A separate problem is that many credits that are eligible for debt relief will have been made to public enterprises and to private firms, and the national debt office is not likely to have details on many of these loans.

In the course of the debt negotiations, the creditor country representatives will present a list of claims presumed eligible for rescheduling. The debtor country representatives will be asked to agree that these are, in fact, valid claims. It is essential that debt record keeping be complete and accurate so that both the existence of the debt and the amount can be verified.

**B. Transfer of Obligations**

The maturities covered by a rescheduling agreement are consolidated and become an obligation of the central government to the creditor government lending agency or export guarantee agency. This task creates special record-keeping problems. Suppose that the rescheduling agreement covers principal and interest falling due during the year 1990. Maturities of the eligible debts falling due in 1990 owed by individual public and private enterprises are transferred to the central government, lowering the foreign debts of these enterprises and increasing the debt of the central government. The central government finds itself with a new debt, representing the consolidated maturities eligible for restructuring, and the individual debts (of the government as well as of enterprises) are reduced accordingly.

**C. Beneficiaries of Relief**

If the debts rescheduled have been in arrears (the restructuring agreement covers obligations due prior to the signing of the debt relief agreement), the debtor will have made payment in his national currency to his commercial bank as required under the original loan obligation. What happens when the eligible maturities are due in the future? The common procedure is that the debtor submits his payment on the normal due date in national currency, discharging his obligation. The central bank or the treasury acquires the funds against which to purchase foreign exchange when interest and principal is due on the consolidated debts. The foreign exchange risk is that of the government.

Alternatively, some governments have permitted the ultimate debtor to submit payments to the government on a schedule following that of the consolidation agreement. The debt relief operation would then provide financial assistance to the debtor enterprise. Most governments that have tried this method have abandoned it, because the results of the debt relief agreement have benefitted the budgets of the enterprises at the expense of the central government.

**IV. Debt Monitoring Difficulties**

If a developing country's debt data are incomplete or very late in being assembled, one can find the source of difficulty by examining each of the above categories of debt separately. Table 19-2 sets forth a general diagnostic of debt data difficulties.

**A. Monitoring Government Direct Debt**

The common symptoms of difficulty are: The total of government debt is not known or is believed to be incomplete; the amount of undisbursed balances (the pipeline) is imperfectly known; the government incurs late charges on debt service obligations even when there is no foreign exchange shortage; the country is not able to service its debts fully because of foreign exchange shortages, but the debt office has great difficulty in assembling information on arrears. Let us examine these problems in turn.
Managing External Debt in Developing Countries

a. Total Loan Commitments Unknown.

This is a problem of centralizing data. Loan contracts, after they are signed, should be passed on to the debt office, but occasionally they are not. This was a common problem of newly independent countries during the 1960s and 1970s when many government departments had independent borrowing authority. The ministry of finance would not learn about the debts until the first request for payments arrived from the creditors. With the advent of serious debt servicing difficulties in the late 1970s, most countries began to require that the minister of finance, or somebody he designates, sign all foreign loans. Thus, the loan contract automatically would reside in the ministry of finance, and, in principle, the national debt office would be informed.

Failure to centralize debts is still a problem for military loans. Often, to preserve the confidentiality of external financing of military purchases, only the minister of defense is privy to the contract — until, of course, the first request for payment arrives in the Ministry of Finance.

It is not enough to centralize all loan records in the ministry of finance: there must be orderly record-keeping as well. But today even the poorest countries are in the process of establishing computerized debt recording systems, and all software systems provide file space for recording the essential details of government loan contracts and for summarizing the total commitments. Some countries still have deficient accounting systems, but the problem today is more one of access to information than of accounting procedures.

b. Available Loan Balances Unknown

The record keeping requirements for active loans (i.e., loans in the process of disbursing) are very simple. The debt office must create a disbursement record file for each new loan. In this file, one records the original commitment value of the loan, supplements (to cover contract extensions or cost over-runs) and cancellations (if undisbursed balances remain after the project is completed). Disbursements are recorded in this file individually, as they take place. With these figures, both the disbursed and the undisbursed balances can be known. The loan record file can be either part of a comprehensive computerized debt management system an accounting card or a ledger page in a manually-operated system.

Here, we have another problem of data centralization, this one more intractable than the problem of centralizing commitment data. Most lenders send disbursement advices to the beneficiary agency, not to the national debt office. Some lenders can be induced to send a copy to the national debt office (Ethiopia refuses to service debts to lenders who do not). International organizations and most bilateral lending agencies send summary accounts of loan disbursements to the national debt office at regular intervals. But, when the loan comes from a commercial bank or a supplier, the national debt office must obtain the required disbursement data from the beneficiary agency itself.

There are two problems here. First, the debt office staff does not attempt aggressively to secure the required information. Secondly, the minister of finance is unwilling or unable to require the necessary cooperation from the beneficiary agency. And finally, the accounting office in the beneficiary agency may be so disorganized that it is unable to keep track of the individual disbursement advices. There are a number of countries in Africa (and a few elsewhere) that suffer from the latter problem. Whatever the cause, the inability to centralize disbursement data means that the national debt office is not able to know the size of the pipeline or to assemble information promptly on disbursed debt for active loans.

c. Existence of Late Charges

The only valid excuse for late charges is that the government unexpectedly finds it does not have foreign exchange to cover the required payment. In the absence of foreign exchange difficulties, the existence of late charges is a symptom of a disorderly debt payments system. Debt offices normally prepare monthly schedules of debt service due, so that the agency managing the government budget (a treasury or an accountant general's office) can verify the validity of the payment well in advance of the due date, and the central bank can assure that the foreign exchange is available. Thus, when the payments notice from the creditor arrives, there should be an orderly movement of documents, first from the debt office to the treasury or accountant general and then to the central bank or other government paying agent, and the debt service payment should be made on, or just before, the due date.
The specific causes of late charges are, accordingly, the failure of the debt office to prepare payment orders sufficiently far in advance, failure to respond to these notices promptly in the treasury or accountant general's office, or deficiencies on the part of the paying agent. Correcting this problem is within the power of the minister of finance - if he is interested in doing so.

d. Current Status of Arrears Unknown

The common difficulty is an inadequate accounting system. Tracking arrears is complicated. There are two possible sources of information: the loan record files maintained in the ministry of finance's debt office and the foreign office of the central bank where payments orders pile up in the absence of foreign exchange. On the side of the national debt office, it must note on a debt service record file for each loan (a) the schedule of debt service payments due, (b) the ordering of each payment and (c) the actual payment. Arrears arise when a payment falls due and is not made; arrears decline when debt service is paid outside a due date, or when there is a debt consolidation.

One reason why arrears are not known is that the records of the national debt office do not reflect this basic accounting relationship. Initial accounting forms for debt service payments, set-up many years ago and not revised when debt servicing difficulties arose, failed to allow for the possibility of arrears. In addition, a number of first-generation commercial computerized debt monitoring packages failed to make adequate provision for the accounting of arrears.

A second possible source of difficulty on the part of the national debt office is that the staff may not keep records current. Another problem is that the flow of documents between the government paying agent and the debt office may be deficient. The debt office cannot up-date its accounting records unless there is an orderly flow into the debt office of information regarding payments actually made.

The alternative source of information is the record of unpaid obligations that should be maintained by the foreign department of the central bank. It must register the payment orders when received and note when they are paid, and, at the same time, keep detailed records of the payment orders due but not paid. Thus, whenever required, it should be able to compile the stock of arrears. Keeping such records manually is difficult, but is not a difficult task when a computer is available. What remains is to reconcile the central bank's records of arrears with the records of the national debt office. Even with computerized systems in both the national debt office and the central bank, a periodic reconciliation process is required. But, surprisingly, it is not carried out.

B. Monitoring Other Public Sector Debt

The government debt office must keep transaction-by-transaction detail on direct government debt, because it is responsible for making payments when due and it must also integrate transactions data into budget and budget-implementation reports. However, the government debt office does not require such detail for the debt of public enterprises, state government debt and the debt of other public sector entities not serviced through the central government budget. What is required is knowledge of the overall debt situation of these entities and the schedule of future debt service payments. Specifically, the debt office should know the debt outstanding at various time intervals (say, quarterly), commitments made, disbursements received and debt service payments made during each accounting period. It also should know the stock of debt, arrears, if any, and the schedule of debt service due on the debt.

Under the World Bank's Debtor Reporting System (explained below), countries must submit loan-by-loan detail on all debt guaranteed by the government as well as on government direct debt. Since most public enterprises cannot borrow abroad without a government guarantee, the World Bank Debtor Reporting System helps set standards for the centralization of data on public enterprise and other public sector non-government debt.

To obtain the needed information, most governments require that public sector entities file periodic reports to the national debt office. If the reports are submitted promptly and are consistent from one accounting period to the next, the government debt office will have comprehensive information on those debts. Gaps in the debt office knowledge of non-government external debt suggests that the debt office is not insisting on securing regular reports from the entities concerned and possibly also not verifying the quality of the reports received.
C. Monitoring Private Sector Debt

The level of detail desired on private sector debt is the same as for non-government public sector debt. However, data on private sector debt is much more difficult to obtain, particularly since only a very small part carries a government guarantee. The borrowings comprise mostly relatively small export credits. Thus, there can be many borrowers with numerous loans. The data collection process is not inherently difficult if the country has an exchange control system, for the information required by the exchange control authorities (to avoid capital export in the guise of overpaying foreign debts) can serve the need of the government debt office. If a country with exchange control does not have comprehensive data on its private sector debt, that is probably because it has not fully exploited the exchange control system.

The data collection process is much more difficult in the absence of exchange control. Direct surveys must be made of private enterprises. If private enterprises do not traditionally cooperate with government statistical enquiries, success will be problematic. But some developing country governments have succeeded in organizing excellent company financial surveys (e.g., Côte d’Ivoire, Malaysia). Where private sector activity is significant, an effort is required on the part of the government debt office.

D. Monitoring Short-Term Debt

The above discussion of debt monitoring problems has concerned long-term debt. Short-term debt (maturity of one-year or less) can be volatile, and its unobserved build-up has created monumental problems for many countries (The Philippines in 1969; Turkey in 1976; Nigeria in the early 1980s). Accordingly, it should be monitored. The bulk of short-term debt is trade-related, and the credits are mostly arranged through the commercial banks. Thus, a prerequisite for statistics on short-term debt is the standardization of commercial banking accounts so that reports on banking activity can be submitted to the Central Bank. Very few developing countries have attempted to prepare external debt data from banking statistics, but with the spread of computerization, this is quickly becoming technically feasible. What remains is appropriate organization of debt-related accounts. Information is also needed on non-trade short-term debt in banking data and on short-term debts not reflected in commercial banking statistics.

The Philippines, following a serious debt-servicing problem in 1969, organized comprehensive reporting of short-term debt. Such information has been an integral part of its total debt statistics for many years. What has been achieved in the Philippines could serve as a model for other countries.

V. Role of the World Bank

The World Bank requires that all member countries that would like to borrow must file comprehensive reports on their external debt. Aside from providing World Bank economists with information with which to assess the creditworthiness of countries, the data base created with reports under the World Bank’s Debtor Reporting System (DRS) provides the primary source of internationally comparable statistics on the external debt of developing countries. The DRS is based on loan-by-loan reports to the Bank of long-term public and publicly guaranteed debt (i.e., with a maturity of more than one year). In addition, countries report long-term private sector debt in aggregate.

Initially, the World Bank requested only summary information on debt from borrowing member countries. Even for countries with relatively good statistical services, reports were not comparable between years, and it was very difficult to maintain comparability of data between countries. Furthermore, aggregated data could be collected in only one format, and it was not possible to re-organize country debt data for different analytical purposes. Consequently, in 1951, the Bank moved from an aggregated to a loan-by-loan data collection system.

The legal basis for collecting data from countries lies in the Articles of Agreement, to which all countries subscribe when they join the Bank. Article III, Section 4, states that "... the Bank shall pay due regard to the prospects that the borrower... will be in a position to meet its obligations under the loan." The "General Conditions Applicable to Loan and Guarantee Agreements" state that borrowers must furnish information with respect to financial and economic conditions in their countries, including data on external debt.

The reports required by the Bank under the Debtor Reporting System are as follows:

Form 1: Description of individual loans. This form shows the amount of the loan, terms of
repayment, names of the borrower and lender and descriptive detail. If the amortization schedule does not follow a regular pattern, then a supplementary form, Form 1-A, is also submitted.

Form 2: Annual report on the status of public and publicly-guaranteed debts. This report is filed three-months following the end of the reporting year (normally the calendar year). It includes figures, for each public and publicly-guaranteed debt, regarding amounts outstanding, arrears, disbursements received, debt service paid and debt relief received. Data are normally reported in currency of obligation.

Form 4: Annual report on the status of private non-guaranteed debt. This is a summary report showing data on the same indicators as Form 2. However, data are not shown loan-by-loan, but are aggregated by type of debtor.

The information received on Form 1 is used to set up a loan record file in the Debt and International Finance’s computerized debt data monitoring system (known as "RXD"). The data on each year’s Form 2 is used to record an historical record for each year. It is then possible to prepare summary data for a country’s external debt. The Form 2 data provide figures for the debt outstanding as of the year of the report and for each previous year. Form 2 also provides data for the flow variables: commitments received, amounts disbursed, debt service paid, etc. In the event Form 2 data is missing for any historical year, the RXD program will extrapolate data. (Many countries no longer fill out forms but report the information requested on DRS reporting forms on computer tapes or diskettes.)

The schedule of future debt service payments on public and publicly-guaranteed debt is not stored in the World Bank’s computer but are projected by RXD each time a debt table is requested. This is done on the basis of the terms information reported on Form 1.

Because the underlying information is on a loan-by-loan basis, it is possible to organize summary tables in a wide variety of formats. Each type of information requested on Form 1 can be used as a classification criterion in preparing tables. The standard format for debt tables is by creditor type (multilateral organizations, bilateral official, private sources), but tables can also be prepared organized by such categories as debtor type (central government, public enterprises, etc.), by economic sector, or by status of debt rescheduling.

Information on individual creditor/debtor relationships is kept confidential. Summary information is published in an annual statistical compendium, The World Debt Tables. In addition, special tabulations can be prepared for the national debt office submitting DRS reports for special analytical uses or as a basis for checking data submitted to the World Bank against internally-generated summary reports.

VI. Creditor-Source Information on External Debt

Information on certain key elements of developing country debt have been available from creditor-sources for many years. The most important such source are figures on cross-border banking statistics compiled initially by the Bank for International Settlements and now by the International Monetary Fund as well. In addition, the OECD collects data on export credits and inter-governmental loans extended by DAC member countries as part of its Creditor Reporting System.

A. Creditor Country Information

The OECD and the International Monetary Fund have each explored how to assemble figures on the debt of developing countries, making use of available creditor-source information, so as to produce more comprehensive and more timely figures on developing country external debt than can be compiled exclusively from debtor country sources. The merit of their work is that it is possible to compensate for two major deficiencies of debtor-country data sources: (a) the lack of data on short-term indebtedness, a volatile component of external debt that had grown in importance during the 1970s and (b) the time-lag in assembling debtor-country data through the World Bank’s Debtor Reporting System. This latter problem, as we have noted above, is the problem of late-reporting by key countries and the time required after receipt of the report to edit it and process the data. (Periodically, the staff of the Debt and International Finance Division estimates the debt indicators for the current year and projects values for a few succeeding years; but these estimates are not substitutes for actual data, particularly when certain components, such as short-term debt and
Managing External Debt in Developing Countries

Disbursements of credits from financial institutions are volatile and are difficult to predict.

a. Cross-Border Banking Statistics

The BIS has been collecting figures on international banking since 1963. Data are collected from the central banks of Group of Ten countries plus Austria, Denmark, Ireland and Switzerland. These figures are based on balance sheet data for external liabilities and assets of commercial banks vis-a-vis individual countries outside the BIS reporting area. There is a quarterly reporting system and a semi-annual reporting system.

The quarterly system is based on the resident/foreigner principle of balance-of-payments accounting: claims include the claims of banks on their foreign branches. The annual semi-annual system is based on a worldwide consolidated balance sheet basis. This means that claims between the banks of reporting countries and their foreign branches are netted-out, and the report includes claims of foreign branches on borrowers outside the BIS reporting area. The semi-annual system provides some breakdown by maturities: claims maturing in less than one year, between one and two years, and more than two years. (One should note that the BIS figures for debts maturing in less than one year do not correspond to DRS-type short-term debt, because the BIS data is on a residual maturity basis.)

Summary data obtained from the quarterly system is available within 3-4 months after the balance sheet data, data from the semi-annual system within 5-6 months. Thus, figures on banking claims on developing countries are available quickly and can provide indications of major changes in commercial bank lending activity towards particular countries.

The International Monetary Fund’s Bureau of Statistics collects international banking statistics from 31 countries: the 25 countries reporting to the BIS plus 6 additional countries. From these reports, three elements of debt information are presented with respect to cross-border banking claims:

(a) Liabilities of deposit banks to deposit banks in the rest of the world;

(b) Liabilities of deposit banks to non-banks in the rest of the world;

(c) Liabilities of non-banks to deposit banks in the rest of the world.

b. Creditor Reporting System Data

The Development Assistance Committee of the OECD (DAC) monitors aid and other capital flows from its 17-country membership to developing countries. The objective was to monitor both the volume and terms of assistance following DAC country pledges to enhance the volume and improve the terms of lending of official development assistance (ODA). Two types of statistical reports are prepared by DAC member countries. One is the Annual Aid Questionnaire that summarizes financial flows to developing countries during a calendar year. The second is the Creditor Reporting System (CRS) loan-by-loan reports on loans and export credits. (Information on export credits with a maturity of less than five-years is reported in aggregate.) These reports provide a mirror image to the DRS reports submitted by the recipient countries. (The CRS was initially a joint World Bank/OECD exercise.) The information contained in these two sets of reports provides creditor-source information on DAC member country flows and claims on developing countries.

B. The OECD Synthesis

The OECD prepares two documents for publication that build on creditor-source information on developing country debt. One is the annual publication, External Debt Statistics. It is preceded by a document containing preliminary and estimated data, Financing and External Debt of Developing Countries. A sample page for India is reproduced in Table 19-3, below. Under long-term debt, the section, "OECD Countries and Capital Markets", is based on CRS and Aid Questionnaire reports to the OECD plus the semi-annual BIS reports. Since the CRS reports on export credits represents export credits extended by banks as well as directly by suppliers, the BIS-source data are adjusted to avoid double counting.

The BIS semi-annual reports have been used to estimate the stock of short-term debt to banks, and the figures are shown separately. The section of the table on long-term debt to non-OECD creditor countries incorporate information compiled by the OECD on claims of OPEC and Eastern European countries to developing countries. The balance of the table uses information collected by the World Bank under the DRS.

A second report by the OECD is a semi-annual publication, Statistics on External Indebtedness: Bank
and Trade-Related External Claims on Individual Borrowing Countries and Territories. This document brings together the BIS semi-annual report on cross-border banking statistics and the OECD CRS data on export credits. It appears about one month after publication of the BIS semi-annual report.

Statistics on external debt are produced by several international organizations. Statisticians from each agency have been in contact with one another over the years, but in 1984 they began to meet regularly to promote the convergence of debt recording practices. This group, the International Group on External Debt Statistics, comprises representatives of the World Bank, the IMF, the OECD and the BIS. In 1988, it published a booklet, External Debt: Definition, Statistical Coverage and Methodology, containing chapters describing the debt statistics produced by each member agency plus a chapter on the "core definition of debt". For further information on the creditor-source statistics described above, the reader is referred to this monograph.

C. Limitations of Creditor-Source Debt Data

The IMF’s International Banking System data provides monthly information on banking claims on developing countries; the OECD’s report on Statistics on External Indebtedness brings together banking and export credit data at six-month intervals; and the OECD document, Financing and External Debt of Developing Countries provides comprehensive estimates of developing country debt six months after the end of the reporting period.

However, there are some limitations of these data. First, the banking data is based on residual maturity rather than on original maturity. A ten-year loan with less than one-year to final maturity is recorded along with 180-day credits. Another problem is that the banking data provide stock figures only; flows must be inferred from changes in stock figures. However, the dollar value of claims denominated in currencies other than US dollars fluctuate in response to exchange rate shifts; given the wide swings in exchange rates during recent years it is hard to assess the extent to which changes in the stock of banking data reflect capital flows as opposed to revaluations.

The creditor-source data do not incorporate schedules of debt service payments, and so they do not provide any knowledge of the debt service profile of individual countries. A difficulty with the OECD summary data is that the figures are available only in a fixed format. Useful as is this format, the analyst would like to re-organize debt data for various purposes; this is not possible with creditor-source data.

Finally, what does one do when one discovers major discrepancies between creditor source data and the debtor country’s own records? If a re-examination of the debtor country’s data does not reveal any errors or suggest any major omissions, one would like to turn to the creditor source data for a clue. But since the information is available only at a very high level of aggregation, it is not possible to find specific detail which can be used to line up against the debtor country’s records. Given the complexity of banking statistics, one cannot presume that the creditor-source data, simply because they originate in the economically advanced countries, are necessarily superior in quality to the debtor country accounts. Useful as creditor-source data are for providing quick insights into changes in developing country external finance, progress in better measuring international indebtedness lies in perfecting debtor country debt data.

VII. Technical Assistance on External Debt Management

In an effort to help developing countries improve the quality of external debt statistics, the World Bank, the IMF, the UNDP and other organizations all offer technical assistance programs. Technical assistance may be provided by a resident advisor, a consulting firm, by short visits of experts or by training programs for national debt office staff. Technical assistance programs on external debt contain some or all of these elements:

(a) Debt policy: Establishing control over borrowing decisions, analyzing the budgetary or balance-of-payments impact of proposed new borrowing and choosing the appropriate methods of finance.

(b) Debt monitoring: Improving a country’s ability to maintain records of its external debt data and to develop statistics. This includes designing or improving the accounting system for recording figures on external borrowing; monitoring debt service obligations to assure prompt payments; centralizing the flow of
information into the debt accounting office; developing summary statistics from detailed debt records.

(c) **Computerized data systems:** Computerizing an existing manual debt accounting and statistical system or installing an entirely computer operated system. Technical assistance projects will finance the purchase of computer equipment, software and the services of an expert team to install the system.

(d) **Training:** Developing expertise in debt monitoring techniques. Technical assistance projects normally provide on-the-job training as well as advisory services, because the object of technical assistance is to enable the country to manage and monitor its debt without outside assistance after the foreign advisor has completed his tour of duty.

**A. Assistance from the World Bank**

Technical assistance from the World Bank Group is made available through several channels: (1) IBRD loans and credits are extended to finance advisory services, purchase of computer hardware and software and training; (2) The World Bank may serve as the executing agency for UNDP-financed projects; (3) the World Bank provides direct training through technical assistance missions by staff members and through special training seminars and courses; and (4) the Treasurer’s Office offers financial technical assistance on the use of international capital markets, asset management and liability management.

a. **Assistance through Loans and Credits**

World Bank loans and IDA credits make it possible for the borrowing country to hire experts or purchase advisory services and equipment from private sources. The borrowing country is responsible for recruiting, and must make the decision on whom to hire. The Bank must approve the terms of reference of the expert, or the firm. The Bank staff may provide advice during the recruitment and selection process, but the selection is done by the country; the Bank's role is mainly to provide financing.

World Bank technical assistance loans and credits do not deal with a single issue, such as debt management, but rather combine a number of technical assistance needs into a single project. The Bank staff must identify the various components, draft terms of reference for the individual advisors and estimate the costs, in consultation with the beneficiary country. Such loans and credits are approved by the Bank’s Executive Board, as all other loans and credits. During implementation, World Bank staff periodically supervise the projects to assure that they are being executed as planned.

b. **Executing Agency for UNDP Programs**

Funds for technical assistance are available under the United Nations Development Program (UNDP). Because the UNDP does not have its own technical staff to implement or supervise these projects, other agencies, including the World Bank, are invited to do so in a capacity of "executing agency". Such projects are established in a 3-way agreement between the UNDP, the World Bank and the beneficiary government.

The beneficiary country must propose the program, and the channel of communication is through the country's designated liaison officer to the UNDP resident representative. Thus, should the manager of a debt office wish to secure UNDP funds for assistance on debt management, he must prepare a detailed project proposal and provide justification for the project. The possibility of having the World Bank be the Executing Agency is discussed by the UNDP resident representative and the local liaison officer. As Executing Agency, the World Bank assists the beneficiary country define the scope of technical assistance, prepare terms of reference and review potential resident experts or consulting firms. The Bank must supervise such projects just as with its own loans and credits.

c. **Direct Assistance by World Bank Staff**

This is carried out by field visits and through special training seminars and courses. Debt specialists from the Debt and International Finance Division will visit a country to assist in the preparation of statistical reports under the Debtor Reporting System, often as part of a larger Bank economic mission. In this course of this exercise, the debt specialist can assess the country's debt accounting procedures and computeriza-
tion system, offer some immediate suggestions for improvement and define longer-term technical assistance needs.

Formal training is carried out through one-week seminars and three-week training courses. The seminars bring together heads of national debt offices to discuss common problems of external debt management. Separate seminars are held for policy issues and for debt monitoring issues. Normally, these seminars are on a regional basis. The three-week training courses are for debt office technical staff. They cover debt accounting and organizational procedures, improving data sources and making efficient use of computer facilities.

The Debt and International Finance Division of the World Bank is developing a computerized debt management system that can be used on a microcomputer. When completed, it will provide state-of-the-art methods of computerized debt accounting procedures. It is presently being made available to a few countries for testing.

d. Financial Technical Assistance

Developing countries are exposed to financial risks through interest rate and exchange rate fluctuations. When managed skillfully, such risks can be reduced through currency and interest rate swaps. The Treasurer’s Office of the World Bank has started a program of financial technical assistance to enable developing countries to use these new instruments of risk management. The approach is to help with institution building, i.e., working with a liability management team, composed of 3-4 people in the ministry of finance or central bank, who need further training in technical and market skills. The Bank’s FTA team will work closely with such a group, helping to identify training needs and to arrange for market orientation or trading experience in New York or London.

During the 18-36 month institution building period, the FTA team will provide guidance when needed to assess risk management options. Computer programs and technical literature will be made available. There may also be risk management seminars for the country’s senior financial managers.

B. Assistance from the International Monetary Fund

The Central Banking Department of the International Monetary Fund has provided a technical assistance program specifically for debt management since 1982. Between 1983 and 1988, 26 countries have benefited from this service.

Upon request from the Minister of Finance or the Governor of the Central Bank, the IMF’s Central Banking Department will recruit a person to serve as a resident advisor. The initial assignment is for a period of up to one year, but extensions are liberally granted up to a total of three years (and, in exceptional circumstances, longer). The IMF recruits the expert from other IMF member countries. They are normally on the staff of central banks, finance ministries or other agencies with primary responsibility for external debt management. The program presently is very small: there were resident advisors only in three countries as of end-October 1990.

C. Assistance from Other Sources

Technical assistance on debt management is also offered by the United Nations Conference on Trade and Development (UNCTAD) and by the Commonwealth Secretariat. Both groups have centered their assistance around the installation of their own specialized debt management software, which is offered to beneficiary countries at no charge.

a. UNCTAD

The UNCTAD system, known as “Debt Management and Financial Analysis” (DMFAS) was introduced in 1981. Twenty-seven countries have installed DMFAS or are in the process of doing so. The UNDP has provided most of the funds for system development and installation, but there has been some additional support from Belgium, Germany, the Netherlands and Norway.

When a country requests assistance by UNCTAD, an evaluation mission is mounted to establish the needs of the country, and the project is defined in a UNDP-financed technical assistance project.
Training of debt managers is an integral part of each project. UNCTAD has a staff of computer experts that are engaged in continuing developments of the DMFAS system. There is also a small staff of experts to assist countries with problems of installation and system maintenance, but support is limited by the size and duration of the UNDP grant the individual beneficiary countries.

b. Commonwealth Secretariat

This program is carried out by the Technical Assistance Group of the Commonwealth Fund for Technical Cooperation. The staff includes computer experts who are engaged in both long-term software development and special modifications to adapt the software for individual countries. In addition, there is a senior advisory staff that makes a careful assessment of the debt management system of a country before agreeing to install the Commonwealth Secretariat's software, "Commonwealth Secretariat Debt Recording Management System (CS-DRMS).

The Commonwealth Secretariat staff direct the preparation of a debt inventory, and then provide training in London for key local staff on the preparation of data input and on how to use CS-DRMS. Commonwealth Secretariat staff review the data input figures and provide training in the field to the entire local office staff. When the system is running, there is further training in the management tools of CS-DRMS.

In some countries, where the project leadership is weak, the Commonwealth Secretariat will provide a resident advisor to direct the changes in the institutional arrangements, the installation of software and the training of local staff. Wherever possible, the management of the project is in the hands of the local debt office. The services of the Commonwealth Secretariat are limited to Commonwealth member countries. There are a few projects for non-Commonwealth countries that are run on a cost-recovery basis, but staff constraints limit the number of such activities.

VIII. Summary and Conclusions

The primary source of information on the external debt of developing countries is accounting information on loan commitments, disbursements and debt service payments organized by national debt offices. Summary information can be compiled on many key elements of developing country external debt from creditor sources. However, for detailed analysis, one must turn to debtor country information. Should this information be deficient, the debt office manager must diagnose the problems at the level of each type of debtor: the central government, public enterprises, and private borrowers. The paper presented a framework for identifying the probable cause of observed problems. Correcting these problems requires an understanding of the difficulties faced at each stage of data collection and special problems of accounting procedures. It is also necessary to make a critical evaluation of the institutional arrangements for debt monitoring.

In an effort to help developing countries improve the quality of their debt information systems, the World Bank, the IMF and some other multilateral organizations provide technical assistance. This takes the form mainly of financing the cost of consulting experts, but there is also some direct assistance by staff members.
(US$ billions)

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<tbody>
<tr>
<td><strong>By debtor institution</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Central government</td>
<td>31.6</td>
<td>47.7%</td>
<td>200.4</td>
<td>45.2%</td>
<td>653.5</td>
<td>65.6%</td>
</tr>
<tr>
<td>State and local government</td>
<td>0.6</td>
<td>0.8%</td>
<td>4.4</td>
<td>1.0%</td>
<td>11.9</td>
<td>1.2%</td>
</tr>
<tr>
<td>Public enterprises</td>
<td>17.2</td>
<td>26.0%</td>
<td>148.0</td>
<td>33.4%</td>
<td>224.0</td>
<td>22.5%</td>
</tr>
<tr>
<td>Private enterprises</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Publicly guaranteed debt</td>
<td>0.3</td>
<td>0.5%</td>
<td>15.4</td>
<td>3.5%</td>
<td>15.7</td>
<td>1.6%</td>
</tr>
<tr>
<td>Private non-guaranteed debt</td>
<td>16.5</td>
<td>25.0%</td>
<td>75.0</td>
<td>16.9%</td>
<td>90.4</td>
<td>9.1%</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>66.2</td>
<td>100.0%</td>
<td>443.3</td>
<td>100.0%</td>
<td>995.6</td>
<td>100.0%</td>
</tr>
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</table>

Table 19-2: DEBT MONITORING DIFFICULTIES

<table>
<thead>
<tr>
<th>Type of debt Monitored</th>
<th>Problems Observed</th>
<th>Probable Cause</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Government direct debt</strong></td>
<td>- Total debt unknown</td>
<td>- Failure to centralize information</td>
</tr>
<tr>
<td>- Assemble loan contracts</td>
<td>- Available loan balances unknown</td>
<td></td>
</tr>
<tr>
<td>- Monitor loan disbursements</td>
<td>- late charges</td>
<td>- Disorderly payments system - Deficient paying agent</td>
</tr>
<tr>
<td>- Order debt service payments</td>
<td>- Current status unknown</td>
<td>- Accounting system design</td>
</tr>
<tr>
<td>- Monitor arrears</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>B. Parastatal Debt</strong></td>
<td>- Data incomplete or very late</td>
<td>- Failure to obtain cooperation - More aggressive effort required</td>
</tr>
<tr>
<td><strong>C. Private Sector Debt</strong></td>
<td>- Data incomplete or unknown</td>
<td>- Need to exploit exchange control data - Need for company financial survey</td>
</tr>
</tbody>
</table>
Table 19-3: INDIA VS US $ Million

<table>
<thead>
<tr>
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<th></th>
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</thead>
<tbody>
<tr>
<td><strong>GROSS DEBT</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Long term</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>I. OECD countries and capital markets</td>
<td>8126</td>
<td>9858</td>
<td>10106</td>
<td>10324</td>
<td>10268</td>
<td>10730</td>
</tr>
<tr>
<td>ODA</td>
<td>7274</td>
<td>8751</td>
<td>7940</td>
<td>7899</td>
<td>7728</td>
<td>6726</td>
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<tr>
<td>Official/off. supported</td>
<td>841</td>
<td>955</td>
<td>1635</td>
<td>1467</td>
<td>1127</td>
<td>900</td>
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<tr>
<td>Official export credits</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>204</td>
<td>260</td>
<td>733</td>
</tr>
<tr>
<td>Guaranteed supplier credits</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>761</td>
</tr>
<tr>
<td>Guaranteed bank credits</td>
<td>...</td>
<td>...</td>
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<td>...</td>
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<td>11</td>
<td>132</td>
<td>491</td>
<td>959</td>
<td>1413</td>
<td>2105</td>
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<td>9</td>
<td>100</td>
<td>450</td>
<td>927</td>
<td>1383</td>
<td>1975</td>
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<td>32</td>
<td>41</td>
<td>32</td>
<td>30</td>
<td>130</td>
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<tr>
<td>Other private</td>
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<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>II. Multilateral</td>
<td>3245</td>
<td>6720</td>
<td>9126</td>
<td>9126</td>
<td>11253</td>
<td>12746</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
<td></td>
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<td></td>
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</tr>
<tr>
<td>concessional</td>
<td>3063</td>
<td>6050</td>
<td>7909</td>
<td>7909</td>
<td>10271</td>
<td>12054</td>
</tr>
<tr>
<td>non-concessional</td>
<td>182</td>
<td>670</td>
<td>1217</td>
<td>1217</td>
<td>1969</td>
<td>2042</td>
</tr>
<tr>
<td>III. Non-OECD Creditor countries</td>
<td>1100</td>
<td>1604</td>
<td>1305</td>
<td>1305</td>
<td>1599</td>
<td>1722</td>
</tr>
<tr>
<td>CMEA</td>
<td>364</td>
<td>311</td>
<td>256</td>
<td>256</td>
<td>294</td>
<td>401</td>
</tr>
<tr>
<td>OPEC</td>
<td>706</td>
<td>1252</td>
<td>1027</td>
<td>1027</td>
<td>1772</td>
<td>1992</td>
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<tr>
<td>Other countries and unspecified</td>
<td>30</td>
<td>41</td>
<td>41</td>
<td>41</td>
<td>117</td>
<td>281</td>
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<tr>
<td>Subtotal: Long term debt</td>
<td>12471</td>
<td>18183</td>
<td>20237</td>
<td>20708</td>
<td>21829</td>
<td>23256</td>
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<td>of which:</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>concessional</td>
<td>11356</td>
<td>16332</td>
<td>17117</td>
<td>17076</td>
<td>17291</td>
<td>20166</td>
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<tr>
<td>non-concessional</td>
<td>114</td>
<td>1851</td>
<td>3420</td>
<td>3632</td>
<td>4230</td>
<td>5965</td>
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<tr>
<td><strong>Short term</strong></td>
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<td></td>
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<tr>
<td>Subtotal: Short term debt</td>
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<td>...</td>
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</tr>
<tr>
<td>Banks</td>
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<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Export credits</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Total external debt excluding IMF credit</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Total external debt including IMF credit</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
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<tr>
<td>Other identified liabilities</td>
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<tr>
<td><strong>Total identified debt</strong></td>
<td>...</td>
<td>...</td>
<td>...</td>
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</table>

**SERVICE PAYMENTS**

<table>
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<tr>
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<th></th>
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<tbody>
<tr>
<td><strong>Long term</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>I. OECD countries and capital markets</td>
<td>656</td>
<td>1003</td>
<td>1162</td>
<td>962</td>
<td>1145</td>
<td>1100</td>
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<tr>
<td>ODA</td>
<td>283</td>
<td>520</td>
<td>458</td>
<td>466</td>
<td>439</td>
<td>443</td>
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<tr>
<td>Official/off. supported</td>
<td>371</td>
<td>450</td>
<td>644</td>
<td>301</td>
<td>575</td>
<td>409</td>
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<td>Financial markets</td>
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<td>50</td>
<td>195</td>
<td>132</td>
<td>248</td>
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<tr>
<td>Other private</td>
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<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>II. Multilateral</td>
<td>113</td>
<td>193</td>
<td>252</td>
<td>252</td>
<td>341</td>
<td>391</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>concessional</td>
<td>70</td>
<td>92</td>
<td>95</td>
<td>98</td>
<td>118</td>
<td>140</td>
</tr>
<tr>
<td>III. Non-OECD Creditor countries</td>
<td>92</td>
<td>199</td>
<td>235</td>
<td>235</td>
<td>240</td>
<td>189</td>
</tr>
<tr>
<td>Subtotal: Service payments, long term debt</td>
<td>861</td>
<td>1394</td>
<td>1649</td>
<td>1450</td>
<td>1726</td>
<td>1679</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>concessional</td>
<td>433</td>
<td>788</td>
<td>773</td>
<td>781</td>
<td>762</td>
<td>720</td>
</tr>
<tr>
<td>Total service payments excl. IMF credit</td>
<td>861</td>
<td>1394</td>
<td>1649</td>
<td>1644</td>
<td>1948</td>
<td>1918</td>
</tr>
<tr>
<td>Amortization, long term debt</td>
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<td>...</td>
<td>...</td>
<td>...</td>
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<td>...</td>
</tr>
<tr>
<td>Interest, long term debt</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Interest, short term debt</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>Total service payments incl. IMF credit</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
</tbody>
</table>

Source: Financing and External Debt of Developing Countries.
20. External Debt Management in Bahrain

Essa Ahmed Ebrahim
Hassan Abdulla Moh'd
Bahrain

The total external debt of Bahrain, even including foreign liabilities of the domestic banking system, is relatively small when compared with that of many developing countries. It is also small in relation to GDP. In fact, Bahrain enjoys a substantial net creditor position vis-a-vis the world. In view of this, it was not considered necessary to have a centralized agency for external borrowing. However, the Government and the Bahrain Monetary Agency monitor developments in the external debt situation of the country.

The four main categories of borrowers are: the Government, the Bahrain Monetary Agency (BMA), commercial banks and non-public private sector enterprises (commercial enterprises). All of these entities borrow independently. Since the number of borrowers who can raise resources abroad is limited, the authorities are in a position to follow external borrowing.

I. Government Debt

Most of the Government of Bahrain’s foreign borrowing have been contracted to finance infrastructure projects such as electricity generation, water plants, road construction, etc. It was relied on development credits and long-term loans mainly from the Arab lending agencies such as the Abu-Dhabi Fund, the Kuwaiti Fund, the Saudi Fund, the Arab Fund for Economic and Social Development and the Islamic Development Bank (please refer to Table 20-1). The total of such debt was only $111.2 million at the end of 1989. As the terms and conditions thereof are favorable, the ratio of external debt servicing to GDP is very small. There has been no borrowing for balance of payments financing as such.

II. Bahrain Monetary Agency and Commercial Bank Debt

The foreign liabilities of the BMA and commercial banks, as can be seen from Tables 20-2 and 20-3, have fluctuated over the years. This is much more so in respect of the BMA. These liabilities form a fraction of their foreign assets. The BMA keeps a close watch on foreign liabilities of commercial banks.

III. Commercial Enterprises Debt

A few enterprises have had recourse to foreign borrowing, mainly from commercial banks abroad and offshore banks in Bahrain. The choice of the source depends on the volume of borrowing, the terms and conditions relating to borrowing, besides other facilities offered by these lending institutions. No firm data are available regarding total external debt of these enterprises, but it is believed to be small. As there are no restrictions in Bahrain on the inflow and outflow foreign money, it is not easy to determine outstanding external debt of these enterprises. External borrowing and repayments flowing through the domestic banking system get recorded in the balance of payments to the extent the system can identify the purpose of transactions. Some large enterprises like Alba have recently gone in for substantial foreign borrowing, highlighting the need for formalized and centralized monitoring of such external borrowing, by the authorities.

So far, annual external borrowing by commercial enterprises has been small, and debt servicing has not created a problem. As a result, individual enterprises have had considerable freedom to decide how to

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1 This paper does not necessarily reflect the opinion of the Bahrain Government or the Ministry of Finance and National Economy, but represents the personal views of the authors.
structure their financing. Their position is not expected to change significantly over the medium term. As mentioned earlier, some large external borrowing are in the pipeline. However, contractual debt servicing will be will covered by the prospective foreign exchange earnings from the project. As a cautionary an measure, the authorities are seriously considering to formalize the arrangements in respect of centralize monitoring of external debt developments of the country.

The external debt situation of Bahrain is not such as to require setting up of a global ceiling on external borrowing. At present, therefore, no agency has the responsibility for establishing ceilings on foreign borrowing. As the external borrowing by enterprises is essentially project related, the choice of finance is determined by the phasing of foreign exchange requirements, the expected flow of exchange earnings from the project and the terms and conditions of the finance.

IV. Debt Monitoring

The Bahrain Government's external debt is administered by the Ministry of Finance and National Economy. The BMA manages its own debt and has detailed information about commercial banks' external borrowing. Information regarding external borrowing of these debtors is available regularly and with a short time lag.

In the case of commercial enterprises, data on their external borrowing are generally available in their balance sheets. No effort has been made so far to pool these data, as external debt, to data, has not been an important issue. There are, however, indications that steps would be taken soon to build up these statistics in a systematic manner.

While external debt management for the state as a whole is not computerized by a centralized agency, the accounts of many individual enterprises including those which have external debt are, however, computerized. As the volume of debt is small and no single agency is charged with the responsibility to monitor to developments therein and to take necessary decisions pertaining thereto, the necessity for centralized computer system to facilitate information gathering and dissemination, as well as for decision making was not been felt strongly so far. As the size of debt and the number of borrowing enterprises increase, appropriate measures will be taken to have complete details of all external debt of Bahrain. This work will also be computerized if such a need is felt.

The Ministry of Finance and National Economy has the responsibility for the Government budget and the management of the external debt of the Government. The Ministry provides details on the Government’s debt regularly to the BMA for recording of the balance of payments transactions. Thus, so far as the external debt of the Government is concerned the internal consistency of balance of payments, budget and debt office is well ensured. Data on foreign liabilities of the BMA and interest thereon are available monthly for balance of payments compilations by the Economic Research Directorate of the Agency. Similarly the same Directorate receives monthly data on foreign liabilities of commercial banks; the interest thereon is at present estimated. Regarding relevant data for other enterprises the coverage in balance of payments is limited to a few large ones from whom these data are specifically obtained for balance of payments purposes. The intention is to cover some more of these. Besides, commercial banks report such transactions flowing through them and they could identify the underlying purpose. There are some problems in ensuring full coverage of these data relating to commercial enterprises in balance of payments as external transactions could be freely effected. Though the coverage relating to external debt and debt servicing in balance of payments is not complete in respect of debt pertaining to non-bank commercial enterprises, efforts are being continued to improve the same.

In conclusion it can be said that the external debt of Bahrain and the debt servicing amounts have been relatively small so far by any standards. These are likely to grow in the near future in view of borrowing envisaged by some enterprises. Borrowing by non-bank enterprises are expected to be for project purposes only and based on proper assessment of servicing of such debts through exchange earnings of the project. In view of the expected growth in external debt, serious thought is being given to centralize the monitoring of all aspects of these transactions so that the authorities would be in a position to influence the development therein, if necessary. Obviously the objective would be to maintain the high creditworthiness of Bahrain and not to do anything which would even remotely affect the growth of the economy and of Bahrain as an offshore financial center.
Table 20-1: BAHRAIN GOVERNMENT OUTSTANDING EXTERNAL DEBT TO DEVELOPMENT FUNDS, 1988-1989
(in US$ millions)

<table>
<thead>
<tr>
<th>Financial Funds</th>
<th>1988</th>
<th>1989</th>
</tr>
</thead>
<tbody>
<tr>
<td>Islamic Development Bank</td>
<td>10.2</td>
<td>18.2</td>
</tr>
<tr>
<td>Abu Dhabi Fund</td>
<td>14.3</td>
<td>12.0</td>
</tr>
<tr>
<td>Saudi Fund</td>
<td>27.3</td>
<td>24.7</td>
</tr>
<tr>
<td>Arab Fund</td>
<td>13.4</td>
<td>12.4</td>
</tr>
<tr>
<td>Kuwaiti Fund</td>
<td>50.6</td>
<td>43.9</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>115.8</strong></td>
<td><strong>111.2</strong></td>
</tr>
</tbody>
</table>

Source: Bahrain Ministry of Finance and National Economy Directorate of Economic Relations.
Table 20-2: BAHRAIN MONETARY AGENCY, FOREIGN ASSETS AND LIABILITIES, YEAR-END VALUES 1980-89 (US$ millions)

<table>
<thead>
<tr>
<th>Year</th>
<th>Foreign Assets</th>
<th>Foreign Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>650</td>
<td>101</td>
</tr>
<tr>
<td>1981</td>
<td>863</td>
<td>48</td>
</tr>
<tr>
<td>1982</td>
<td>797</td>
<td>22</td>
</tr>
<tr>
<td>1983</td>
<td>811</td>
<td>43</td>
</tr>
<tr>
<td>1984</td>
<td>741</td>
<td>3</td>
</tr>
<tr>
<td>1985</td>
<td>838</td>
<td>27</td>
</tr>
<tr>
<td>1986</td>
<td>843</td>
<td>25</td>
</tr>
<tr>
<td>1987</td>
<td>1,023</td>
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</tr>
<tr>
<td>1988</td>
<td>845</td>
<td>75</td>
</tr>
<tr>
<td>1989</td>
<td>1,097</td>
<td>116</td>
</tr>
</tbody>
</table>

Table 20-3: BAHRAIN COMMERCIAL BANKS' FOREIGN ASSETS AND LIABILITIES, YEAR-END VALUES (US$ millions)

<table>
<thead>
<tr>
<th>Year</th>
<th>Foreign Assets</th>
<th>Foreign Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>848.7</td>
<td>626.0</td>
</tr>
<tr>
<td>1981</td>
<td>910.1</td>
<td>325.8</td>
</tr>
<tr>
<td>1982</td>
<td>949.8</td>
<td>332.1</td>
</tr>
<tr>
<td>1983</td>
<td>1,246.8</td>
<td>397.6</td>
</tr>
<tr>
<td>1984</td>
<td>1,156.0</td>
<td>278.5</td>
</tr>
<tr>
<td>1985</td>
<td>1,556.5</td>
<td>338.6</td>
</tr>
<tr>
<td>1986</td>
<td>1,842.5</td>
<td>402.1</td>
</tr>
<tr>
<td>1987</td>
<td>1,841.8</td>
<td>389.2</td>
</tr>
<tr>
<td>1988</td>
<td>2,270.2</td>
<td>424.7</td>
</tr>
<tr>
<td>1989</td>
<td>3,104.7</td>
<td>865.2</td>
</tr>
</tbody>
</table>

21. Debt Management In Malaysia

Hadenan Abd Jalil, Mament Bin Ali, Wan Salamah Wan Sulaiman
Ministry of Finance, Malaysia

This paper provides a brief analysis of Malaysia’s debt position and the debt management strategies adopted by the Government in the 1980’s. The following areas will be covered: (a) Power and legal framework under which borrowing is undertaken; (b) Profile of outstanding debt; (c) Debt management system in Malaysia; (d) Prevailing issues related to debt management; (e) Public policies on debt and its management.

The emphasis of this paper is on public sector debt management. As in any other developing country, the Government of Malaysia has been the main driving force behind the country’s development efforts. This trend will be reversed in the future with the private sector assuming a greater role and ultimately to be the main "engine of growth". Accordingly, attention is also given to the problem of monitoring private sector debt.

I. Legal Framework

Malaysia’s Federal Constitution provides the legal framework under which the Government can undertake borrowings both from domestic or foreign sources. As stated under Article 111 of the Constitution, the Government "shall not borrow except under the authority of Federal Law". Being a Federation, the Constitution does not authorize State Governments to borrow except from the Federal Government, or from financial sources approved by the Federal Government or with Federal Government guarantee.

Appendix A lists some relevant legislation governing the power and procedure to borrow either through domestic or foreign sources. As such, there are laws and legal requirement related to loan activities with international financial institutions such as the World bank, Asian Development Bank and Islamic Development Bank. Even loans taken within the country are governed by specific legislative requirement. It is also stipulated that any Loan Agreement signed by the Government needs to be tabled in the Parliament (in the form of statute papers).

Through legislation, the Parliament sets the ceiling on the debt level of the Federal Government. At present, the maximum level of loan from each source as stipulated in the relevant Acts as indicated in Table 21-1.

Table 21-1: PARLIAMENTARY CEILINGS ON FOREIGN BORROWING

<table>
<thead>
<tr>
<th>Legislation</th>
<th>Maximum Loan Permitted (M$ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>External Loans Act, 1963 (covers all foreign borrowings of Federal Government)</td>
<td>30</td>
</tr>
<tr>
<td>Loan (Local Ordinance) 1959 (covers loans in the form of Government Securities)</td>
<td>60</td>
</tr>
<tr>
<td>Treasury Bills (Local) Act, 1946 (Revised 1977)</td>
<td>5</td>
</tr>
<tr>
<td>Extended Credit (Amendment) Act, 1973 (covers external Suppliers' Credit)</td>
<td>3</td>
</tr>
<tr>
<td>Government Investment Act, 1983 (covers the issue of non-interest investment certificates)</td>
<td>1</td>
</tr>
</tbody>
</table>

The legislative acts also identify the objective, or purpose, or loans. A guiding principle of Government finance is that expenditure for development purposes will be financed through borrowing and

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1 Figures quoted in this paper are in Malaysian Ringgit in which one Malaysian Ringgit was equivalent to US$2.705 as of December 1989.
surplus available from revenue. Authorization for borrowing is given in section 2(1) or the External Loans Act, 1963:

The Federal Minister (that is to say, the Federal Minister for the time being charged with responsibility for finance) may from time to time raise loans outside the Federation:-

(a) for the purposes of the Development fund or someone or more of those purposes; or

(b) for the repayment or amortisation of loans raised outside the Federation, whether under this section or not.

The respective Acts of Parliament have provided a very important limitation to the extent of debt that can be committed by the Government. They have restricted public sector debt at a manageable level.

II. Debt Profile

The current level of debt in Malaysia is closely linked to the size of various Five year Plans that were implemented in the past. For the First Malaysia Plan (1966-70), actual development expenditure was only M$4.2 billion. However, the development expenditure has increased nearly twenty times by the end of fourth Malaysia Plan (1981-1985) period, i.e. M$81 billion. However, given the unfavorable economic scenario for the Fifth Malaysia Plan (1986-1990), the total public sector development expenditure is estimated to be less than M$50 billion.

The ever increasing size of development plans over the years has resulted in an increase in the level of both domestic and foreign borrowing. For the first Malaysia Plan (1966-70), public sector borrowings were small, i.e. M$0.5 billion from foreign sources and M$1.9 billion from domestic sources. For the Fourth Malaysia Plan Period (1981-85) the level of public sector borrowings increased substantially - a total of M$27.1 billion drawn from foreign sources and M$24.3 billion from domestic sources. Under the Fifth Malaysia Plan (1986-90), it is estimated that public sector net foreign borrowings will be M$16.7 billion and domestic borrowings will be M$16.7 billion and domestic borrowings to be M$30.9 billion.

Table 21-2: PUBLIC SECTOR BORROWING

(M$ billions)

<table>
<thead>
<tr>
<th>Amt.</th>
<th>%</th>
<th>Amt.</th>
<th>%</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st Plan</td>
<td>0.5</td>
<td>21</td>
<td>1.9</td>
<td>79</td>
</tr>
<tr>
<td>2nd Plan</td>
<td>2.1</td>
<td>32</td>
<td>4.4</td>
<td>68</td>
</tr>
<tr>
<td>3rd Plan</td>
<td>3.9</td>
<td>29</td>
<td>9.6</td>
<td>71</td>
</tr>
<tr>
<td>4th Plan</td>
<td>27.1</td>
<td>53</td>
<td>24.4</td>
<td>47</td>
</tr>
<tr>
<td>5th Plan</td>
<td>16.7</td>
<td>35</td>
<td>30.9</td>
<td>65</td>
</tr>
</tbody>
</table>

As at the end of 1989, the total outstanding debt of the Malaysian Government was estimated to be M$92.4 billion. An analysis of the outstanding debt highlights the following features:

(a) As at the end of 1989, domestic debt constitutes 70.5% of the nation's GNP whereas the external debt represents 26.6% of the nation's GNP (M$95.2 billion);
(b) Domestic debt accounts for 72.6% of the public debt outstanding; and

(c) Market loans (i.e., loans from financial institutions) turned out to be an important source of foreign borrowing, accounting for 67.8% of Federal Government outstanding external debt.

A. Federal Government Domestic Debt

Government securities are mainly held by the social security and insurance institutions, accounting for M$36.9 billion or 62% of total securities outstanding. Out of which the Employees Provident Fund (EPF), the single largest institutional investor, held M$34.7 billion or 58.3% of the total. The holdings of the banking sector was M$9.2 billion or 15% of the total.

The outstanding Treasury Bills (M$4.3 billion) at the end of 1989 were held by the banking system and the discount houses for liquidity purposes. It is significant to note that a major portion of the non-interest bearing Investment Certificates outstanding of M$1 billion were held by one of the commercial banks.

It is an indication that the Government has been relying mainly on domestic resources to implement various development projects and programs. In addition, the Government also tapped the largely non-inflationary domestic resources to prepay external loans from financial institutions.

B. Long Term External Debt

Malaysia's long-term external debt amounted to M$44.1 billion at the end of 1989. The Federal Government accounted for 57% of the total, non-financial public enterprises 34% and private enterprises 9%.

In 1987-88, Malaysia's net external borrowing turned negative (-M$9.8 billion) following new initiatives to reduce the absolute size of the debt through selective prepayment of external loans by both the Government and the private sector. Consequently, Malaysia's outstanding external debt declined to M$47.3 billion at the end of 1988. This was the first decline in external debt in more than a decade. In 1989, it further declined by 6.2% to M$44.1 billion. Nevertheless, Malaysian has to formulate appropriate economic, monetary and fiscal policies to control the level of external borrowings and to overcome issues related to external debt.


The direct loans of the Federal Government consist mainly of market borrowing, project loans and suppliers credits.

Market borrowing of the Federal Government was the fastest growing category of external debt in the early 1980s. At the end of the 1980, market loans comprised only M$2.2 billion of 21.8% total external debt. By the end of 1989, the market loans, which comprise of syndicated loans, bonds and Floating Rate Notes (FRNs) total to about M$17.1 billion or 38.8% of total external debt.

Project loans obtained from multilateral sources (i.e. World Bank, ADB and IDB), bilateral and miscellaneous project loans used to account for the largest share of external debt. Malaysia's access to cheap official or multilateral loans with long maturities is limited because Malaysia was classified as being more developed than other developing countries. As at the end of 1989, project loans amounted to M$7.6 billion or 17.2% of total external debt.

Suppliers' credits are a fairly recent source of funds for the Government. At the end of 1989, such credits amounted to M$0.47 billion or 1.1% or total external debt.


The debt of non-financial public enterprises (NFPEs) with and without Government guarantee have grown in importance in recent years due to the increase in external borrowings by these enterprises in the early 1980s to finance their large investment programs. Total loans amounted to M$14.9 billion, 33.8% of total external debt, as of end-1989. The debt comprised of syndicated loans, project financing from bilateral and multilateral sources as well as suppliers' credit.
c. Private Sector Debt.

Private sector external debt increased markedly from M$2.7 billion at the end of 1980 to a peak of M$7.5 billion at end of 1986. It decreased to M$5.2 billion at the end of 1988; and, in 1989, it further decreased to M$3.9 billion or 8.8% of total external debt.

At the end of 1989, the currency profile of external debt is fairly well diversified. About 46.9% of the total external debt was denominated in United States Dollars, 30.6% denominated in Japanese yen and the balance in Sterling, Deutsche Mark, French Francs, Swiss Francs, Canadian Dollars, Dutch Guilders and Singapore Dollars.

The current level of external debt needs to be closely monitored so as to ensure that debt servicing is contained within sustainable limits. It is to be noted that since 1986, Malaysia has not drawn on the IMF.

III. Debt Management System in Malaysia

In Malaysia, four major agencies of the Government are responsible for debt management. They are:

Federal Treasury, specifically the Finance, Debt and Loan Management Division, which has the responsibility for approving all public sector borrowing and for meeting public debt payment obligations.

Office of the Accountant-General which maintains Government accounts related to public debt and executes all debt payment transactions.

Bank Negara Malaysia (Central Bank of Malaysia).

The Bank undertakes the issue and management of the Government's domestic debt. It also services and maintains records of the public debt for the Government;

In addition, the Bank administers the Exchange Control Act, 1953 on behalf of the Government. In the discharge of its function, the Exchange Control Department, among other tasks, supervises, records and monitors all foreign exchange flows, and approves the foreign currency borrowings of residents and the local indebtedness of non-resident controlled companies in Malaysia.

The Bank also maintains records on the foreign assets and liabilities of the financial institutions under its supervision.

The Bank assists the Government in the raising of foreign currency loans from the financial markets and is also the banker for the servicing of the outstanding foreign loans on behalf of the Government.

Economic Planning Unit (EPU), which is the planning agency of the Government and is involved in the process of drawing up the country's foreign exchange budget each year.

The relationship among the above agencies is shown in Appendix B. The involvement of several agencies in debt management has resulted in some differences in interpretation among them. This relates to the terms of coverage, timing as well as classifications and definition. To improve on the system, the Government has established a Debt Management Unit in the Finance Division of the Federal Treasury, to design, manage and monitor the overall public sector debt, including the Medium and Long Term (MLT) external obligations of the Government as well as its guaranteed debt. The Central Bank will cover the private MLT debt. This institutional establishment is in accordance with a recommendation of World Bank Mission 1985.

Malaysia has achieved a certain level of progress in the usage of computer-aided approach in debt management. The Treasury itself has succeeded in developing a Public Debt Monitoring System (PDMS) using Micro-computers. Detailed description of the PDMS used by the Treasury is given in Appendix C. The Central Bank also developed a computer-aided system for debt management and the details are given in Appendix D.

To further streamline the collection of statistical data on debt between the different agencies involved, the Government has developed a common data base system described in Appendix E. The system, which is called "Investment and Loans System" (ILS),
is housed in the office of the Accountant General. The first stage of this process involved only the public sector debt which is already in operation. The second stage will incorporate the private sector debt. With the establishment of the system, there will only be one source of data namely that of the ILS.

V. Debt Management Issues

It is recognized that debt to a nation means economic and social costs to the country at large. As such funds available from loans have to be utilized for productive purposes. Loans should be invested in projects that ensure adequate returns that can service their own loans and also projects that can generate growth in the economy so that the country will be able to service its debt commitment.

Malaysia in recent years has been monitoring the level of debt service closely in order to ensure that the debt service ratio of Malaysia increased from 4.3% in 1980 to 18.9% in 1986. It moderated significantly to 16% in 1987 and declined further to 13.3% in 1988. In 1989, the ratio was 8.9%. The improvement in the debt service ratio in the last three years is due mainly to the country’s effort to minimize external borrowing, initiative to refinance and prepay external loans as well as the strong growth in the country’s exports of goods and services.

With a view to coordinating debt management policies within the Malaysian Government, an External resources Committee (ER) has been established in the Treasury. Its objectives are to:

(a) Formulate policies and strategies on foreign borrowing;

(b) Study the impact of foreign financing on Balance of payments, ordinary budget and development budget;

(c) Explore the traditional sources as well as new sources of foreign financing;

(d) Review and assess the effectiveness of external assistance received in terms of project implementation;

(e) Monitor foreign exchange and external debt arising out of the need to finance large public sector projects;

(f) Determine the level of foreign debt under varying circumstances;

(g) Set guidelines on publicly guarantee loans; and

(h) Monitor and control private sector operations which have an impact on the balance of payments.

The ER will be renamed External Debt Management Committee (EDMC) as soon as the Debt Management Unit is fully established. The EDMC is expected to be given more authority to manage the country’s debt when its role is reviewed.

Malaysia will continue to borrow mainly from non-inflationary domestic sources. However, the Government has taken steps to ensure that in the process of getting domestic funds, the private sector will not suffer or be unable to obtain local resources for their activities. the recent amendments to the Employees Provident Fund Act that allow EPF to invest its funds with the private sector is to achieve the above objective. the external borrowing will be contained at prudent levels in order not to jeopardize the Government’s future access and its favorable standing in the international markets, as well as to ensure that the debt service ratio is within manageable limits.

The Government continuously monitors developments in the international capital markets for refinancing opportunities. This is in line with the objective of lengthening the maturity profile of the external debt in order to smooth any “bunching” or repayments and to achieve cost savings. Reflecting this policy, the Government took advantage of the easier conditions in the international capital markets to obtain new loans. Since 1984, it has prepaid a total of M$14.0 billion.

Malaysia had also been successful in maintaining its high credit rating in the international markets through careful management of its “presence” in individual markets and by employing diverse financial instruments. the Government had over the years diversified its borrowings in terms of currency, instruments, markets and sources. This is to achieve a better balance in the currency and maturity profile of its external debt.

The Government will, in the future, give special attention to sectors that can earn foreign exchange. As such, the implementation of the Industrial Master Plan will focus itself to projects/sectors that are export-oriented. Industries and local producers have
been encouraged to increase their productivity and reduce cost of production so as to enable Malaysian products to compete in the world market.

V. Conclusions

The Malaysian Government recognizes the importance of proper debt management. In its efforts, priority is given to the creation, maintenance, processing and dissemination of debt-related information. With such information, the Government can determine the level and structure of debt and the servicing obligations, maintaining them within acceptable limits and managing them to meet the country's best interest. Hence the monitoring and management of public sector debt will continue to be an important Government policy in the future.
List of Legislation Related to Domestic and Foreign Loans

(1) Financial Procedures Act 1957
(2) Development Fund Act 1966
(3) Loans (World Bank) Act 1958
(5) Loans (Islamic Development Bank) Act 1977
(6) External Loan Act 1963
(7) Extended Credit (Amendment) Act, 1973
(8) Loans Guarantee (Bodies Corporate) Act 1965
(9) Treasury bills (Local) Act 1946
(10) Loan (Local) Ordinance, 1959
(11) Loan Guarantee Act, 1972
Appendix B

Administration of Debt Management

Ministry of Finance

- Treasury

  - Economics & International Division
  - Finance and Loan management Division
  - Accounting Division (Accountant General)

  - External Section
  - Internal Section
  - Investment Section
    - Market loans & Guarantee Loans
    - Economic Sectors (Users of loans)

Bank Negara Malaysia

- Public Debt Division
- Exchange Control Division
- Economics Department

Economic Planning Unit
Public Debt Monitoring System (IPDMS) Malaysia

I. Provider Characteristics

1.1. Name and background of system provider

Financial Management System Unit (PMSU) is the financial management research and development unit in the Federal Treasury, Ministry of Finance, Malaysia. It is responsible for the modernization of the financial management of the Malaysian Government.

The Unit’s electronic Data Processing Section (EDPS) operates a Sperry 1100/61 E1 computer to provide computer services to all the divisions in the Federal Treasury. It is responsible for the design, development and implementation of the Public Debt Monitoring System (PDMS).

1.2. Origin and evolution of the current vision of the system

The steep increase of foreign debt liabilities in 1981-1984 prompted the Malaysian Government to look for a more efficient means to monitor the country’s debt. At the end of 1984 a team of EDP personal from the EDP section, FMSU developed the PDMS. This was designed to run on an IBM PC/AT using Dbase III. The prototype system was found satisfactory and since has been used by the Finance Division in the Treasury. The system consists of three modules: the external project loans, the internal loans and the market loans.

II. Hardware/Software Characteristics of the Systems

2.1. Software

The Public Debt Monitoring System is developed using Ashton-Tate Dbase III Plus. The design philosophy used is that the PDMS must be easy to use. End users need only select from the menu screen to execute desired operations. “Help” screens are incorporated and function keys used to facilitate job handling.

2.2. Hardware

The present hardware in use consists of Hewlett Packard Vectra Model 45 with internal memory of 640KB, enhanced color graphics monitor, 40MB of hard disk storage each and 2 near letter quality printers capable of 200 cps and at least 240 print positions.

III. Functions of the System

3.1. The PDMS can monitor the current and projected external debt situation of the country by building various scenarios. It answers the “what if” questions:

(a) If there is a change in interest rates with respect to any loans or loan groups.

(b) If there is a change in the exchange rates of loan currencies involved; or

(c) If a new loan is added or is under consideration for commitment by the country.

3.2. The PDMS also provides an early warning system to the external debt managers as to the due amount on interest payment; principal repayment, and total repayment.

The above reporting can be monitored for an individual loan, loan currency groups, in foreign or local currency; on a yearly, quarterly or a monthly basis.

3.3. The PDMS can keep track of actual transaction for debt servicing and these historical data can be used to generate statistical reports.

IV. Features

4.1. The PDMS is an on-line system. Data can be entered as and when transacted and status reports can be produced within minutes.

4.2. It has comprehensive full-screen data manipulation capabilities. Unlike a line by line editing system, on can view the information on a full screen and makes amendments on any items in display by just over striking that item. This makes it easy to operate.
4.3. It is menu-driven. Whatever functions desired of the system can be selected from a menu. This makes it user-friendly for non-data processing personnel.

4.4. Ease of backup: To diskettes or cartridge tape.

4.5. System security: physical equipment lock, software lock, and locked in a room.

V. Capacities

5.1. Loan creation
   (a) creation of new loans
   (b) editing loans
   (c) enquiry of any individual loan
   (d) updating any existing loan
   (e) printing detailed information of any loan

5.2. Loan transaction
   (a) capturing transaction of loan repayments and draw-downs.
   (b) editing, updating and printing transaction records.

5.3. Reporting
   (a) projections of loans (with new interest rates) by year.
   (b) projections of loans (with new exchange rates) by year.
   (c) disbursements of loans as of DD, MM, YY
   (d) status of market loan debt as of DD, MM, YY
   (e) interest payment of loan as of DD, MM, YY
   (f) principals and outstanding repayments of loans as of DD, MM, YY
   (g) loan outstanding, disbursements and repayment as at end of DD, MM, YY
   (h) any other ad-hoc reports on existing data can be produced with ease since it uses a 4th Generation Language.

Note: This appendix was prepared by the Finance Division, Federal Treasury, April 17, 1989.
The Bank Negara Malaysia Debt Management System

The Bank Negara Malaysia (Central Bank of Malaysia) is responsible for data management of the Government’s domestic debt; of the medium and long-term debt of the private sector and of the non-financial public enterprises (NFPEs) that are not guaranteed by the Federal Government, as well as the short-term external liabilities of the financial institutions. Secondary data on direct and guaranteed loans of the Federal Government are also maintained by the Bank.

I. Government Domestic Debt

Acting as fiscal agent of the Government, the Bank is empowered under the Loans (Central Bank of Malaysia) Act, 1960 to undertake the issue and management of the Government's domestic loans, namely Government securities, treasury bills and non-interest bearing Investment Certificates. The Bank also services and maintains records of the public debt for the Government. Such records, which include information on loan issues, registration of subscribers, transfers, transmissions, interest payments and redemptions, are stored in the Bank’s mainframe computer. The data are updated regularly. The program was developed in-house to be used on the Bank’s IBM hardware. Reports are provided on a "batch" basis (e.g. a specified program is run automatically at the end of the month or week) by the Computer Center to the Public Debt Division and the Banking Department, the primary end-users. However, any other reports or data requested will require the development of additional programs. As the program is not a pre-packaged software, it is not menu driven.

The Bank has recently invested in a new software to provide the necessary logistics for scriptless trading. As the Bank is the central depository for the domestic securities, there would be no necessity for sellers and buyers to physically withdraw and deposit scripts whenever a transaction occur. This will reduce substantial administrative work as changes in holders following any transaction will be done within the computerized system. The Bank is currently working on this project and it is likely to be ready for implementation later this year or early 1990.

II. External Debt of Private Sector

The bank administers the Exchange Control Act, 1953 on behalf of the Government. In the discharge of its function, the Exchange Control Department (ECD), among other tasks, supervise, record and monitor all foreign exchange flows; and approves the foreign currency borrowings of residents in excess of M$1 million, the domestic borrowings of non-resident controlled companies in excess of M$10 million, and all guarantees given by residents to foreigners.

Chart D-1, at the end of this appendix, gives a summary description of the debt information management and control system. The Department is also responsible for monitoring and maintaining a complete record of private sector external borrowing as well as external loans of NFPEs not guaranteed by the Government. Information are derived from exchange control forms (ECM10 and Form KPWP). The ECD maintains a dual data system. All basic data on individual loans are recorded manually on control cards as well as stored in a Lotus-123 microcomputer system. Information are maintained on the name and country for lender, the borrower, the date of agreement, the amount and currency of borrowing, the detailed repayment terms, interest rates, including the first and last interest payment dates, and frequency of these payments, the type of credit facility and the purpose of loan. Any changes in the terms and conditions of the loan as approved are also recorded.

All borrowing entities are also required to submit on a quarterly basis (not later than 10 days after the end of each quarter) all transactions pertaining to the foreign borrowing, such as the actual outstanding balance of each loan, disbursements, principal repayments and interest payments, and any payments in arrears. The maturity profile of the loans are also required. The loan processing unit would then verify the information derived from these reports against the basic loan terms and conditions and record them on the appropriate loan cards and on the PC.

Reports on aggregate loans outstanding, including the flows of repayment and interest payments by foreign currencies and conversion to ringgit equivalent, as well as the maturity profile of the loans are generated on a quarterly basis. However, some modification is required to incorporate additional information while
additional programs will need to be written to generate other debt reports.

III. Short-Term External Liabilities of the Banking System

The financial institutions comprising commercial banks, merchant banks and finance companies which fall under the supervision of the Central Bank are required to submit information on their foreign assets and liabilities on a regular (weekly, monthly and annually) basis, along with other types of statistics. This is a legal requirement under the Banking Act, 1973 (Section 21) and the Finance Companies Act, 1969. A large part of the external liabilities of the commercial banks represent borrowing from head offices, branches and associates abroad to comply with the net working funds requirement (in lieu of capital) for the branches of foreign banks operating in Malaysia.

Information from individual financial institutions are submitted to Bank Regulations Department by way of diskettes and these are subsequently transferred to the mainframe using the M204 system. The same data base management system is used in the IMF.

IV. Consolidation of National Debt Statistics and Projections of Borrowing and Debt Servicing

The Economics Department undertakes the consolidation of the public sector external debt data compiled by the Treasury with private sector data compiled by the Bank to generate the total national external debt statistics. The department also generates the maturity profile of all committed medium and long-term loans as well as project the debt service schedule of these loans. The Department also attempts to project the external borrowing requirements of the nation. the Department works closely with the other Departments in the Bank as well as in the Treasury, the Accountant General’s Office and the Economic Planning Unit to enhance the external debt management system. The data are maintained in IBM-PCs and debt reports are generated using micro-based spreadsheet software (Lotus-123).

The Department also generates the maturity profile of the outstanding domestic debt as well as project the interest payments schedule of the loans.

Similarly, the Department also attempts to project the domestic borrowing requirements of the Federal Government as well as the absorptive capacity of the major subscribers to the government loans (e.g. the Employees Provident Fund and the banking system).

V. Data Processing Resources

The Bank Negara’s data processing operations involve three mainframe computers: an IBM 4341 system, dedicated to check clearing, and IBM 4361 model 1 system for other data processing work and an IBM 4381 system for back-up and end-user purpose. Software products available for these systems include, among others, Easytrive Plus, DL1, M204, SAS, DBase III and Mantis. The staff at the Bank’s computer center are well-trained, professional individuals, competent to carry out the design and implementation of sophisticated systems.

Recognizing the increasing cost effectiveness of microcomputers and their usefulness in many statistical and economic analyses, the Bank has acquired a large number of microcomputers, especially the IBM-PC, for all the Departments in the Bank. While the major systems application are on the main frame computer, many statistical reports and economic analyses are generated on personal computers.

VI. UNCTAD Debt Monitoring and Financial Analysis System

The Bank installed the Debt Monitoring and Financial Analysis System (DMFAS) package designed by UNCTAD on IBM PC-AT in the Economics and Exchange Control Department in 1985 and the enhanced package in 1987. However, neither Department has made use of the system to maintain the external debt data information because of some limitations in data entry and data editing. The system appears to be slow and cumbersome.

Considering the number of private sector loans and the volume of data involved, the PC version of the DAS does not seem feasible as it would take more than 24 hours for the PC to process the 1,500 private sector loans. Besides, as our exchange control policy become more liberal, less information may be required from the borrower and thus the information cannot be imputed into the UNCTAD system. Reports cannot be generat-
ed from the system if data input is incomplete. Also, many of the private sector loans (especially those borrowed from the head offices and associates abroad) normally have not definite repayment schedules, thus making it impossible to monitor them in the rigid UNCTAD system where you need to specify the disbursement and repayment schedules. In addition, UNCTAD has also not developed a system whereby loans captured through DMS on the mainframe could be downloaded to the PC versions of the DAS for aggregation and generating reports. Though UNCTAD has made some enhancements to the system, the processing time for loans is still 50 loans per hour.

VII. Conclusion

The establishment of a good debt monitoring system has enhanced the Bank's management of both the domestic and external debt. The Bank will continue to step up its effort to further improve the debt management system.

Note: This appendix was prepared by: Jabatan Ekonomi, Bank Negara Malaysia, April 17, 1989.
Chart D-1, Private External Debt Management and Control System of Bank Negara Malaysia

Exchange Control Department

- Process and approves loan applications by company
- Letter of approval/rejection sent to company
- If loan approved, company to provide quarterly report to ECD on all transactions of the loan
- Any change in terms and conditions of loans seek permission
- ECD record all information and transaction on control cards and PC-Lotus 123
- ECD to update any changes on all records
- All transactions are consolidated and tabulated in a report
Investment and Loans System

I. Overview of the Investments and Loans System

The investments and Loans System (ILS) currently being developed by the Accountant General Department comprises of 4 "modules". They are:

(a) The External Loans Module (ELM);
(b) The Federal Government Loans Module (FGLM i.e. loans given out by the Federal Government);
(c) The Domestic Loans Module (DLM); and
(d) The Investments Module (IM).

System development and implementation have been phased, and the External Loans and Federal Government Loans Modules are targeted for implementation around July 1989. Thereafter system development and implementation of the other two systems will commence.

The systems are currently being developed on A-Series Unisys computers using the 4GL tool, LINC.

II. Objectives of the System

The investments and Loans System is being developed with the following objectives in mind:

1. To enhance management effectiveness by generating essential and timely management and operational information for the proper control, monitoring and follow-up of all loans and investments.

2. To minimize duplication in establishing a common data base on loans which will generate necessary information and meet the reporting requirements of all common users of the system viz:
   - Accountant General Department (AGD)
   - Treasury

(3) To ensure proper accountability through maintaining appropriate historical records of movements (including approval, disbursement and subsequent repayment) and status of all loans; movements and status and income/dividends earned from investments made by the Federal Government.

(4) To promote operational efficiency in loan administration and documentation through automating of relevant processes/tasks, e.g., interest and dividend calculations and preparation of relevant advices.

(5) To establish the information base to assist the Federal Government in the overall management of the nation's financial risks.

(6) To establish appropriate interfaces and improve integration and co-ordination with other systems in AGD.

III. Hardware/Software Features

1. Environment

   (a) ILS runs under Unisys' LINC environment
   - it is therefore transportable across the entire family of Unisys (burbroughs) mainframes
   - advantages of a 4GL language in maintaining applications systems can be realized

   (b) The system is designed for on-line real-time processing

   (c) Any configuration of network connected to the mainframe can be handled by the application.
Appendix E

(2) Security

(a) Special routines control the access to menus, screens, reports and functions.

(b) Use of a data dictionary reduces the impact that changes of definition of data will have on the programs.

(3) Decentralization

(a) Specification of the above control is designed to be decentralized. That is, while the computer center controls access to applications and systems resources, the designated person(s) in the Investments and Loans Section will control the specific ILS functions.

(b) Operation of the system is also designed to be decentralized. Functions such as data entry, verification, reporting, updating etc. will be carried out by the ILS staff as an extension of the work they are currently doing.

(c) Reports and enquiries are built using the building block concept. They are put together using well tested library routines to perform standard functions for data access and calculations. This makes development and maintenance very simple. Any system change will be completely transparent to most report programs.

(4) Time Independency

(a) The system is designed to be time-independent. That is, reports can be run for any period specified provided, of course, the information is relevant and the data is available.

(b) The system is designed to obviate the need for special programs to be run at fixed times - daily, monthly, yearly, etc.

(5) Program Maintenance

(a) The system is entirely parameter driven. Most changes, such as addition of new departments, classification etc., can be handled without any program modifications.

(b) Use of a data dictionary reduces the impact that changes of definition of data will have on the programs.

(c) Reports and enquiries are built using the building block concept. They are put together using well tested library routines to perform standard functions for data access and calculations. This makes development and maintenance very simple. Any system change will be completely transparent to most report programs.

IV. Functions of the System

(1) Recording

(a) Capability for on-line updating of the system.

(b) Maintain detailed and summarized records in various currencies at various loan and sub-loan levels and with capability to convert foreign currency balances to Malaysian Ringgit equivalent at selected rates of exchange.

(c) Automated posting of accounting and loans/investments transactions to the system by the use of assigned codes.
(d) Generate posting/transaction listings/reports and trails of all up-dates to the system.

(2) Reporting

(a) Generate detailed operational reports up to transaction level.

(b) Output programmatically detailed and summarized management reports in foreign currencies with the Malaysian Ringgit equivalent, if required, at specified rates of exchange with capability to analyze the loans and guarantee portfolios in accordance with specific classifications.

(c) Identify delinquent loans and guarantees in accordance with predetermined aging periods.

(d) Provide forward projections of loan principal repayments and other charges payments to assist the management of the foreign currency, interest and liquidity exposures.

(e) Identify loans falling inactive in accordance with predetermined parameters

(f) Generate statements of loans accounts both periodically and on demand

(g) Provide flagging to be used only by authorized officials to monitor loans/investments requiring special supervision.

(3) Enquiry

(a) Facility for on-line enquiry at predetermined reports with ability to output such screen on hard copy.

(b) Such facilities to provide information on:

(4) Special Calculations

(a) Capability to calculate and apply various interest structures (including capitalization), charges and other fees.

(b) Ability to convert foreign currency loans balances to the Ringgit equivalent at various rates of exchange.

(c) Ability to calculate the effective cost of foreign currency loans (all in cost).

(d) Provide the information to calculate the cost of redeeming a loan earlier when there is a need to reschedule loans.

(5) Other Productivity Aids

(a) Generation of reminder letters/reports to end borrowers of guaranteed loans to effect repayments in accordance with agreed schedules.

(b) Generation of warning letters/reports to end borrowers of guaranteed loans that their repayments in accordance with agreed schedules.

(c) Ability to generate subsequently graphics (additional hardware/software will be required for this).

(6) Interface

(a) Computerized accounts reconciliation with the main AGD Accounting System.
Appendix E

(b) Interface between External loans and Federal Government Loans regarding re-lending loans.

(c) Subsequent interface with Domestic Loans System.

(d) Subsequent interface with SWIFT at BNM, when approved.

(7) Security Features

(a) Restricted access to the system by authorized users at AGD, the Treasury, BNM and the Prime Minister’s Department.
22. Maldives - External Debt Management

Mohamed Ahmed Didi
Maldives

As in other small economies, external financing is of critical importance and has been the pivotal force for the development of the Maldives. The country's national account data shows that total consumption is larger than its gross domestic product and additionally larger than its gross national product. In the face of reduced national resources, it is the net inflow of external resources that has to finance the whole of investment. In such a setting, coordination of external finance in respect to both mobilization and utilization is certainly an important task. However, at present, there are some deficiencies in the institutional setup with regard to the flow of external finance.

External financing is negotiated by the Ministry of Foreign Affairs (MFA)/External Resources Section. Foreign loans, since they have to be repaid, are allocated among various national entities through the Ministry of Finance (MOF). Hence, information on such loans is maintained by the MOF. The Ministry of Planning and Environment has focused mainly on the estimation of the requirements of external finance, for the country as a whole on the basis of submission by individual Ministries or Departments. The Maldives Monetary Authority (MMA) is responsible for compiling the balance-of-payments data, reserve management and to some extent analysing the external debt.

According to the terms of Law No. 21/76, no government agency or department in the Maldives can borrow funds from abroad without the approval of the President of the Republic. However, requests for approval are not processed through the Ministry of Finance. Once a project or a programme is included in the Development Plan and approved for foreign financing, the department or agency responsible for the project or programme is free to approach the Ministry of Foreign Affairs/External Resources Section to arrange external financing. The MFA sounds out possible donors and, in association with the executing / implementing agency, proceeds to negotiate and conclude the loan agreement. The Ministry of Finance is not always consulted in advance before a loan is contracted. Quite often, MOF comes to know of the loan only after it has been concluded. On the other hand, the Ministry of Finance, in terms of the official Business Rule, has the responsibility for the maintenance of all accounts and records of the debts of the State. The existing arrangements hardly facilitate the discharge of these responsibilities - as even basic loan details are not often transmitted to the concerned agencies as a matter of course when a loan is concluded.

The position in regard to disbursements is similar. Withdrawal claims are sent by the following agency to the lender. They are routed through of only where loan agreements so require, as in the case of loans from Asian Development Bank. Disbursement advices are not always sent to the MOF, though some lenders provide copies. However, service payments have to be made by the MOF though the MMA out of its own budget. The Office of the President has to authorize every payment of principal and interest. Such approvals are conveyed to the MMA to effect payments, with a copy to MOF.

With regard to Government borrowings, all agreements are presently kept by the borrower. The MOF has built up a database by obtaining loan agreements and data on disbursements from the concerned agencies. On the basis of the information contained in loan agreements, MOF projects repayments and interest payment schedules. Repayment requests are made by the MOF of to the Office of the President which in turn advises the MMA and the MOF to effect the payments when they become due. On receipt of the necessary approval, the MMA effects the payment in the loan currency and notifies the MOF of the exact date of payment and the exchange rate. The MOF then makes the necessary accounting entries and transfers the equivalent Maldivian Rufiyaa to the MMA.

The MMA has also built up a parallel database on external loans. The information is gathered from various departments of the government, and parastatals who have borrowed externally. Based on these data and that on service payments available within, the MMA has set up a separate file for each loan. It uses these data to compile the statistical tables containing various tables analysing external public debt. The information collected is also used for reporting to
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various international agencies such as the World Bank. Many of the reports and tables are produced using the CS-DRMS software package developed by the Commonwealth Secretariat for Management of Debt in Small Countries.

The procedure for contracting parastatal concerned. Guarantees for the loans are issued by the MOF, where required. These loans are, however, serviced directly by the concerned parastatal.

As for short-term debt, data is available only with respect to the overdraft facilities availed by the State Trading Organization from various commercial banks. It appears that no other department or parastatals has short-term credit facilities.

No data is available on private sector borrowing. In the absence of exchange control, private sector entities are free to borrow from abroad or from foreign Banks located in Maldives and to repay these loans out of the foreign exchange accounts they are free to hold. To the extent these loans are provided by foreign Banks located in Maldives, the Maldives Monetary Authority has some information, as it monitors the level of foreign liabilities of these Banks.

Even though the Maldives has no serious debt problem, there is certainly an awareness for the need for setting up alternative arrangements to coordinate the contracting, recording and monitoring of external debt. Presently there is no ceiling on the total amount of foreign borrowing that can be undertaken during any given period of time. Approval for borrowing depends largely on the degree of priority given to the projects that needs to be financed. It is worthy to note that given the small size of Maldives, the unit cost of a project is relatively higher. Since the country is relatively underdeveloped, it is the policy of the Government to borrow only from official sources, on very soft terms. However, due to the essential nature of some projects, and only if concessional financing is not possible, it is necessary to resort to commercial borrowing.

The sole responsibility of analysing external debt of the country lies with the Maldives Monetary Authority. For this purpose, the computer package developed by the Commonwealth Secretariat has been in use since 1987. The CS-DRMS software, designed to record debt data and assist in the management of debt, has the capability to:

- maintain a complete inventory of all loans and basic details of loans.

- respond to specific enquiries and forecast debt service payments, both individually and in aggregate.

- produce standard reports, write and add special reports (country specific) to the menu.

- monitor loan/grant utilization covering both delays in the effectiveness of loan and delays in disbursements/reimbursements.

- carry out sensitivity analysis of the effect of interest rate and exchange rate variables on debt service indicators.

- test the implications of different volumes of new borrowings, based on different assumptions regarding currencies and repayment terms.

- determine the grant element and effective rate of interest of loans, evaluate different proposals for refinancing or rescheduling loans.

- use the output from CS-DRMS with exogenous economic data to project critical economic indicators.

- capture domestic loans and on-lending to parastatals.

The reports generated by the system is extensively used by MMA for policy decisions and in advising the Government. Although the Maldives Monetary Authority is also responsible for compiling the balance-of-payment data, the information on the capital accounts side, especially with regard to foreign private capital (and to some extent with respect to foreign official grants) is deficient.

The flow of information between MMA and the Ministry of Finance is quite substantial. As mentioned earlier, the MMA effects the payments of principal and interest in the currency required and notifies the MOF of the exact date of payment and the exchange rate. The MOF then makes the necessary accounting entries and transfers the equivalent funds in local currency to the MMA. Hence, it is assured that the accounts generated by MMA and MOF on debt transactions are consistent. However, since the MMA
produces its debt statistics expressed in U.S. Dollars and the MOF uses the Maldives Rufiyaa in preparing its budget documents, the two sets of figure are not always comparable due to variations in the exchange rate used.

It is critical for the MOF to play a major role in channelling and utilizing foreign finance to ensure systematic accountability. By acting as the focal point of official funds, the MOF could ensure rational use and generate adequate and timely information which, in turn, could be used by other agencies. A committee consisting of senior officials from the relevant agencies should be entrusted with the task of overseeing national debt management. Hence, the flow of information between the agencies is ensured. The MMA should be given the extra responsibility of monitoring foreign private capital inflows, whereby, systematic data on the total debt of the country could be obtained. Such extensions and some streamlining of present Government procedures could result in improved mobilization and utilization of foreign resources, and thus the present institutional setup need not be dismantled.

The stages of external debt management in the Maldives are illustrated in the Annex.
# ANNEX

## Stages of External Debt Management

<table>
<thead>
<tr>
<th>Stage</th>
<th>Description</th>
<th>Responsible Ministry</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Incorporation of the project in the Plan for External Financing and determining priorities for financing.</td>
<td>Ministry of Planning and Environment and line ministries concerned with the approval of President’s Office.</td>
</tr>
<tr>
<td>3.</td>
<td>Negotiation with donor countries or specialized financial organizations and signing loan agreement</td>
<td>Ministry of Foreign Affairs and line ministries.</td>
</tr>
<tr>
<td>4.</td>
<td>Disbursement of funds under Loan Agreement</td>
<td>Ministry of Finance and line ministries.</td>
</tr>
<tr>
<td>5.</td>
<td>Monitoring of utilization of loans under different agreements; systematic maintenance of loan files (computerization process).</td>
<td>Line ministries and agencies concerned, Ministry of Finance and Maldives Monetary Authority.</td>
</tr>
<tr>
<td>6.</td>
<td>Repayment of Principal and Interest; Amortization process</td>
<td>President’s Office, line ministries, Ministry of Finance and Maldives Monetary Authority.</td>
</tr>
<tr>
<td>7.</td>
<td>Recording, Analysing and Evaluation of all loans and grants; reporting to International agencies; input to Balance-of-Payments compilation.</td>
<td>Ministry of Finance and Maldives Monetary Authority.</td>
</tr>
</tbody>
</table>
The problem of external debt management must be examined with reference to the steady growth in foreign economic assistance to Pakistan since 1950. Up to June 1989 Pakistan has contracted $36.7 billion ($28.3 billion in loans and $8.4 billion in grants) of which $27.6 billion including $7.1 billion of grants have been disbursed leaving an undisbursed (pipeline) balance of $8.5 billion. The external debt profile of Pakistan as on 30th June, 1989 is summed up in Table 23-1.

The long term external outstanding debt of Pakistan as of June 30, 1989 stood at 35.2 percent of GNP and 188.5 percent of foreign exchange earnings, while debt servicing ratios come to 3 percent and 16 percent, respectively. Pakistan is receiving aid under both bilateral and multilateral arrangements. Pakistan is the recipient of foreign economic assistance from nearly twenty countries and eight multilateral agencies largely on concessional terms. The assistance to Pakistan has been provided in the form of project aid, commercial aid, food aid, balance-of-payments support and technical assistance.

I. External Borrowing Procedures and the Coordination of Debt Management

The Economic Affairs Division (EAD) was created as a full-fledged Ministry in 1948, but it was merged with the Finance Division of the Ministry of Finance in 1960. Subsequently, with the formation of the Aid-to-Pakistan Consortium in early 1960 and with the increased quantum of aid inflow, it was felt that there should be a separate organization to deal with debt management. As a result Economic Affairs Division was separated from the Finance Division in 1963, and the monitoring of foreign economic assistance was entrusted to this Division. Its responsibilities covered both the inflow of aid and the outflow of debt service payments.

A. Organizational Structure

At the present time, debt management is being dealt with by the External Finance Wing of the Ministry of Finance with respect to commercial borrowings, the State Bank of Pakistan (SBP) relating to private sector borrowings and obligations to International Monetary Fund (IMF) and the Economic Affairs Division (EAD) concerning Public Sector borrowings. The SBP is responsible for controlling and monitoring borrowing by the private sector, for compiling the balance-of-payments statistics and formulating and monitoring exchange control procedures. The External Finance Wing of the Ministry of Finance monitors and controls the commercial borrowings of the Federal Government/Public Sector, supervises external borrowing by the private sector, negotiates agreements with IMF, prepares and monitors the foreign exchange budget and exchange control policies as well as overall policies regarding external borrowings.

The EAD is responsible for negotiating and implementing aid agreements for both loans and grants with the bilateral donors and with multilateral agencies (except the IMF) the EAD monitors foreign aid utilization, foreign aid budgeting and projections. It maintains external debt profiles, manages public sector external debt, including authorizations of remittances of all external debt service. It also makes recoveries.

The EAD comprises nine units: i) the Administration Unit, (ii) the Technical Assistance Unit (iii) the International Economic Relations Unit, (iv-vii) the four policy units dealing with (a) World Bank and Asian Development bank (b) Aid Consortium countries other than the USA, (c) the USA and (d) Economic Cooperation with African, Eastern European Asian and Islamic countries, (viii) the Research and Statistics Unit (ix) the Debt Management Unit. The four policy units of EAD are responsible for programming external aid and for the negotiation and signing of aid agreements. Copies
of the signed agreements are supplied to the Debt Management and Research and Statistics Units. The four policy units also monitor aid utilization with a view to removing bottlenecks and simplifying disbursement procedures in the light of the deliberations of "Project Review Meetings" held with the World Bank the Asian Development Bank and with bilateral donors. These meetings are attended by representatives by Pakistan executing agencies as well by EAD.

The Debt Management Unit is responsible for debt monitoring. It consists of four subunits:

(a) The Directorate of Coordinations and Budget. It is responsible for preparing estimates of debt service payments, monitoring expenditure against the budget allocation on monthly basis, monitoring disbursement advices from creditors for each loan and issuing debt service payment authorities to which remits;

(b) The Directorate of Accounts. It monitors the utilization of commodity loans and the generation of the corresponding rupee accounts; it monitors the utilization of all grants; it issues debt service payment authorizations for all loans from USA, Canada and commercial lenders to the State Bank of Pakistan for remittance of the relevant foreign exchange;

(c) The Directorate of Payments. It maintains departmental accounts of foreign loans and credits contracted by the Federal Government with creditor countries/agencies with respect to disbursements, repayments, interest payments and other charges in the currency of the loans, both in US $ and in Pakistan rupees;

(d) The Debt Relief and Rescheduling Section. It negotiate debt relief arrangements with creditors countries, analyzes the terms and condition of consolidation arrangements to see that the grant element (concessionality level) envisaged in the consolidation relief arrangements are within the framework of multilateral arrangements agreed to with Aid Consortium. This section has also been assigned responsibility for computerizing external debt, since the last debt relief agreement was negotiated in 1981.

(e) Research and Statistics Unit. It consists of three sub-units: (i) the Foreign Exchange Budgeting Section, (ii) the Commitment, Disbursements and External Debt Disbursed and Outstanding Section, and (iii) the monitoring of Aid Utilization Section.

B. Foreign Aid Negotiations

Pakistan's annual external borrowing requirements, are presented in the document, "Memorandum for the Pakistan Consortium", prepared jointly by the Planning and Development Division of the Ministry of Finance and by the EAD. It is presented to the Annual Aid to Pakistan Consortium meeting that is generally held each April in Paris. In addition, a list of aid-worthy projects is also compiled and is furnished along with the documents. At the meeting, the consortium members, after reviewing the overall economic position of the country, normally allocate their pledges by project and commodity aid. However, the specific projects to be financed from the pledges are identified later on.

The programme for utilizing these pledges is drawn up by EAD in consultation with Ministries, Provincial Governments and the Planning and Development Division. Priority projects are identified. The programme is then negotiated by EAD with donor countries/agencies and may undergo modifications in this process. The non-Consortium and Islamic countries do not make any formal pledges; aid from these sources is arranged through bilateral talks or through Joint Ministerial Commission meetings.

III. The Integration of Debt, Budget Preparation and Balance-of-Payments Accounts

Information on debt service payments made and on disbursements received is collected by the EAD and is carefully reviewed to insure consistency between the external debt, budget and balance-of-payments records. The Debt Management Unit is responsible for figures on debt service payments; the Research and Statistics Unit assembles disbursement datas.

A. Integrating Data on Debt Service

The Debt Management Unit is the primary source of information on debt service payments with
respect to bilateral and multilateral aid loans to the Pakistan public sector. It prepares payment authorizations in accordance with the amortization schedules of the loan agreements. They are sent to the State Bank of Pakistan for authorize remittances of the relevant the foreign exchange to the concerned creditors. The SBP, after making the payments, so informs the Debt Management Unit. The debt service payments data with respect to commercial loans to the public sector and with respect to all private sector borrowings are obtained from the External Finance Wing and from the SBP. Agencies that make debt service payments from overseas assets such as PIA, report these remittances to the Debt Management Unit.

The Debt Management Unit consolidates all the information on debt service payments and sends summary monthly and quarterly reports. These figures are discussed in Joint Ministerial meeting and are reconciled before being released for use by the concerned agencies.

B. Intergrating Data on Disbursements Received

The Research and Statistics Unit receives copies of all loans/grants agreements pertaining to direct government borrowing from the relevent policy units and from the External Finance Wing. It obtains copies of loan agreements pertaining to public sector agencies guaranteed by the Federal Government, directly from the individual borrowing agencies. The utilization of individual loans and grants is monitored through disbursement advices sent by the creditors. These reports are supplemented by information obtained from the executing agencies on special forms designed by the Research and Statistics Unit. The information so received is assembled on a monthly basis for purposes of monitoring the foreign exchange budget. Quarterly reports concerning commitments and disbursements are circulated to the Debt Management Unit of EAD, State Bank of Pakistan, and to the Finance and Planning & Development Divisions. These reports cover each loan and grant and also each aid-financed project. Data are also available by creditor and by executing agency.

There is a time lag of about six weeks following the receipt of information on aid utilization from the concerned executing agencies.

The SBP uses this information when compiling balance-of-payments statistics. The resulting estimates discussed by the "Standing Committee on Balance of Payments" before they are released for use by the concerned agencies and for outside users.

All this data work in the EAD has been done using a manual accounting system. While the collection, compilation and presentation of external debt data has been very accurate, reliable and efficient, there is, however, a need to have a Central Coordination Unit especially when each of the three units involved (SBP, EAD and Finance Division) are in the process of computerizing their systems.

IV. Computerization of External Debt in Pakistan

Computerization of External Debt in EAD is being carried out with the assistance of United Nations Development Programme (UNDP) as a part of United Nations Conference on Trade and Development (UNCTAD) system project. UNCTAD, being the executing agency, has provided necessary computer hardware and software and training facilities to establish the computer system. The main software package used is known as the Debt Monitoring and Financial Analysis System (DMFAS). It is developed by UNCTAD and is operational in several Asian and African Countries.

Registration of foreign loans in the computer, being the immediate objective of the project, has been achieved. This has resulted in a reliable data base facilitating the preparation of annual budget regarding the repayments and the evaluation of the future repayments. EAD is in the process of verifying the data base in order to improve its reliability regarding actual repayments and disbursements.

Further information on the computerization of debt management in Pakistan is presented in the paper by Mr. S.S. Husain Zaidi, "Use of Computers in Debt Management - the Experience of Pakistan".
Table 23-1: PAKISTAN EXTERNAL DEBT TRANSACTIONS  
1950 - JUNE 1989  
(US $ billions)

<table>
<thead>
<tr>
<th></th>
<th>Repayable in Foreign Exchange</th>
<th>Repayable in Pakistan Rupees</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Loans contracted</td>
<td>27.6</td>
<td>0.7</td>
<td>28.3</td>
</tr>
<tr>
<td>2. Loans disbursed</td>
<td>20.5</td>
<td>0.7</td>
<td>21.2</td>
</tr>
<tr>
<td>3. Loans repaid</td>
<td>6.8</td>
<td>0.3</td>
<td>7.1</td>
</tr>
<tr>
<td>4. Debt disbursed and outstanding</td>
<td>14.2</td>
<td>0.4</td>
<td>14.6</td>
</tr>
<tr>
<td>5. Undisbursed debt</td>
<td>7.3</td>
<td>-</td>
<td>7.3</td>
</tr>
</tbody>
</table>

(Pipeline as of 1.7.89)
24. Debt Management in Sierra Leone

Ernestus Coker
Sierra Leone

External debt monitoring and analysis is presently undertaken both in the Ministry of Finance and the Bank of Sierra Leone using files and registers maintained manually. This type of collection of information cannot be made use of conveniently in this modern age, in order to forecast external payment obligations, when, for example, exchange rates and international interest rates vary, since a manual system lacks flexibility. Similarly, flexible aggregations of external debt data which are required for balance-of-payments analysis and foreign exchange budgeting, are cumbersome and time consuming to prepare. As such, this system needs improvement.

I. Borrowing Policies

Sierra Leone maintains a general policy of relating all government and government guaranteed loans, especially project financing, to the overall economic performance of the economy and, in particular, to the availability of foreign exchange to repay loans. At the beginning of each financial year, a foreign exchange budget is prepared by the Bank of Sierra Leone. It is the basis for incurring additional foreign exchange expenditure for a particular financial year.

Over the past few years the government has relied on mainly foreign financing for its development programme. It is very difficult to match the requirements for foreign financing to foreign exchange earnings. One reason is the unreliability of Sierra Leone’s foreign exchange earnings. If prices of agricultural produces would be constant, one could reliably budget foreign exchange earnings; but, taking into consideration the fluctuation of prices of agricultural produce, preparing a foreign exchange budget becomes very cumbersome. This difficulty is not unique to the Sierra Leone economy but is characteristic of most agricultural exporting developing countries.

The shortage of foreign currency has over the years created difficulties for the government of Sierra Leone to meet its external obligations. Consequently, government borrowing has been limited mostly to concessional loans from international organizations.

II. Debt Monitoring Procedures

The Ministry of Finance, as the agency responsible for the management of all government debts, keeps full records of all local and foreign government loans. It is also responsible for ensuring that proper provision is made for loan repayment in the budget estimates. Information on each individual loan is recorded in an index card which contains all the relevant data on that loan. These index cards are updated regularly. Disbursements on government loans are recorded in a ledger as and when they are countersigned by the Ministry of Finance and on confirmation from the creditors that the disbursement forms are acceptable.

When a payment of principal or interest on a loan is to be made, the normal procedure is for the Ministry of Finance to instruct the Bank of Sierra Leone to make a specified payment to a creditor. In a few cases, such as where payment orders with respect to promissory notes have been issued, the Bank of Sierra Leone has blanket authority to make payments as and when they fall due, without specific instructions. It notifies the Ministry of Finance of the payment retrospectively. When the Ministry of Finance is notified of such payment, an entry is made on an index card.

The Bank of Sierra Leone, as the government’s banker, is responsible for effecting loan payments. It is also responsible for finding the foreign exchange to make payments on foreign currency loans. The Public Debt Section within the Bank of Sierra Leone keeps records of debt transactions undertaken by Bank of Sierra Leone on behalf of the government, draws up debt profiles to assist in the forward management of loan payments, particularly in foreign currency, and advises on debt policy generally. The records kept by the Bank of Sierra Leone are similar to those of the Ministry of Finance. The use of index cards by the Bank of Sierra Leone has recently been complemented
Managing External Debt in Developing Countries

by the use of individual loan files. The Public Debt Section keep its own copies of loan agreements from which information is transferred to the files and payment schedules calculated. If loan agreements are not available, the Ministry of Finance provides the details. Actual payments are entered on each index card and on a payments file as payments are effected by the Foreign Operations Division within the Bank of Sierra Leone and communicated to the Public Debt Section.

The coding system used by the Bank of Sierra Leone for numbering the loans is different from that of the Ministry of Finance. The cards and files are updated periodically; but the information on the individual cards and files are not normally consolidated into a single schedule covering all government debt, though monthly debt profiles are produced and quarterly payment schedules are drawn up.

Payments in foreign currency of principal and interest on foreign loans are effected by the Foreign Department of the Bank of Sierra Leone. In principle, these payments are made on specific instructions from the Ministry of Finance. But, as mentioned above, the Bank of Sierra Leone has blanket authority to make payments on loans and notify the Ministry of Finance.

Because of Sierra Leone's foreign exchange difficulty, there is hardly ever sufficient foreign exchange available in any given month to enable the Bank of Sierra Leone to meet foreign payments in full. An ad hoc system has therefore developed under which the Foreign Department makes a weekly list of outstanding critical payments in order of priority. The priority order is decided by the Foreign Department in consultation with the Governor of the Bank and the Minister of Finance. Once the list has been agreed upon, payments are then effected by Foreign Department according to the amount of Foreign Exchange available.

The main drawback of the present system is that none of the three operational centres, i.e., the Ministry of Finance, the Public Debt Division and the Foreign Department at the Bank of Sierra Leone, has complete information on the current state of individual loans. This is partly because there is an inadequate flow of information between the three operational centres. The aggregation of debt statistics under the present system is cumbersome and time consuming task. As a result, there are drawbacks as to the type of information supplied for adequate debt monitoring and policy formulation.

This present system, therefore, lacks a central clearing house for information, where all debt data are received, coordinated and processed; it lacks a fast, effective and self-checking means of recording, monitoring, updating and processing debt data; and it is not able to produce rapid forecasts of the effects of possible changes. These shortcomings could be rectified by the establishment of a National Debt Office and by the computerization of the whole system.

III. Proposed Changes

The Present Debt Management System has been discussed at length among interested parties, and it has been established that there is a need for a National Debt Office that would act as a central repository for all information on national debt and that would be responsible for coordinating the activities of the Ministry of Finance, the Public Debt Sector and the Foreign Operations Division at the Bank of Sierra Leone.

A. A National Debt Office

The first task of the National Debt Office will be to complete the creditor reconciliation of the inventory of the public sector foreign debt and to ensure that the information available in the three operational centres is accurate and consistent. The establishment of a National Debt Office would not eliminate completely the functions of the three operational centres. The Ministry of Finance would continue to bear responsibility for meeting the obligations incurred by the government.

Specifically, the office would need to ensure that loans are contracted when needed, that the proceeds are applied to their proper purpose and that the government funds the local currency needed to meet all payments obligations. The Banking Department of the Bank of Sierra Leone would continue to advise the government on its debt payments, and the Foreign Department would be responsible for the foreign exchange requirements resulting from the government's debt obligations, and for meeting those requirements within the framework of the overall foreign exchange policy.

Because the Bank of Sierra Leone is responsible for making actual payments, and therefore has a constant need for accurate information, I believe that the National Debt Office should be located in the Bank of Sierra Leone.
B. Computerization Proposals

At present, the three operational centres in the Ministry of Finance and the Bank of Sierra Leone are in the process of adopting a common integrated system for automated debt monitoring. This would enable the three centres to conduct regular and instant checks on the compatibility of their debt records and to identify areas where differences in data or assumptions need to be reconciled. It would also allow each centre to provide full information about the implication of policy alternatives to management within its own sphere of responsibility.

To this end, an exploratory mission was undertaken by a Senior Systems Analyst of the United Nations Conference on Trade and Development (UNCTAD) to assess the needs of the Government and the Bank of Sierra Leone in the area of debt management including the installation of computer system. It is hoped that, after securing the necessary funds, the UNCTAD Debt Management System (DMFAS) would then be installed in both the Ministry of Finance and the Bank of Sierra Leone. All data entry would then be centralized at the Bank of Sierra Leone. A copy of the updated data based could be transferred to the Ministry of Finance on, for example, a daily or weekly basis. Thus, the reporting and analysis function would be fully available for both institutions. At the same time, data integrity would be guaranteed by the centralized data entry.

The computerization of the public debt would provide Sierra Leone with up-to-date status reports on external debt. The recording of actual disbursements and debt service payments (loan ledger) will be computerized as well as data on loan terms, debt servicing schedules and other characteristics of loan agreement. A computer system would also permit frequently reviewed projections of existing debt to be made with a considerable improvement in flexibility and accuracy. In the process of computerizing the register of existing loans, a registration certificate will be assigned in order to verify that the loan has been registered. This will constitute a permanent mechanism in the sense that all future loans will be assigned a certificate upon being registered.
25. External Debt Management in Sudan

Syed Omar Ibrahim Eltahir
Sudan

Sudan, being a less developed economy, has a continuing need for development finance from abroad. During the initial growth of the country, public foreign debt was increased to meet development needs, and by fiscal year 1978/79 Sudan was faced with a prohibitive foreign debt-service burden. Now, the public foreign debt of Sudan is currently in excess of 12 billion dollars, and the management of the debt is one of the central components of the national recovery program.

I. Organization of Debt Management

The principal units dealing with external debt are located in the Ministry of Finance and Economic Planning and in the Bank of Sudan. The responsibility for the management of Sudan’s external debt is vested in the Ministry of Finance & Economic Planning under the Act of 1977. Prior to the passing of this Act, individual government units and public bodies could make foreign exchange commitments, without the approval of the Minister of Finance, even though such commitments ultimately became liabilities of the government. The practice led to uncoordinated borrowing by public bodies and a lack of control over future commitments that was not acceptable once the overall level of external debt become significant.

II. The Bank of Sudan

The Bank of Sudan is responsible for the management and allocation of the external reserves of the country and is empowered to borrow in its own name up to one year under the Bank of Sudan Act. In general, foreign borrowing during a given period of time is not determined by the actual foreign exchange requirements. It is rather determined by the availability of concessional aid, by lines of credit extended by foreign commercial banks and by the availability of acceptable collateral (mainly produce contracts). Because of the continued severe shortage of foreign exchange in Sudan decisions on foreign debt service can not be made without reference to the immediately availability of foreign exchange.

The Bank of Sudan is responsible for the management of its own short-term foreign debt. Due to the present severe shortage of foreign exchange in Sudan, decision on the servicing of any sector of the public debt must take account of the other sectors, and there is close consultation between Bank of Sudan and the Ministry of Finance and Economic Planning.

II. The Ministry of Finance and Economic Planning

Since the passing of the Finance & Accounts Procedure Act greater coordination was needed between the different sectors and departments involved in external finance. A Directorate General of external finance is being established to perform the function headed by a Director General who will report to the Minister. The Director General will be responsible for the computation and presentation of comprehensive data on all aspects of Sudan external finance. This will include the external financial position on behalf of the Government, with particular emphasis on the management of Sudan’s foreign exchange borrowing requirements and debt servicing obligations. The Directorate will advise the Minister on all matters pertaining to external finance, and it will be required to develop policies, strategies, procedures and controls for external finance. The Directorate will consist of following Departments:

(a) Loan Administration & Technical Assistance, Planning Department, Ministry of Finance.

(b) Loan Repayment Section, Finance Department, Ministry of Finance.

(c) Commodity Aid Department.

(d) External Finance Foreign Exchange, and Budget, Economy Department, Ministry of Finance.
At this time, there is no computer system in the Ministry for managing external debt. One is needed, in a special directorate for this purpose, that is capable of holding accounting type records of all public foreign exchange borrowing and grants. These records should contain details of all transaction on each account interest and capable repayment schedule to the maturity of loans and be suitable for use as a data base for the preparation of debt reports & projections.
Shortly after the preceding note was written by Mr. Eltahir, the Ministry of Finance and Economic Planning announced a major revision in its organizational arrangements for external debt management. The main feature was the establishment of a Debt Management Unit in the Planning Wing of the Ministry. This unit and four companion units are now placed in the General Department for Economic Cooperation. The head is an Undersecretary who reports to the First Undersecretary of Planning. In turn, he reports to the Minister of Economic Planning (see Chart 1).

The Debt Management Unit is responsible for ordering repayments of all government loans and for renegotiating debt on behalf of the government. Three units are responsible for negotiating new loans and implementing the agreements (the Project Aid Unit, The Commodity Aid Unit and the Food Aid Unit). The fourth unit, the Disbursement Unit, monitors drawings on foreign loans and is responsible for maintaining statistics on all loans.

Prior to this reorganization, these functions were carried out by four separate departments. In the Finance Wing of the Ministry, there was an External Finance Department and a Repayment Section. In the Planning Wing there was a Loan and Technical Assistance Department. The Commodity Aid Department existed independently of the other units. It is visualized that the functions of these groups will be carried out more smoothly, now that they are linked in the General Department for Economic Cooperation. This Department will be working closely with the Foreign Aid Department and the Rescheduling Department of the Bank of Sudan.
Chart 25-1: DEBT MANAGEMENT IN THE MINISTRY OF FINANCE AND ECONOMIC PLANNING

- The Minister of Finance and Economic Planning
- First Undersecretary of Planning
- General Department for Economic Cooperation
  - Debt Management Unit - Orders repayments of all loans; participates in debt rescheduling negotiations
  - Project Aid Unit)
  - Commodity Aid Unit)
  - Disbursement Unit - Monitors disbursements for all loans
I. External Borrowing Procedures

The control of debt and the management of borrowings are principally centered in the Undersecretariat of the Treasury and Foreign Trade (UTFT), attached to the Prime Minister’s Office. The UTFT is authorized to borrow in the name of central government and to negotiate with the foreign lenders. The General Directorate for External Economic Relations of UTFT is responsible for formulating the external borrowing program. It follows developments in the international capital markets, analyzes the terms and conditions of agreements, and negotiates the various loans. This Directorate may also assist in loan negotiations involving municipal governments and State Economic Enterprises.

The Treasury exercises a key role in the formulation of the Budget and the Annual Economic Programs, working closely with the State Planning Organization (SPO), the Central Bank (CB) and the Ministry of Finance and Customs (MOF). The Treasury is responsible for decisions on the level and composition of borrowings, the sources of such borrowings and the sequencing of borrowings from capital markets.

The total foreign borrowing requirements of the public sector are formulated in the context of both five year development plans and annual programs. The Treasury determines the foreign financing needs for the current year in line with the annual program, in accordance with the budget.

There is little control over external borrowing by parastatal enterprises, and by private enterprises, due to the liberalization of the foreign exchange control regime. However, all direct borrowing by public enterprises and all private sector borrowing exceeding one year maturity are subject to the Treasury’s approval. All borrower’s are obliged to register new loan agreements to the External Debt Follow-up Department of the General Directorate for Public Finance. After the signature of loan agreements, borrowers are obliged to report disbursements and repayments on a monthly basis. Borrowings of less than one year do not require prior approval, but need to be reported to the External Debt Follow-up Department.

II. Monitoring External Debt

The General Directorate for Public Finance of UTFT has the responsibility of monitoring the long-term direct debt of the central government and other public sector entities. Public sector borrowers must register new loans and their repayment schedules with this Directorate. Borrowers also must report disbursements received. Data reports are submitted monthly. The Directorate also assembles available creditor information on loan disbursements and repayments. Short-term debt is monitored by the Central Bank. The CB also monitors its own medium-and Long-term liabilities, the Dresdner Scheme and related matters concerning liquidity and reserve requirements. The CB monitors some disbursements of bilateral and other official credits. It effects the public sector’s debt servicing, acting on instructions from the Treasury. The CB, together with the Treasury, collects from the banking sector information on commercial bank external debt.

The Treasury is responsible for reporting budget-related external debt information to the Exchequer and Audit Department and to the Government Accounting Office of the MOF. To verify internal government information on debt, the Treasury assembles available creditor data.

The External Debt Follow-up Department of the General Directorate for Public Finance produces statistics and analysis the External Debt of Turkey for debt and liability management purposes. This Department registers the new loans to the External Debt Information system and tracks all disbursements and debt servicing and updates the data information system. The External Debt Follow-up Department generates annual and semiannual external debt reports that cover debt outstanding, disbursements, amortization and interest payments. Some debt statistics are also monthly.
III. Debt Monitoring Problems

Turkey has a large number of outstanding loans, contracted by diverse borrowers and managed by several government agencies. Problems of data compilation are inevitable. A few of these problems are:

(a) The large number of loans and complex nature of data elements of each loan.

(b) There is a need to produce both aggregated and detailed data.

(c) The computerized information of debt service payments based on Turkish debtors' records sometimes differs from information available from creditors.

(d) Notice of allocation and payment orders are normally sent to the Central Bank of Turkey 10 days before due dates. But, sometimes, payments are delayed because of the payment advices are not received on time.

(e) Data are not reported to the General Directorate for Public Finance on time.

(f) Borrowers keep their accounts in Turkish Lira as of the transaction date, and the precise foreign exchange equivalent is not known. This causes differences between the creditors' accounts and those of the Turkish debtors.

IV. Computerization

The data-base of medium-and long-term loans has been computerized within the External Debt Follow-up Department. Work on the External Debt Information System (EXDIS) started in August 1983. Borrowers are obliged to file monthly reports on disbursements and repayments to the External Debt Follow-up Department. The Treasury assembles the information from both debtor and creditor sources, and the Central Bank prepares inputs on debt data based on banking information. All these data provide inputs to EXDIS, which was designed to cover medium and long-term public and publicly guaranteed debt, private debt and also short-term debt.

The computerization project is ongoing, and has been implemented in two phases, with the support of World Bank and IMF staff. Two separate teams work on this project, the design team and the programming team.

Phase one covers the entering of all public, publicly guaranteed and private medium-and long-term debt. It includes entering and retrieving data from the database through a local area network, instruction and training of data managers, and preparation of documentation. Phase two includes more output reports and increased control of data. The collection of data being the core of a good working system, legal and administrative measures have been taken to permit a continuous flow of information: the registration of new loans, the centralization of debt management cooperation between units and good quality control.

In phase one, urgent and simple reports are produced, such as debt service payment time tables and projections, medium-and long-term debt outstanding, disbursements, repayments and interest payments during a specific period. In phase two more detailed reports will be produced such as "alert" reports on payment delays.

We have an IBM 4341, which will be upgraded to a 4381 with a larger capacity for memory and for disk storage. We have approximately sixty-four terminals, of which about fourteen are reserved for the external debt system. For software, the existing operating system was chosen as the basis for the external debt system and PL/I Language for writing the programs. For database management the SQL/SD Language of IBM was chosen.

The principal users of EXDIS are selected staff of the Treasury and the Central Bank. There are no direct linkages between the Treasury's EXDIS and computer systems of agencies that serve as data sources. The information from different sources must be entered manually, with reports coming either by mail or by messenger.

V. Coordination

The General Directorate for External Economic Relations is responsible for foreign borrowing, and the General Directorate for Public Finance is responsible for external debt management. Both Directorates are under the Undersecretariat of the Treasury and Foreign Trade, and there is close collaboration between these...
two departments. The Treasury conducts analytical studies. International capital markets are followed by General Directorate for Foreign Economic Relations.
27. Debt Information Systems

Summary of the Discussion

Rapporteurs:
- Dr. Munir Z. Abu-Ghazaleh, Jordan
- Miss Yücel Irgat, Turkey

Debt Management requires accurate and adequate statistics and information on debt. One way of reporting the debt is based upon its type i.e. classify debt according to the status of borrowers. The discussion emphasized the necessity of coordinating the statistics on various types of loans managed by various officers or sources.

It is very important to have a designated loan office to be responsible for all foreign loans; parties involved, interest rate, maturity etc., in order to accurately express their annual burden and thus plan their service.

Countries often encounter the problems that disbursement are less than complete execution.

Because disbursement advice is received by beneficiary and not by central loan agency. Countries often pay additional charges on deferred payments due to delay on-time repayments indicating the lack of proper timely data more than the lack of sufficient funds.

Considering the burden of debt, the financial resource providing is the important aspect of the debt management. Thus among the participant countries, Ministry of Finance, Treasury Department and the Central Bank have the vital role in the repayments of principal and interest according to the accurate information and to allocate the currencies for this purpose with close relations regarding the currency composition and currency management information about debt.

Read Chapter 19 by Thomas Klein, "External Debt Information Systems in Developing Countries", particularly the table summarizing the difficulties of debt monitoring.
Part V - Use of Computers in Debt Management

28. Introduction

As in nearly all other disciplines, the computer revolution of the 1980s has transformed external debt management. At the beginning of the decade, the work of the debt accountant, the statistician and the debt manager was largely a pen and ink operation aided by adding machines and calculators. A few countries supported accounting and statistical operations with main-frame computers. In the mid-1980s the micro-computer appeared, and "user-friendly" software packages soon followed. During the remainder of the decade, micro-computers became more powerful, and their prices fell. Even low-wage countries have found it cost-effective to use micro-computers in debt management. At the end of the 1980s manual processes were rapidly giving way to computerized technology. As the decade of the 1990s opens, we are seeing all countries with some level of computerization in their external debt management and all countries seeking ways to using micro-computers more effectively.

Debt accounting was initially done by making entries in ledgers or on debt record cards, each card representing one or more aspects of the accounting process required for each loan. For example, accounting clerks would make an entry for individual loan disbursements. They would then calculate manually the amount of disbursed debt created and the amount of the loan remaining to be drawn down. When advices from creditors were received regarding debt service due, these amounts, too, were recorded manually on debt record cards, and the totals of debt outstanding remaining were calculated. Schedules of debt service payments due during the life of each loan were calculated by hand and copied on to the debt record cards.

Form a technical point of view, these debt accounting procedures could be transferred easily from manual record cards to computer files. However, early computer systems were mounted on main-frame computers that were normally operated in a central government computing bureau. Data on transactions had to be copied on to coding sheets and punched cards prepared. The central computer bureau processed the information and returned a tabulation of the reports required.

Main-frame computer records of accounting records were of limited value. Filling out coding sheets meant duplicating the data entry functions of the manual process, and the computerized output was available only with a time lag. The value of the main-frame computer was more in preparing statistics on external debt than in maintaining accounting records. Transactions recorded in many currencies could be converted into a common currency quickly. The use of foreign loans during a month, a quarter or a calendar year could be compiled quickly, as well as the amount of debt service paid. Amounts of debt outstanding could be calculated definitively, and projections could be made of future debt service due. Figures could be prepared either in a common foreign currency, such as the US dollar, or in the national currency.

While the main-frame stage of computerization did not replace day-to-day manual accounting operations, it did enhance the timeliness and quality of summary statistics on external debt. The major drawback was that the format of statistical presentations was fixed. If a different type of presentation was required, the debt office manager had to secure the help of a programmer in the central computing office. Since such skilled staff was scarce, there was always a delay in obtaining special tabulations.

The micro-computer's impact on debt management was revolutionary. Because the machines were inexpensive relative to main-frame systems and did not have to be operated in special air-conditioned, dust-free rooms, it was possible to place them in the debt office. Also, they could be operated by the regular debt office staff and did not require computer specialists to perform routine work. Some work was best done on specialized software created for debt management, but there remained much manipulation of data that could be performed by "off-the-shelf" software, such spreadsheet packages like Lotus 123 or data base packages such as DBaseIII.

The benefits of the micro-computer for debt management are substantial with respect to the work of the debt accountant, the debt statistician and the debt
manager himself. The accounting records of each loan can be kept on-line by the clerks in the debt office who formerly had to enter information on loan-card records. There is no longer a need to enter information once in a manual record and then copy it on to a form for entry into a main-frame computer. Reports could be printed at will. Regarding statistics, summary information can be obtained at frequent intervals from the accounting records (once they are all up-to-date). The format of output can be varied.

What is totally new is the possibility of the debt office manager himself using the computer for analysis. The manager can obtain general statistics on debt from the standard computer output and extract information required using his own micro-computer. He can compose reports directly using word-processing software and input summary statistics. He can make, on his own, broad simulations of the consequences of proposed foreign borrowings or of external shocks created by changes in foreign exchange rates or of interest rates. Before the micro-computer, the debt office manager required a staff of technicians with clerical support to obtain and manipulate the data necessary to secure the answers required. Now, the debt office manager can pose questions and obtain the answers quickly by himself.

In the seminar, Mr. Klein described the changes in debt management that have been made possible by the micro-computer and micro-computer based software. He reviewed the impact on debt accounting, statistics and on managerial functions. He referred in his lecture to a paper by Robert Valentin, "Computer-Based Systems to Meet Debt Management Information Needs". Following his presentation, Mr. Hussain Zaidi of Pakistan described how micro-computers have been used in debt management in his country. Mr. Khanani of the Islamic Development Bank discussed the use of micro-computers as a management tool, demonstrating his points with Lotus 123 applications.

The Valentin and Zaidi essays are reproduced in this section (Chapters 29 and 30). The reader is referred also to the essay on Malaysia's debt information system in Chapter 21, which describes how computers are used for debt management in the Ministry of Finance and in the Central Bank.
29. Computer Based Systems to Meet Debt Management Information Needs

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Canada

The debt crisis has heightened awareness within developing countries, and within the technical assistance agencies which help them, of the need for better information upon which debt management decisions can be made. An important and highly visible part of the response to this need has been the development of a number of computer-based debt management systems (CBDMSs). Indeed, such systems have been seen by some as a panacea for the problems involved in providing a usable information base for debt management decision-making. However, it is well known that such systems do not operate in a vacuum, but depend upon effective communication and cooperation amongst the data suppliers and the users, the availability of trained staff, and the existence of appropriate legal and institutional arrangements. A debtor requires two main resources for successfully dealing with its debt: an adequate source of funds for servicing the debt, and a well-organized, timely supply of information to enable it to develop and implement the necessary policies and to structure and administer its debt portfolio effectively. Unfortunately, there is not much that we as systems people can do about the supply of funds to diminish the debt burden, but we can do something to help improve the supply of information to assist with better, more effective debt management.

This paper consists of three parts. The first will be a "theoretical", or perhaps "conceptual", examination of the information needs of managers of external debt and of the functional composition of Computer-Based Debt Management Systems (CBDMSs) which have been developed or which could be developed to help meet these needs. The second will be a summary of some of the main problems experienced by developing countries with the use of CBDMSs as we know them today, based upon the author's recent experiences in the UNDP Debt Management Review. Finally, the third will be the author's views of what may be missing form debt management information systems today - or, as seen in a slightly different way - where the opportunities are for some interesting and useful systems work in the future.

I. External Debt Management Information Needs

A. Functions of Debt Management

According to Mehran (1985, p.10), the management of a country's external debt has five basic functions: policy, regulatory, operational, accounting, and statistical. Each function has its own particular information requirements, and these can be assisted to greater or lesser degrees by the use of computers.

Traditionally, the term "debt management information systems" has referred to systems supporting the latter two complementary functions (accounting and statistical), and most of the software development and technical assistance to date has been in these areas. This is not surprising given that these functions support the day-to-day management of a country's external debt and its servicing, and provide the database upon which all operational actions and policy decisions are ultimately made. They are also required to meet the reporting demands of lending agencies such as the World Bank, and the needs of Paris Club negotiations. In a sense, the information requirements to support these functions and the types of systems needed to meet them are already well understood, and there is significant experience with them. However, there is ample scope for technical assistance agencies to explore the possibilities

1 The author is Associate Director, Information Sciences Division, International Development Research Centre, Ottawa, Canada. This paper is an abridged version of a presentation to The World Bank Debt Systems Conference, held in Paris, France in April 1989. It incorporates selected portions of the work undertaken by the author as part of the UNDP Debt Management Review. He would like to thank UNDP for allowing him to use this material, but would like to emphasize that he takes sole responsibility for the opinions expressed in this paper.
for computer-based tools to assist in the other three functions, particularly in the area of collecting, storing, distributing, and sharing information and experiences from various developing countries.

The accounting function consists of creating and implementing a framework to record and control data on the status of a country's indebtedness, and the transaction flows related to it. Much has been written about the scope of information to be included in a country's external debt management information systems. Mehran (1985) points out:

The commonly-used narrow definition of external debt includes all medium-term and long-term debt (of one year or more) owed by the public sector to non-residents. A broader definition adds short-term public-sector debt, direct investment, and private-sector debt (both short-and long-term). Definitions become complicated because the distinction between different types of external obligations such as loans, grants, and direct investment is not always clearly discernible.

Many developing-country debt managers would view the basic minimum of information to be captured by an external debt management system to include medium- and long-term debt owed by the public sector (including direct government borrowing, Central Bank borrowing, and parastatal and private-sector borrowing guaranteed by the government) to non-residents of the country. Obviously, any institution or country developing or implementing a debt management system requires it to be able to handle the debt stock and instruments which fall within its mandate or interests. From the systems point of view, this relates to the capabilities of the system to structure and store particular types of data elements and their characteristics. For example, a debt management information system could be called upon to include information on the following (not all necessarily mutually exclusive):

- medium- and long-term loans
- short-term loans (including suppliers' credits, trade and non-trade, short-term credits, notes, etc.)
- syndicated credits
- restructuring and refinancing agreements
- external grants
- domestic borrowings
- domestic on-lending of external borrowings
- domestic instruments (e.g. Treasury Bills, local inscribed stocks, etc.)
- bonds
- equity investments.

Information may be required at various levels of aggregation, depending on the type of debt instrument and the borrower. This aggregation can apply to both basic information on individual loans and information on individual transactions related to a loan. (Note that henceforth the term "loan" will be used for any sort of debt or debt-related instrument from the above list). The accounting function is also directly related to administrative control; for example, information may be derived from or may be used by other administrative systems in place, such as for authorizing foreign exchange transactions.

The statistical function (or, as it is sometimes referred to, the statistical and analytical function) converts the data contained in the database which has been constructed for accounting (and control and monitoring) purposes into meaningful information for management. Generally, summary figures are provided for a set of variables aggregated across a particular subset of loans selected according to particular criteria and produced with given periodicity. In addition to providing information based on historical data and the current stock of debt, projecting statistics is an important aspect of this function. Analytic tools to provide sensitivity testing (for example to determine the effect of changes in interest or exchange rates, or to determine the potential effect of a particular borrowing strategy) can provide a basis for day-to-day portfolio management as well as for developing future borrowing strategies. Thus, the information generated is of use not only to debt managers, but also for larger macro-economic purposes such as government budgeting and balance-of-payments planning. In addition, the statistics generated can be of great use for fulfilling reporting requirements, both internal and external to the country.

Mehran's first three functions (policy, regulatory, and operational) depend on the latter two (accounting and statistical) for accurate data on a country's indebtedness, but have broader requirements as well.
These include:

(a) current legal administrative guidelines (e.g. laws, procedures, regulations) and documentation (e.g. existing policies);

(b) relevant legal documentation (e.g. agreements);

(c) interpretations and examples of past experience (e.g. current international practices, recent negotiations);

(d) published literature on debt management; and

(e) market information and sources of finance.

Much of this is currently scattered and duplicated through various files in different ministries and agencies, or is retained in the heads of officials. It is generally not organized into a coherent information system which would permit easy access by a variety of users. In some cases, much of the information that would be highly pertinent never reaches the officials in charge at all, although it may be available in the country, as it may be held, for example, in the private (and partly foreign-owned) banking system. It should be emphasized that a good deal of relevant information can come from sources outside a particular country, and that South-South exchanges of information and experience can be particularly useful. Efforts by the U.N. Regional Economic Commissions to establish information networks on more general development and planning information, such as ECA's PADIS and ECLAC's INFOPLAN, are a start in this direction.

B. Computer-Based Debt Management Systems (CBDMSs)

For the purposes of this paper, a Computer-Based Debt Management System (CBDMS) is taken to be a computer-based tool used to record, process, manage, analyze, and report on debt-related data. In particular, the systems considered focus primarily on managing external debt of developing countries. Such systems consist of the following components.

1. Hardware. This refers to the physical equipment on which the system operates: The computer (microcomputer, minicomputer, or mainframe computer), data storage devices (disks, tapes), terminals, communications devices, etc. The specific configuration depends on: local requirements, such as the scope of the application (types of loans, number of loans, level of transaction detail retained); the number and locations of users; the operational environment (online, batch); hardware and related systems already in place; and the CBDMS software to be used.

2. Software. This includes both the system software (operating system, programming languages, system building blocks and utility packages such as database management systems, spreadsheets, word processors, report generators) and the applications software, i.e. the debt management software. It is the latter which is the focus of attention in this conference, and indeed is often seen by users as the CBDMS. Debt management software can be written locally by a developing-country institution to meet its specific needs -- with or without outside technical assistance -- or it can be taken as a package from a software supplier, either a technical assistance agency or a commercial organization, and adapted to varying degrees to meet local needs.

3. Database. This includes the definitions and structure of the data to be stored and used by the system, as well as the data itself (both input by the user into the system and generated by the system). Typically, a CBDMS contains the following types of data (Hunsberger [1985], pp. 5-8):

(a) the basic loan register, containing the principal elements taken form the loan agreement (borrower, lender, date of signature, commitment amount, use of funds). This information normally does not change unless a refinancing or rescheduling operation occurs;

(b) planned transaction schedules, including schedules for future disbursements, amortization and interest payments, and fees. In some systems, planned events are entered manually transaction by transaction, while in others descriptions of periodic transactions (e.g. semi-annual principal repayments, quarterly interest pay-
ments based on a specific interest computation formula) are entered;

(c) projected future transaction schedules, generated by some systems based on the descriptions of periodic transactions in (b) above. These projections depend on the availability of estimates for future interest and exchange rates and assumed profiles of disbursements;

(d) actual transaction data, in a historical file containing details of transactions which have taken place (usually at the individual transaction level, although transactions may be aggregated for various reasons);

(e) debt relationships, including linkages between individual loan agreements under frame agreements, loan syndication, rescheduling or refinancing exercises, and parallel agreements for domestic on-lending;

(f) exogenous data, including financial market data such as interest and exchange rates (historical, current, and in some cases projected); market conditions (e.g. for portfolio management); and national macro-economic indicators such as GNP and export earnings. Some of this data may be derived from other systems operating in the country or elsewhere;

(g) utility information, such as codes used for institutions and currencies, and creditor addresses and contact information;

(h) administrative data used to control the flow of work related to debt management (e.g. new loan authorizations, data validation, payment authorizations, budget allocations); and

(i) interfacing data, used to explicitly link data within the debt database to other systems (e.g. corresponding record/transaction numbers, budget coding).

4. **Documentation.** This includes system and user documentation, manuals, training materials, standard data entry forms, and standard operating procedures.

C. **Functional Capabilities of CBDMSs**

CBDMSs vary a good deal in sophistication, complexity, and functional capabilities. The following list represents classes of functions found in many current CBDMS implementations, with the order roughly approximating increasing sophistication and power, as well as the historical evolution of many systems. Note that the classes are not necessarily mutually exclusive. Functions include:

1. **Data entry, validation, and editing,** in order to create and maintain the components of the debt database (as generally defined above). This includes what is commonly referred to as debt registration/recording and debt transaction accounting.

2. **Generation of projected transactions,** based on rules for periodic disbursements, payments and fees.

3. **Production of standard reports,** with varying degrees of user parametrization for record selection, aggregation, computation, and output formatting. Reports can be based on debt and exogenous data entered by the user, extracted from external systems, and/or generated by the CBDMS. Reports can include single loan summaries and histories, ledger accounts, arrears notices, creditor exposure, external debt outstanding, debt service projections, country reports for the World Bank, various statistical aggregations, utility reports, etc.

4. **Querying and ad hoc reporting,** including an interactive query program to enable selection of records meeting specified criteria and a reporting language or report generator permitting easy user definition of reports. Note that if user parametrization is sufficiently generalized, the "standard" reports in function 3 may be able to meet many of these requirements.

5. **System utility and maintenance functions,** including file backup, security, parameter initialization, etc.
6. **Analytic/management tools, to support:**

   (a) sensitivity testing, to determine the effect of variations in exchange and interest rates on future debt servicing;

   (b) new loan testing, to evaluate loan offers or possible borrowing strategies;

   (c) calculation of exchange rate gains and losses in multi-currency loans;

   (d) calculation of the grant element in loans;

   (e) reporting debt data in machine-readable form to external agencies (e.g. the World Bank); and

   (f) accessing external financial or statistical information sources (e.g. Reuters, IP Sharp).

9. In the case of a supplied CBDMS package, facilities for customizing data structures, processes, and reports or for developing new functions which can be integrated with those already provided in the package.

10. **Decision-support systems and tools, to assist in policy formulation, evaluation of alternative strategies, development of negotiation strategies, and portfolio management and optimization of composition, maturities, and interest and exchange rate exposure.** Such systems would be sophisticated extensions of the tools included in functions 6 and 7 and would use the collective expertise contained in the information sources in functions 11 and 12.

11. **Access to information sources (both within a developing country and from other countries) for policy formulation, regulatory functions, and debt coordination, including:**

   (a) laws, regulations, procedures for authorization, contracting and administration of loans;

   (b) foreign exchange regulations and procedures;

   (c) examples of workable institutional arrangements;

   (d) economic and financial policies impacting on external debt management;

   (e) current international loan practices (e.g. what creditors can and cannot require, sample agreement clauses);

   (f) new financial techniques and their implications for developing-country debt strategies;

   (g) detailed experience in previous negotiations;

   (h) training opportunities; and
(i) sources of technical advice (including consultants).

12. Access to information sources for operational portfolio management, including:

(a) market conditions including availability, instruments, maturities, etc. (see also function 8 (f));

(b) sources of finance; and

(c) undrawn amounts in existing loans.

13. Access to networking facilities for information exchange amongst debtors, including electronic mail and computer conferencing.

Note that functions 10 - 13 are not currently considered part of CBDMSs or of other operational support systems used by debt managers. Such functions, or, as in the case of 12 and 13, the related information sources, would be labour-intensive and demanding to construct and maintain. In addition, functions 11 -13 would partly depend on the development of TCDC arrangements to identify, classify, process, and share the information amongst developing countries. See also Section III.

II. Problems with the Implementation and Use of CBDMSs in Developing Countries

The introduction of any technology-based tool into developing countries can be impeded by a number of potential problems. CBDMSs are certainly no exception, and many of the standard lessons of computer-based information applications apply. The principal problems encountered during the UNDP Debt Management Review in which the author recently participated include:

1. Need for identification of the principal systems and user requirements and the logical selection of an approach and/or specific hardware and software. This is a classical data processing problem, with local systems staff often unfamiliar with the set of applications (in this case debt management) and users unable to express their requirements clearly in systems terms, or, because of unfamiliarity with the capabilities of systems, unsure of what they reasonably can ask for. Exchange of information and experiences, through conferences and workshops such as the ones organized by the World Bank in Paris in 1985 and 1989 can play a very useful role. Selecting a system or technical partner can require specialized knowledge and skills beyond those available in some developing countries and may necessitate the use of impartial outside advice (Hunsberger [1988]). In many cases, the choice is heavily influenced by considerations that have little to do with the relative advantage of the CBDMS software itself. The point is, however, that once the choice has been made and the results become visible as the system is installed, there is little chance to compare with alternative systems and a natural tendency to uphold the decision made. In reviewing the experiences of the countries visited, the author did not feel that system selection was one of the major impediments to progress, either in the past or at the present time.

The selection of an approach as discussed above will usually directly determine the hardware to be used for debt management. For example, if a CBDMS package is selected, the range of hardware (and operating systems) on which it will operate, and the mode of operation (single-user or multi-user), will be determined by the capabilities of the package (both current and expected in the near term). In most cases, this has been an IBM-compatible microcomputer under MS-DOS, although at least one package is available under XENIX with multi-user access.

It is likely that packaged systems will evolve to support operation in Local Area Network environments as well as full multi-user access. If custom-built software is to be developed for debt management, this may be to utilize existing (mainframe and minicomputer) hardware, or to become a component of an existing financial information system.

2. Need for the development of a detailed plan for coordinated debt information management in a country. This is closely related to
point a, as it involves identifying all of the potential sources and users of debt information, as well as existing systems in place, and developing a rational approach to sharing the overall task of debt information management. This is often done as part of the initial assessment by technical assistance agencies, although potential overlaps identified at this stage may not be resolved prior to system implementation because of pressures from one or several of the institutions. It is evident that such a detailed plan for coordinated debt information management should be developed and problems of mandate, overlap, information flows, and data standards should be resolved preferably before any system implementation work is started in a developing country and at any rate before the system starts producing regular reports.

3. **Duplication of effort.** One specific problem which may be identified as part of the process in point b is duplication of effort, especially in situations where resources are limited. In a number of cases, traditional rivalry between the Central Bank and the Ministry of Finance has resulted in some overlap and thus in wasted efforts. In the worst case, one runs the risk of ending up with conflicting sets of debt data. It is important that clear operational guidelines for institutional cooperation and a mechanism to coordinate the many aspects of debt management (including the use of CBDMSs) be developed as part of each above-mentioned developing-country debt information plan. The effectiveness of this mechanism should be reviewed periodically as part of the process of monitoring debt management projects by donors and technical assistance agencies.

4. **Difficulties with interfacing to related computerized systems.** A CBDMS may be connected to other financial applications and systems (both within an institution and outside), either via the transfer of data to and from the CBDMS (this is the most common method with standard CBDMS software packages) or via direct systems integration (usually only with custom-built systems). In the case of data transfer, the CBDMS is operated separately (perhaps on a different computer) from the other financial system, and data is exchanged in a pre-defined format, usually on an external medium such as diskette or tape (although it may be via direct file transfers using data communications), at regular intervals. Software is required to extract the required data from one system, to reformat it, and to load it to the other system, although it is generally not a problem to prepare such software. In some cases, only specific data elements will be exchanged (e.g. actual loan repayment transactions extracted from a system at a Central Bank and used to update the payments file in a CBDMS); in others, entire records are transferred (e.g. when private and public debt are handled by different agencies and merged into a national database). On the other hand, the case of direct systems integration usually implies that databases or data elements and functions related to debt management are added to or built as part of a custom-built financial management system operating on a central minicomputer or mainframe computer (e.g. for handling all operations within a Central Bank). Data may be shared by different applications as part of a common database, or may be extracted in real-time or at fixed intervals by a program running on the computer.

The "connection" between a CBDMS and another system requires clear technical specifications to permit the appropriate exchange of information, synchronization of updates, and coordination of functions. Obviously, the task is enormously easier if both systems are using the same CBDMS software. The specific local requirements and conditions, as well as cost and benefits, must be taken into account when planning any interface with a CBDMS. Although the technical difficulties involved should not be minimized, often the main problem is the lack of will to carry out the interfacing because of disagreements between the operators of the systems being connected.

5. **Inadequate resources.** Debt management projects can suffer from a lack of resources allocated locally or in external assistance
projects. Human resources, equipment, and technical support seem to be the three main areas for which inadequate provisions are sometimes made. It is important that the design of debt management information projects be reviewed carefully in the light of similar experiences in other countries to ensure adequate resource allocations.

6. Lack of expressed political will. In some cases, the main problem seems to be a lack of appropriate direction from authorities to ensure that debt management activities are accorded a proper position in institutional priorities. This, of course, is related to the question of local resources allocated for debt management mentioned in point e. There is a need for sensitizing senior government officials as to the benefits which can accrue if appropriate attention is given to debt management information activities.

7. Staffing. Another common problem is recruiting and retaining adequate technical staff, especially given financial conditions within many government departments. Incentives such as opportunities for training, technical exchanges, and study tours abroad can be used, and efforts to match renumeration to responsibility and productivity can be useful in this context.

8. Training. Problems seem to arise more frequently with respect to basic or introductory training related to computers, information systems, and debt than with more advanced, product-specific technical training.

9. Hardware and software maintenance. Generally, these are not major problems, although in some cases hardware failures do occur. Software problems tend to focus on missing functionality from systems (i.e. features which were promised but which were not present or delivered on schedule), rather than on "bugs" in the systems.

III. Present Gaps and Future Directions for CBDMS Development

Developers of CBDMSs (or indeed of any computer-based system) are faced with a constantly moving target. User requirements, other related systems operating in the same institutional environment, financial practices and instruments, government policies and approaches, and computer technologies — all of these evolve and make new demands on their systems. Technical assistance agencies which supply CBDMS packages receive feedback from their users in debtor countries, form their resident advisors, and from their staff, and attempt to satisfy sometimes conflicting demands within an overall system evolution framework. Sometimes changes are dictated as well by internal system demands, brought about by the need to improve performance, reduce system overheads, replace obsolete development technologies or tools, and so on.

In the author's view emphasis in future systems development work should be in three main areas.

1. Facilities for customizing data structures, processes, and reports or for developing new functions which can be integrated with those already provided in the package.

To date, most users of CBDMS packages have been satisfied with using the package more or less in a turn-key modality, although in some cases they have required additional functionality from the system supplier before fully implementing the software. In addition, the principal CBDMS packages provide some facilities for user customization, mainly during system installation. However, it is generally not easy to add data elements, for example, to the loan file data definition, if a user wants to write a separate application program to access or manipulate the loan record. As more developing-country users begin to use computer-based tools in all aspects of their work, the demand for customized solutions or for interconnections between applications will grow. In the case that a CBDMS is based on an underlying database management software package, which comes with applications development tools, it should be relatively easy for the system devel-
oper to document the steps necessary for the user to develop special programs and to provide the necessary "hooks" into the system to facilitate this.

2. **Decision-support systems and tools, to assist in policy formulation, evaluation of alternative strategies, development of negotiation strategies, and portfolio management and optimization of composition with regard to maturities and to interest and exchange rate exposure.**

Currently, CBDMSs provide the user with relatively limited facilities for constructing different scenarios and determining the effects of changes to various parameters on critical variables computed by the system. At its simplest, the user must generate the required variables (for example, by printing the associated reports or by computing and then exporting the variables to a spreadsheet), save the contents of the database, modify the parameters in question (often one-by-one), recompute the variables, and compare the results. This can be a time-consuming and tedious process (although not as tedious as doing the entire analysis manually!). Determining optimum scenarios may require multiple iterations of this procedure. Also, more senior or less frequent (and less technical) users may require higher-level, more user-friendly interfaces to the system than are currently available for asking such "what-if" questions. The construction of appropriate scenarios may also involve accessing external data sources or models, or indeed may require exporting data from the CBDMS for processing by external processes. There is great potential for interesting work in this area with existing CBDMS-created databases and software.

One set of techniques which may be extremely useful in building on the power of existing CBDMS analytical tools, financial models, and the cumulative personal experience of debt managers are those referred to as expert systems techniques (Feigenbaum and McCorduk, 1983):

An 'expert system' is an intelligent computer program that uses knowledge and inference procedures to solve problems that are difficult enough to require significant human expertise for their solution.

The expert system program contains or access- es appropriately coded and structured data, and facts (i.e. general knowledge and experience), as well as rules, models, and heuristics, and applies these, in interaction with the user, to propose solutions to the problem being addressed. The problem itself must be capable of being clearly defined and given appropriate limits, and of solution via a structured problem-solving approach. The existence of case studies is necessary to check the validity of the results obtained (O.I.I., 1985, p.16). It would be difficult, for example, to produce an expert system to advise on the best way to structure a country's economy to service debt, but it might be possible to write one to suggest improvements to a given debt portfolio. At least one bank is already working on a system to help forecast exchange rates.

An expert system depends on knowledge and experience experts to tell it how to approach a given type of problem (Applied AI Systems and Cognos Advance Technology, 1985):

To create an expert system, an expert in the chosen field is selected and debriefed. The knowledge engineer searches for rules that associate facts about the expert's domain. This is a lengthy process of interviewing, codifying, testing and verifying, then rewriting to ensure that the knowledge in the system is indeed as the expert intended. When the system is completed, it can be used as an assistant to less-experienced users, or in place of the expert, depending on the particular application. A user querying the system will get the required solution, and can demand an explanation of how the system arrived at its conclusion. There are immediately obvious benefits in training, advisory, and warning systems, as well as longer-term ones once various ancillary technologies mature.

Research would be required to determine the extend to which such techniques could, for example, advise a debt manager on hedging interest rate exposure through swaps based on the database contained in the country's CBDMS and the knowledge base and inference rules (containing other expert debt managers' practice under comparable circumstances) in the expert system. Current portfolio theory may be a starting point for work on some specialized tools for this class of problem.

3. **Access to information sources for policy formulation, regulatory functions, debt coordination, and operational portfolio management and to networking facilities to update the content of these sources and to exchange information amongst debtors.**

There are a number of specific needs for information for policy formulation, regulatory func-
tions, debt coordination, and operational portfolio management which could be better met by the systematic collection and organization of specific type of information. Examples of these types of information are listed above, (see section I.C., paras 11 and 12).

There could be a number of different modalities for providing access to such information, depending on the source of the information and the existence of related systems and services already in place or planned. For example, a database of laws, regulations, and procedures for authorizing, contracting, and administering loans might be part of a national, legal or administration information system. Information may also come from external sources, such as commercial, financial or statistical services, and then may be analyzed and repackaged by a national service to meet local needs. At the regional or global level, there may be opportunities to establish or to participate in existing information systems and networks. Country-specific information can be shared via contributions to cooperative databases, newsletters, and referral services. Thus, for example, documentation (i.e. publications, working reports, etc.), on workable institutional arrangements for debt coordination might be deposited with an existing regional development information system (such as PADIS in Africa or INFOPLAN in Latin America) for analysis, indexing, and inclusion in the system’s databases and information products. There may also be relevant specialized global information services, like UNITAR’s nascent Resource Centre on Debt Management Training, which could be tapped. In the case of cooperative database construction or exchange of information records in computer-readable form, standard methodologies may have to be created or adapted to format and index the information. Of course, some of this information (such as experiences during previous negotiations) can be quite sensitive, yet potentially very useful to other developing countries in similar situations.

In addition, networking among developing countries, both at the personal level (as is done today at varying degrees), and via new electronic-based methods such as electronic mail and computer conferencing, could greatly facilitate information exchange and sharing, as well as access to organized information sources at the national, regional, and global levels.

Some measure of coordination may be required to facilitate technical aspects of these information activities (e.g. standards for database records, networks, interconnections, etc.), but this need not be a monolithic structure. Indeed, there is potentially a role for all of the relevant actors, including national debt-related bodies, UN agencies, development assistance donors, technical assistance agencies, the World Bank, regional development banks, possible developing-country debt-related resource centers, and so on.

IV. Conclusions

Some debt managers dream of having a computer terminal on their desks with access to all of the national debt information (from the local CBMMS), other relevant national information systems (economic, administrative, etc.), and regional and global information sources, as well as the tools to locate, analyze, process, and repackage this information on demand. The realization of this dream is still some time to come, but there are steps that we can all take to bring that day closer.

As can be seen, there are many opportunities for interesting systems research and development work to expand the capabilities of existing systems, build new tools and new types of tools, better organize and facilitate access to all sorts of information which is presently difficult or even impossible to find, and share experiences at all levels. Although there are limits to what even a perfect information supply can do, it can make a difference to debt management, and hence ultimately to socio-economic progress in developing countries.
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30. Use of Computers in External Debt Management: The Pakistan Experience

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Pakistan

The government of Pakistan is in the final stage of installing the UNCTAD computerized debt management system, the "Debt Management and Financial Analysis System" (DMFAS). It has been placed in the Economic Affairs Division of the Ministry of Finance, financed within the framework of a 1987 UNDP technical assistance project. Until that time, Pakistan had maintained debt records manually. In view of the complexity of debt management and the need to have reliable and timely statistics, Pakistan decided to move to a computerized debt management system.

I. Background

The objectives introducing computers in Pakistan’s debt management are:

(a) To provide information needed for macroeconomic policy making;
(b) To assist in the budgeting and control of foreign exchange resources;
(c) To provide an accounting record of transactions related to foreign borrowings;
(d) To analyze alternate sources of funding;
(e) To track the use of external resources by economic sector and project;
(f) To give information needed for the day-to-day management of foreign obligations; and
(g) To provide periodic reports to the World Bank and other foreign aid agencies.

The Pakistan government is aware that many computer systems in developing countries have not produced satisfactory results. The main reason for this lack of success is that a computer system is not the debt management system itself but only an adjunct to the system. The computer is useful only for countries that already have the necessary elements of a good management system in regards to both its structure and its staffing. If these necessary elements for the system do not exist, a computer will not help. Automation cannot precede or be a substitute for the development of an effective management system.

To appreciate the complexity of debt management in Pakistan, one must note that Pakistan has 1,300 long and medium terms loans outstanding 4,000 repayment schedules. The total debt outstanding at the end of June 1989 was $14.2 billion. The amount of principal and interest paid on long-term debt during the year 1988-89 was $1.2 billion.

There are three agencies in Pakistan that are responsible for managing external debt: (a) The State Bank of Pakistan, (b) The Finance Division of the Ministry of Finance, and (c) The Economic Affairs Division of the Ministry of Finance.

(a) The State Bank of Pakistan regulates private sector borrowing, which is very limited. Annual repayments of private sector debt amount only to around $25 million per year. The repayment is made directly by the State Bank of Pakistan.

(b) The Finance Division is responsible for contracting short-term commercial/cash foreign loans with maturity ranging between one year to three years. Loan repayments are made by the Economic Affairs Division, except that payments to the IMF are made directly by Finance Division.

(c) The Economic Affairs Division is responsible for contracting all foreign loans from Aid Consortium countries, financial institutions, non-consortium and The Islamic countries and short term borrowing from Islamic Development Bank. The Economic Affairs Division is
thus responsible for repayment of foreign loans to the extent of 97% of the total repayments.

The Pakistan Government has reviewed its overall debt management system parallel with the computerization project. A special technical mission from the World Bank was invited to Pakistan, and it made a number of specific recommendations:

(a) Improve coordination amongst key agencies, such as the Economic Affairs Division (EAD), the Finance Division and the State Bank of Pakistan.

(b) Establish a Data Coordinating Unit.

(c) Establish a Commercial Borrowing Unit.

(d) Concentrate the monitoring of disbursement of aid in the Debt Management Wing.

These recommendations are all under various stages of implementation. Further information on Pakistan's external debt management system is presented in Chapter 23.

To centralize the monitoring of the total external debt of Pakistan, a Data Coordinating Unit has been formed in the Economic Affairs Division which will facilitate the Computer Cell to generate the reports containing the total external debt profile of Pakistan using UNCTAD software. To assist with the monitoring of foreign aid, UNCTAD has been asked to enhance its software so as to provide the Debt Management Wing with a computer facility to record aid utilization, including technical assistance.

II. The DMFAS

The DMFAS software has been designed to fulfill the operation, statistical and analytical needs of a wide variety of users within government with responsibilities for different aspects of debt management and external financial planning. The system consists of three modules, the core of which is the Debt Monitoring System (DMS) written in COBOL. This may be installed on mainframe, minicomputer or microcomputers. The DMFAS system in Pakistan is designed to run on microcomputers. The UNDP project financed two IBM PC-AT machine with printers plus two Compaq machines with similar characteristics. In addition, the UNDP financed one relatively high-speed laser printer.

The basic DMFAS package, prepared by the UNCTAD staff, consists of three modules. The first module (DMS) enables the debt office to record loan terms and other information required to project repayment schedules, to record actual transactions (the loan ledger) and to select pre-formatted reports for control and management. The second module, the Debt Aggregation System (DAS), is a flexible table generator written in dBASE-III Plus. This module provides the debt office with the capacity to design specific tables and reports that can produce summary debt data from the loan-by-loan detail. The user can select the periodicity required for projections of debt service payments, and the currency in which the report is presented and the data of payments. The third module, the Debt Projections System (DPS), provides projections of debt service payments. It is written in Lotus 1-2-3.

The computer cell in EAD has have supplemented the DMFAS core system with its own software applications to perform the following functions:

(a) Monitor Aid Utilization. This program is written in dBASE-III.

(b) Report debt to the World Bank semiannually on Debtor Reporting System Form 2.

(c) Record day-to-day repayments of foreign loans. This is related to the monitoring of Pakistan's foreign exchange reserves.

(d) Calculate the grant element of loans calculate present worth and generate repayment schedules.

III. Implementation Problems

The installation process, as of mid-1990 is largely complete, and it is considered one of the best applications of the UNCTAD system. All of the basic data necessary to analyze the existing debt portfolio are available on the system. However, three major issues must be resolved for the UNCTAD system to become fully operational.

(a) The present system is managed in unit set apart from the main stream work. This arrangement tends to reinforce the general resis-
tance of the accountants using the system. Resolving this problem will take a lot of careful management and will require machines on the desk of those staff members actually compiling the data.

(b) The project implementation has been done under the guidance of a locally hired consultant funded by UNDP and whose contract will eventually expire. EAD would clearly need services of a full time system analyst a person who will be a permanent staff member.

(c) The UNCTAD (DMFAS) system is essentially a tool for external debt accounting, and its present design does not permit easy manipulation of data to provide the type of reports required by policy-makers.

A further suggestion is that the scope of the system should be expanded to incorporate short-term debt, private sector debt and transactions with the IMF. Clearly, further system development will be required, particularly if Pakistan is to have a complete management information system and if a meaningful analytical use is to be made of the data base. These improvements may be made either directly in the DMFAS or "off-line" by down-loading data from DMFAS and writing special application programs to solve problems individually. Discussions have been held with UNCTAD officials about resolving the above issues and incorporating the enhancements desired.
31. The Use of Computers in Debt Management

Summary of the Discussion

Rapporteurs:

Mr. Ernestus E.A. Coker, Sierra Leone
Mr. S.S. Hussain Zaidi, Pakistan

It was the general view of the participants that computerized debt management system should be recommended to all developing countries for the fact that it helps to speed up debt data processing and allows decision makers to use debt information more easily than manual debt management. It was clear that computer systems are complex and need trained and qualified officers to operate the system for the preparation of data base to produce effective results. Even small errors in entering data will cause the system to produce erroneous results.

At present about fifty developing countries have attempted to install computer systems for the recording of their external debt data; but, to date, most of these efforts have not produced satisfactory results. The main reason for this lack of success is attributed to an error in perception. A computerized operation is not the debt management system itself but only an adjunct to the system.

There are two widely used systems; the UNCTAD [DMFAS] and the Commonwealth [DMRS] system. The participant from Maldives explained the working of Commonwealth [DMRS] system. After some discussion of how the two systems work, it was generally accepted that although both systems have shortcomings, the Commonwealth system is more suitable for small countries with few loans. There is a general shortcoming with both the systems when it comes to computerizing French loans. It was generally accepted that developing countries should themselves prepare their own software according to their need, possibly using a standard system as a core.

Pakistan and other countries who are presently using the UNCTAD [DMFAS] system have proved that modules like DMS [Debt Aggregate System] and DPS [Debt Projection System] can be used successfully and this system could be modified to meet the requirements of individual countries.

In the last few years emphasis has been put on the use of computers for management purpose, in addition to accounting functions Pakistan has developed the following programmes of its own to meet the data requirement for policy-makers and agencies.

(a) Aid utilization written in d BASE-III Plus.
(b) Form 2 [Debt position of each loan] of The World Bank. The report is being submitted semi-annually.
(c) Day-to-day repayments of foreign loans to watch foreign exchange reserves.
(d) Calculation of grant element and payment schedules.
VI - Macroeconomic Policy Issues

32. Introduction

How much foreign debt can one's country prudently contract is perhaps the single most vital question that external debt managers must answer. In this portion of the seminar, Constantine Michalopoulos of the World Bank presented a macro-economic framework for assessing debt servicing capacity. The basic relationships in his presentation may be found in the paper by John Underwood, "Debt in a Macroeconomic Context" (Chapter 33).

The starting point of the analysis is the basic national income and expenditure accounting identities that relate consumption and investment, savings and investment, and imports and exports. The framework can be expanded to identify the role of the government in economic activity. Consumption, investment and savings are separated into private and public components, and taxation is introduced into the system. The framework illustrates the point that if investment is to exceed savings, financing must be available to make possible an excess of imports over exports. This gap represents the current account deficit. More explicitly, the current account deficit represents private savings less private investment plus the amount by which government expenditures exceeds government revenues. The current account deficit represents external borrowing during a given accounting period.

The model is extended over time, and net borrowing is cumulated into a stock of debt. When borrowing requirements are positive, the stock of debt grows and so does interest obligations. In order to estimate a country's future debt servicing capacity, the variables impacting on the balance-of-payments must be projected well into the future: the growth of export earnings, the growth of expenditures on imports and domestic savings and investment. Borrowing requirements can be disaggregated into concessional and non-concessional borrowing. Thus, the debt service payments required by future borrowing are a consequence of the type of borrowing undertaken as well as the evolution of production and expenditure.

Debt and debt service payments can be scaled against GNP and against exports. When the debt service ratio climbs above 20-25%, one must be aware that debt will become a constraint on domestic activity. When the debt service ratio reaches higher levels, the economy will clearly become vulnerable to shocks having an adverse impact on net export earnings. The development strategy, in that it has an impact on the balance-of-payments must be reviewed to see if modifications could constrain imports. Also, the choice of borrowing would have to be reviewed to see if less reliance on non-concessional financing would reduce significantly debt service requirements. With high projected debt service ratios, budgetary policies must be re-examined to see if it is possible to increase public sector savings (current revenue less current expenditure) so as to reduce external borrowing needs.

The economic planning process similarly requires that the projected evolution of the economy take into account the changes in macro-economic variables over time that their impact on the country's debt servicing capacity be assessed. Similarly, proposals for external borrowing, or changes in the country's borrowing strategy need to be assessed in the same fashion.
33. Debt in a Macroeconomic Context

John Underwood
World Bank

The basic reason for external borrowing by a sovereign country is consumption smoothing over time. Out of its own income, the residents of a country have a choice between domestic consumption and domestic investment (or foreign investment, which should be small in most developing countries). If the country is at a relatively low level of development, the level of consumption is likely to be low. Each unit of foregone consumption is extremely costly. External borrowing allows a country to invest more now with less of a sacrifice of current consumption. The cost of the external borrowing is a sharing of the future returns from the investment with the foreign lenders.

I. Why Borrow Externally

Most countries that have moved up the ladder of development have followed a pattern of reliance on external capital at the early and middle stages of their development. Often, these countries themselves become capital exporters at a later stage of development. The exceptions, countries that financed their development without reliance on external capital, have normally been countries with very strong central governments that could impose the necessary hardship on their citizens that was the counterpart of high levels of domestic investment financed out of domestic savings. The social optimality of this approach can be questioned.

External borrowing must be matched, of course, by external lending. Lenders in more wealthy countries are willing to lend because projects in capital poor developing countries tend to have higher rates of return than project in capital rich countries. External lending and borrowing allows capital to be used where it is most productive.

External borrowing also allows countries to smooth consumption across output or income failures. If a country suffers a serious crop failure, for example, it may decide to borrow abroad to avoid a serious decline in consumption. In return, it will repay when crop production returns to normal. Countries that suffer temporary terms of trade losses—declines in the prices of their exports relative to their imports—can borrow to smooth consumption. The IMF’s Compensatory Finance Facility is an example. Unfortunately, countries sometimes mistake long term declines in the prices of their exports for short term price declines. They borrow to smooth consumption only to find that their income remains low when the debt comes due. Countries are well advised to borrow only to partially compensate for what they perceive as a temporary shock to income.

Countries also borrow abroad to take part in international trade at a reasonable cost. They do so by taking on short term trade credit. Without trade credit, countries would have two choices: barter trade or cash transactions. Barter trade is inherently inefficient and expensive. The chance that the firm or country that wants to buy a country’s exports is also the firm or country that is the best source for a country’s imports is extremely small. Trade credit allows a country to conserve on scarce foreign exchange rather than having it tied up in the purchase of imports or the production and shipment costs of exports. Countries (or firms or government agencies within countries) sometimes are tempted to use short term trade credits to finance long term projects. In order to avoid this situation, debt managers must monitor trade credit and keep it in line with the volume of trade transactions.

External resource movements to support investment take two major forms: external debt and foreign direct investment (FDI). (Official development assistance, another major source of foreign capital, will be discussed below.) The two have different attributes. External debt poses the higher risk for the borrowing country but promises the higher return. If an investment financed by external borrowing turns out badly, the country (assuming the debt carried a government guarantee) faces the same external claim as if the

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1 The author is Lead Economist, Debt and International Finance Division, World Bank. The views in this paper and the personal views of the author and do not necessarily reflect those of the World Bank.
investment had turned out well. If an investment financed by FDI turns out badly, the recipient country shares the loss with the investor. If the same investment financed by FDI turns out extremely well, the country must share some of that good fortune with the investor. Through the 1970s and early 1980s external borrowing eclipsed foreign direct investment. As some of the risks of external debt have become apparent, many countries are reconsidering the merits of foreign direct investment.

II. Sovereign Debt and Domestic Debt

Sovereign borrowing and lending is different from domestic borrowing and lending for one reason. Sovereign borrowing, by definition, does not take place under the jurisdiction of a single legal system. Domestic borrowers face domestic lenders that can pursue well defined legal rights in cases of default. In the extreme, a lender can use the courts to liquidate the borrower. Sovereign lenders can impose sanctions on defaulting sovereign borrowers, but these sanctions are often of a kind that do not directly benefit the lender: withdrawal of trade credit and disruption of the external trade of the defaulting country.

Because sovereign lenders know of this difference, they do not lend as much to sovereign borrowers as they would to the same borrowers in a domestic setting. Sovereign borrowers face credit ceilings. Because of credit ceilings imposed on account of sovereign risk, not enough capital ever moves internationally to actually equalize its rate of return in developed and developing countries. Ironically, sovereignty is detrimental to capital flows in support of development.

Credit ceilings create a second potentially important distortion in borrowing countries. The cost of a loan to a borrowing country is more than the interest rate on that loan. Since a new loan moves the borrowing country closer to its credit ceiling, it has an added cost that is not necessarily paid by the borrower. The additional debt makes the country less creditworthy and pushes up the average cost of borrowing for all borrowers. One policy open to a borrowing country is to impose a tax on external borrowing to equate the cost to the borrower with the true cost to the country. The difficulty countries face in the determination of the appropriate tax rate.

Many factors influence credit ceilings. Countries that want to borrow internationally must be aware of the determinants of these ceilings. In the discussion below outlining the evaluation of a borrowing program, most of the data considered are the same data that lenders would use in setting a credit ceiling.

III. The Macroeconomic Evaluation of a Borrowing Plan

In general, if a country is to benefit from external borrowing, its economy must grow so that an adequate amount of new resources becomes available to service to debt. The growth must be sufficient to provide increase consumption and increased debt service.

Some simple identities are useful in relating growth to external debt:

\[(D_t - D_{t-1}) - (R_t - R_{t-1}) = i_D t_{t-1} - R_{t-1} + M_t - X_t\]

where:

- \(D\) is year-end debt;
- \(R\) is year-end external reserves;
- \(I\) is the average interest rate on debt and reserves (assumed for simplicity to be equal);
- \(M\) -is annual imports of goods and all services except interest on the external debt;
- \(X\) is annual exports of goods and all services except interest on reserves;

Note that the subscript \(t\) refers to year \(t\). All variables except interest rates and growth rates are measured in nominal dollar terms; we abstract from changes in exchange rates among major currencies. For simplicity, we will call \((M-X)\) the trade deficit. Identity (1) ignores any capital flight, which could add to debt without any corresponding trade deficit or interest payment deficit. (Debt service on all debt is assumed to be paid on an annual basis, as is interest on reserves.

We can simplify further by discussing net debt, \((D-R)\). The above equation becomes:

\[D_t - D_{t-1} = iD_{t-1} + M_t - X_t\]

If we divide both sides of (2) by \(D_{t-1}\), we have:

\[d = i + (M - X)/D;\]

Here we have, for added simplicity dropped the time subscripts. "\(d\)" is the rate of growth of debt.
If we multiply and divide the last term by Y, where Y is Gross Domestic Product (GDP):

\[(4) \quad d = i + \frac{(Y/D)}{M/Y - X/Y}.\]

This identity bears some examination. External debt grows rapidly ("d" is high) if (a) the interest rate is high or (b) imports are a much bigger share of GDP than are exports. As debt becomes higher, relative to output (D is large relative to Y), the interest rate becomes the most important determinant of the rate of growth of debt. Stated differently, if creditors impose a ceiling that keeps d (the rate of growth of debt) low, countries facing a high interest rate must generate a large trade surplus, relative to GDP when their debt is large relative to GDP.

We can usefully introduce another identity at this point, the GD identity:

\[(5) \quad Y = C + I + G + X - M = C + S + T,\]

where:
- C is domestic private consumption;
- I is domestic private investment;
- G is government expenditures;
- S is domestic savings;
- T is government revenues.

The other variables have been defined above. This is the familiar identity relating the demand for final product to the uses of income.

By simplifying (5) we derive:

\[(6) \quad M - X = (I - S) + (G - T).\]

Substituting for (M-X) in (4),

\[(7) \quad d = i + \frac{(Y/D)}{(1 - S)/Y + (G - T)/Y} \]

We can see from this equation the possible reasons for a rapid debt build-up. If private investment is high, relative to private savings, the country’s external debt will grow rapidly. Alternatively, if government expenditures (for consumption or investment) are high relative to government income—and this deficit is not offset by an excess of private savings over private investment—the debt will grow rapidly.

This identity is also useful to identify the choices available to a country that must adjust to a higher interest rate or to a decline in "d" imposed by creditors. Countries can (a) cut private investment; (b) increase private savings (cut private consumption); (c) decrease government expenditures; or (d) increase government revenues—all relative to GDP. If GDP is growing rapidly, the changes are less onerous. Countries that have maintained high levels of G in the face of a rise in i and an imposed decline in d have often generated the necessary revenue through inflationary money creation.

The choices faced by a country that must adjust are likely to have a differential impact on the rate of growth of GDP. For example cuts in private investment or in the investment component of government expenditures are likely to decrease GDP growth. A very rapid decline in d can lead to a downward spiral; it may be in the interest of creditors, collectively, to ask for a slower moderation in the rate of increase in external debt in order to preserve investment and growth.

Eventually the rate of growth of debt, "d," must be less than the rate of interest. This can be shown by contradiction. If any one country's external debt grew forever faster than the world rate of interest, at some point the country would no longer be small in terms of the world credit market; its external borrowing would drive up the world rate of interest. If we look at equation (3) we see that the implication of this eventualty is a trade surplus; at some point, X must be greater than M if d is less than i. No country can borrow forever to finance trade deficits. Eventually, it must be service, through trade earnings, a share of interest payments coming due. If we look at equation (7), we see that a country must eventually run some combination of private savings surplus or government surplus in order to generate the necessary trade surplus.

For countries that are large recipients of official development assistance (ODA), these identities must be interpreted slightly differently. ODA grants and the grant equivalent of ODA loans should be subtracted from the trade deficit (M-X). These grants finance net imports without adding to the country’s external debt. The debt stock should include nonconcessional loans and the present discounted value of concessional ODA loans.

**IV. The Need to be Forward-Looking**

In order to evaluate the macroeconomic aspects of a borrowing plan, policymakers must be forward looking. Borrowing is inherently a dynamic activity. Borrowing today increases resources available today but it also affects resources available in the future and
increases the call on future resources. A policymaker must take into account the use of funds, in terms of the likely rate of return on the increased investment, the policies the borrowing country intends to follow, and the external environment the country is likely to face. The policymaker must also take into account the risks that the outcomes, in terms of returns, internal policies, and external environment, will differ from those deemed to be most likely.

From the above analysis, three points emerged which are worth repeating. First, growth is the key to creditworthiness and the relaxation of credit ceilings; and investment is the key to growth. A high rate of investment is a necessary but not sufficient condition for creditworthiness. (Investment must also be efficient. Borrowed resources invested unwisely are worse than no borrowing at all.) Second, debt should grow consistently faster than exports only when debt is small, relative to exports. Third, the interest rate is not the only cost of an external loan. Each loan pushes the borrower nearer to credit ceilings, a cost in addition to the interest rate.

A fourth point is worth considering with regard to a forward looking evaluation of a borrowing plan. Be careful in using the present exchange rate between the local currency and a basket of foreign currencies in an evaluation of a borrowing plan. Large borrowings tend to appreciate the local currency above its long term time trend. When payment obligations build up and the country needs more foreign currency, downward pressure is exerted on the local currency.

The policymaker must make forecasts based on the best current data available and on alternative assumptions about each of the macroeconomic components identified above. Some of the most useful data elements to be calculated and projected in the evaluation of a borrowing plan are outlined below.

V. Data Needs for the Evaluation of a Borrowing Program

A. Data Related to Economic Growth

Since growth is the key to avoiding debt servicing difficulties, some of the most important data requirements for the evaluation of borrowing plan are related to growth. These include:

(a) Investment/GDP: Investment must be consistently high, relative to output if a country is to borrow at international interest rates for any length of time.

(b) ICOR: The incremental capital output ratio measures the efficiency of investment. It is the ratio of investment to the change in output, usually measured as cumulative investment relative to the change in output over a period of five years or more. A "good" ICOR is on the order of five or less a very high ICOR is an indication that a country cannot use capital efficiently and should avoid market borrowing. Note that ICOR is not a constant but will change with policy changes. The policymaker must, however, avoid the temptation to assume unrealistic ICOR's in projections.

(c) Growth rate of exports: (dependent on the growth rate of output, consumption, imports, external conditions) exports are the only source of funds to service external debt (other than new borrowings or ODA).

(d) Growth of external liabilities, related to ability to pay:
including:
- likely disbursements from debt already committed;
- likely new commitments and disbursements from these commitments;
- assumed changes in reserves;
- debt service (principal payments separately from interest payments) on old debt and assumed new debt;
- interest/export ratio—a fairly good measure of the "burden" of debt on an economy;
- debt service ratio: (DSR—debt service divided by exports—historical series projections) useful in identifying potentially problematic bunching of debt service payments. Note that this ratio is best used in the context of a medium term forecast; export booms can lead to "debt service ratio euphoria" and terrible mistakes in borrowing policy; there is no right debt service ratio; countries have been forced to reschedule with DSRs of 10; however, as a rule of thumb, a DSR above 25 should be a matter of concern.
Note that the interest service used in the interest service ratio should include interest on all external debt, including short-term and private nonguaranteed long-term, and charges on IMF purchases. Amortization should exclude short-term debt but include IMF repurchases and amortization of all public, publicly guaranteed private external debt.

B. Data Needed to Measure Country Vulnerability

Borrowing countries need to recognize their vulnerability to external factors that could reduce their ability to support external debt. Some of these factors include:

(a) Export Concentration: if a country is dependent on one or two exports for a major share of its export earnings, it should be wary of taking on as large a debt burden as a country with a diversified export base.

(b) Vulnerability to exchange rate changes: countries should project the effects on dollar debt service of plausible appreciations of other major currencies and relate these effects to likely changes in export receipts and import costs from the same exchange rate patterns.

(c) Reserve Levels: countries that are vulnerable because of export concentration or exposure to interest rate or exchange rate risk should maintain higher levels of reserves. They should relate the minimum level of reserves to measures of the magnitude of the kind of shocks they may face in terms of export earnings or increased debt service.

C. Data Required from the Debt Office

Debt offices should be capable of producing the elements of data related to debt and debt service. Forecasters in other governmental units need these data to combine with data on output, exports and other macroeconomic variables in order to provide policymakers with the information they need to evaluate an external borrowing program in the context of macroeconomic policy.

To review, the debt office must be able to produce data on expected disbursements from the pipeline of contracted debt, and to make projections of principal payments and interest payments on existing debt. The debt office should also be capable of producing alternative principal and interest payment projections on the basis of alternative exchange rate assumptions as well as alternative interest rate projections on the basis of different assumptions of major world interest rates.
1. The present discounted value (PDV) formula, in its simplest form, for a loan of two periods is:

\[ PDV = \frac{P_{t+1} + I_{t+1}}{d} + \frac{P_{t+2} + I_{t+2}}{d^2} \]

where P represents amortization, I interest payments and 1/d the discount rate (the inverse of 1 + i where i is the relevant market rate). The formula can be extended in the obvious manner for loans of longer periods.
34. Macroeconomic Issues

Summary of the Discussion

Rapporteurs:
- Mr. AbdulRazak Mohamad Ali Abdullah, Iraq
- Mr. Essa Ahmed Hassan Ibrahim Bucheery, Bahrain
- Mr. Hassan Abdullah Mohamed, Bahrain
- Mr. Mohamed Ahmed Didi, Maldives
- Mr. Mudher Mohamed Saleh Kassim, Iraq

Countries with serious debt problems are characterized by imbalances in their current account, large budget deficits and high inflation. In such a setting, economic adjustment is necessary. To minimize the level of external borrowing the current account deficit has to be reduced, which means increasing growth of exports and decreasing the growth of imports. To decrease the level of domestic borrowing, the budget deficit has to be reduced to manageable level.

The different choices faced by a country that must adjust has different impacts. A reduction in investments to reduce the budget deficit are likely to decrease the growth rate of the economy. However, by reducing the government consumption expenditure and increasing revenue through tax reform would improve the budget deficit and would not have an adverse impact on the economic growth.

It is possible to finance the budget deficit totally from domestic sources. Private savings could be mobilized to finance the deficit. However, this would possibly have the effect of crowding out the private sector. Secondly, the Central Bank could finance the governments' requirements, but gone beyond a manageable limit, could have inflationary pressure on the economy.

The current account deficit could be financed by drawing down the country's foreign reserves or from foreign capital flows in the form of foreign investments. But financing is mainly by borrowing from private banks, governments, international organizations and capital markets. In order to reduce the current account deficit resources should be shifted to increase exports and imports substitution whereby the volume of imports is reduced. To make the country's exports more competitive in world markets, it is necessary to devalue the currency to assess its real exchange rate. However, devaluation has the effect of increasing the government expenditure and the money supply which is inflationary. Therefore, devaluation should be accompanied by restraints in government expenditure and contractions in money supply.

Devaluation of the currency usually has the effect of making imports more expensive, hence not very attractive to the domestic market. However, in some circumstances of imports substitution, a high component of imports are needed, therefore making import substitution expensive.

In conclusion, countries with severe external debt problems has to implement certain adjustment policy reforms. Mobilization of domestic resources through prudent fiscal and monetary policies would increase revenue, which in turn would take the pressure of the budget and stabilize the economy. It is necessary for these policy changes to create the proper environment for an active private sector. Public enterprises that are burdensome to the budget should be restructured to make them allocate and use their resources efficiently. In addition, adequate infrastructure is needed for efficient operations of public enterprises. Reforming the productive sector of the economy to enable efficient allocation of resources through proper price signals and removing the biased protection barriers is an important step in the adjustment process. It is possible that these policy reforms may effect some disadvantaged sector of the population and proper safeguards could be put in place by identifying and targeting relief measures.
VII - Debt Renegotiation

35. Introduction

As an indication that the debt problems of developing countries are global, more than fifty countries have had to seek debt relief from their creditors during the 1980's. Thomas Klein of the World Bank described the institutional arrangements for debt relief and the experiences that countries have had in rescheduling their debts (see Chapter 36, below). The Paris Club reschedules debt owed to official creditors (including officially-guaranteed export credits) and consortia of commercial banks restructure debts to banks not covered by export credit insurance. Initially conceived as a vehicle for helping a country bridge a temporary liquidity problem and so help it restore its creditworthiness, multilateral debt relief has now arranged orderly approaches to debt reduction for severely indebted countries.

Debt and debt service reduction agreements have been negotiated with commercial bank creditors along with financial support from the IMF and the World Bank. Chapters 37 and 38 below, reproduce articles from Finance and Development which explain the role of these institutions in this new debt strategy.

Following Klein's presentation, Messrs. Ahmad (Jordan) and Eltahir (Sudan) described the experiences of their countries. Both countries have had to deal with both commercial bank consortia and the Paris Club. Mr. Ahmad and Mr. Eltahir described underlying situations that led to the need for debt relief, explained the process by which debt relief was negotiated and evaluated the gains obtained from relief.

In the summary of the discussion, the rapporteurs noted that there are many problems associated with debt relief. There must be a balance between debt relief, adjustment and new financing; many debtor countries, after making painful adjustment efforts, have found fresh financing lacking. Furthermore, the negotiating process, particular the process whereby Paris Club agreements are implemented through separate bilateral agreements, has become so stretched out that by the time one agreement (covering only one to two years) is put into effect, it is time to start negotiating a follow-up agreement.
When money is lent by one person to another, it is done with the understanding that the loan will be repaid as scheduled. Similarly, when the lender is a bank, a government or an international aid agency, and the borrower is a third-world enterprise or government, the loan is also expected to be repaid. This has not always been possible. Between the first oil shock in late 1973 and September 1990, more than 50 developing countries requested debt relief because they have been unable to service their external debts for balance-of-payments reasons.

The response to debt servicing difficulties has been three-fold. Debtor countries have adopted adjustment programs to improve the efficiency of their economies and to enhance their export potential. The IMF, the World Bank and bilateral donors have supported these adjustment programs with financial aid. Creditors have agreed to debt relief, organized on a multilateral basis. Until recently, debt relief has been conceived as a contribution to solving temporary liquidity problems of the debtor country. The objective of debt rescheduling from the 1960's through the mid-1980's was as follows: By achieving an orderly restructuring of obligations, treating all creditors alike, it should be possible to restore the creditworthiness of debtor countries for the new finance required for international trade and for economic growth.

The debt rescheduling agreements in this quarter of a century period helped resolve the acute international liquidity problems faced by the individual countries requesting debt relief, and debt restructuring took place in an orderly manner (i.e., no creditor received significantly more preferential treatment than another). However, new financing was not always forthcoming after debt restructuring, particularly from commercial bank creditors.

In 1988, payments difficulties intensified. Both Paris Club and commercial bank creditors introduced major changes in their approaches to debt restructuring in which debt reduction, not just a reordering of maturities became an objective of debt relief. The Paris Club adopted a "menu approach" to the terms of repayment for the consolidated debt of low-income countries. Later, in 1990, the Paris Club started offering selected lower-middle income countries limited debt conversions. The commercial bank creditors agreed to debt conversion and voluntary debt reduction programs, which, starting in 1989, could be supported by funds from the IMF, the World Bank and bilateral official lenders. This change in the nature of debt relief arrangements provides the occasion for taking stock of the institutional arrangements for debt relief and how they have evolved over time.

I. Debt Renegotiating Fora

Wherever possible, creditors have insisted that debt be renegotiated through multilateral fora, rather than with individual creditors. The forum for negotiating debt relief depends on the type of credit being renegotiated (see Table 36-1). Export credits that are insured or guaranteed by an agent of the creditor country are renegotiated through the Paris Club. So are inter-governmental loans of OECD countries. Commercial bank loans not covered by export credit insurance are renegotiated through special steering committees, or bank advisory committees, organized by consortia of creditor commercial banks. Other loans and credits are negotiated bilaterally.

Loans from multilateral organizations are not subject to debt relief. The World Bank has argued that participation in debt renegotiation would impair its ability to sell securities on international capital markets. The contribution of the World Bank and other multilateral development institutions to countries in need of debt relief is to maintain, and, if possible, increase, net lending. That multilateral organizations are exempt from rescheduling their loans is an understanding that holds with the tacit acceptance by the creditor fora.

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1 The author is a Senior Economist with the Debt and International Finance Division of the World Bank. The views are those of the author and not necessarily those of the World Bank.
Table 36-1. FORA FOR RENEGOTIATING DEBT

<table>
<thead>
<tr>
<th>Type of Debt</th>
<th>Negotiating Forum</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Loans from multilateral organizations</td>
<td>Not eligible for debt relief</td>
</tr>
<tr>
<td>2. Loans from governments</td>
<td></td>
</tr>
<tr>
<td>OECD countries</td>
<td>Paris Club</td>
</tr>
<tr>
<td>OPEC countries</td>
<td>Occasionally Paris Club, mostly bilaterally</td>
</tr>
<tr>
<td>CPE countries</td>
<td>Bilateral negotiations</td>
</tr>
<tr>
<td>Others</td>
<td>Paris Club, if insured exports are negotiated, otherwise bilaterally</td>
</tr>
<tr>
<td>3. Loans from commercial banks:</td>
<td></td>
</tr>
<tr>
<td>Insured export credits</td>
<td>Paris Club</td>
</tr>
<tr>
<td>Other loans</td>
<td>Consortia of commercial banks</td>
</tr>
<tr>
<td>4. Suppliers credits</td>
<td></td>
</tr>
<tr>
<td>Insured</td>
<td>Paris Club</td>
</tr>
<tr>
<td>Not insured</td>
<td>Bilateral negotiations</td>
</tr>
</tbody>
</table>

II. Debt Relief from Official Creditors

A. The Paris Club: Institutional Arrangements


Creditor countries that take part in Paris Club negotiations have in common a system of insuring private export credits against transfer or political risks (but not against default by individual debtors). The larger OECD countries are regular members, but other countries with export credit insurance systems also take part. Since 1980, Brazil participated in 18 agreements with 12 countries. Mexico, Argentina, the United Arab
Managing External Debt in Developing Countries

Emirates, Kuwait and Morocco each have occasionally participated in Paris Club meetings as creditor countries. Participation varies between meetings: only representatives of creditor countries with significant claims on the debtor country take part. There can be as few as 3 or 4 creditor countries represented or as many as 15. Countries with relatively small claims attend meetings in observer status. There are also observers from the IMF, the World Bank, UNCTAD, the OECD, and from time to time, regional development banks and the EEC.

The USSR, other Eastern European countries and China do not take part in the Paris Club, because they do not have an export credit insurance system. These countries all reschedule debt bilaterally, parallel with the Paris Club (although not with identical terms) when requested by a debtor country. Most OPEC creditor countries also renegotiate debts bilaterally parallel with Paris Club members.

In its early years, the largest creditor country organized a Paris Club meeting after conferring with the government of the debtor country and with the other major creditor countries. Since 1979, the French Government has provided a secretariat and a permanent chairman. This facilitates the organization of meetings, which now take place almost monthly and makes possible dealing with several countries at the same meeting. From 1961-79, there were only a few meetings each year, and each meeting was devoted to negotiations with a single country.

The Paris Club remains an informal group, without a charter and by-laws and without permanent membership. Nevertheless, the continuity of participation by the larger OECD countries makes possible the careful observance of precedents in dealing with each request for debt relief.

b. Preparation for Paris Club meetings.

A Paris Club meeting is initiated by a telex from the Minister of Finance of a debtor country to the President of the Paris Club through the French Ministry of Finance. At their monthly planning meetings, the creditor countries will discuss the request for relief and agree on a date for negotiations, contingent on an IMF program that supports adjustment measures being in effect. The President of the Paris Club may meet informally with debtor country representatives during this planning period.

A few months before a Paris Club meeting, the debtor country government prepares a memorandum to its creditors formally requesting debt relief. It describes the situation that led to the need for debt relief, explains the measures being taken to correct the balance of payments, calculates the payments gap that must be closed through debt relief, and proposes a specific relief package and terms of repayment. Along with the country’s preparatory document, the debtor country government sends to each creditor country government a list of debts owed potentially eligible for relief and the amounts of the specific maturities that it wishes to reschedule.

c. The negotiations.

Paris Club meetings are short, rarely lasting more than one day. The essential points to be decided are the scope of debt relief and the terms of repayment. The creditors first must decide:

(a) What is the time period over which relief is needed (the consolidation period)?
(b) On what type of debt should relief be given: export credits only or inter-governmental loans as well?
(c) What should be the "cut-off" date on eligible loans? Maturities on loans signed after this date are not eligible for debt relief.
(d) Should contractual interest be rescheduled or principal only?
(e) Should arrears on eligible categories of debt be rescheduled? A related question is whether or not to include previously rescheduled debt.
(f) What proportion of rescheduled debt should be consolidated, 100% or some smaller amount?

Decisions are made on the terms of repayment:

(a) Over how many years may the consolidated debt be repaid? With how many years of grace?

(b) What provision is made for repayment of the non-consolidated portion of eligible maturities.
(if less than 100% is rescheduled)? Are they to be repaid on original due dates or at some later time?

(c) Are arrears to be consolidated? Previously rescheduled debt? If so, should they be repaid on the same terms as rescheduled current maturities, or should they be repaid at a faster rate?

d. Creditor country concerns

When arranging debt relief, creditor countries are concerned that all creditors be treated equally by the debtor country, that the debtor country is making an adequate effort to redress its economic situation, and that payments of interest and principal on the rescheduled debts are made when due. By 1980, commercial bank debt (exclusive of insured export credits) formed a significant share of the total debt of middle-income developing countries. Concerned about the possibility that debt relief on official credits would free financial resources to pay other creditors on schedule, special clauses were routinely placed in Paris Club agreements that required the debtor country to secure debt relief from commercial bank and other creditors on terms comparable to those extended by the Paris Club. To assure that this is done, the Paris Club prefers to keep consolidation periods short before continuing with debt relief.

The creditor country governments insist that the debtor country take vigorous measures to correct the balance-of-payments problem that led to the need for debt relief. Otherwise, they fear debt relief could be used to delay adjustment measures rather than to complement them. Most countries requiring debt relief had postponed adjustment to external shocks and had borrowed to finance the resulting balance of payments gap. As evidence of an adequate adjustment effort, the Paris Club asks that the debtor country be eligible for use of its IMF upper-credit tranche facilities under a stand-by agreement. A Paris Club meeting will not take place (with rare exceptions) unless an appropriate IMF program is in effect.

e. Special role of the IMF

In addition to assuring the Paris Club on the adequacy of the debtor country's adjustment effort and to providing emergency finance through the use of Fund resources, the IMF plays a direct role in Paris Club meetings. At the beginning of each Paris Club meeting, the IMF representative circulates a short-term balance of payments forecast for the debtor country in question, offered as a framework for assessing the need for and the magnitude of debt relief. The forecast of the current account assumes that adjustment policies have been implemented: thus, projected figures for imports represent maximum possible import compression. The capital account includes estimates for disbursements of emergency financing (including IMF resources), and it also indicates the size of the remaining financing gap that must be closed through debt relief. Possible debt relief from Paris Club participants and other groups of creditors is indicated. The creditor country representative can then see the proposed debt relief in the context of a comprehensive framework. As Stephanie Griffith-Jones has observed, "The IMF has become a technical secretariat for the Paris Club".

f. The Agreements

At the conclusion of a Paris Club meeting, when all the various issues have been resolved, an "Agreed Minute" is signed on an "ad referendum" basis. For debt relief to take effect, the debtor country must negotiate an agreement with the government of each participating creditor country. This takes the form of an enabling agreement with the government itself plus individual agreements with each lending agency. For France, for example, agreements are signed with COFACE with respect to insured export credits and with the CCCE with respect to loans from that agency following signature of a general agreement with the French government.

The bilateral implementing agreements incorporate all the general conditions of debt relief agreed to in the Paris Club and then specify two elements that, by their nature, must be negotiated with individual creditors. These are: (a) the list of loans and maturities that are covered by debt relief and (b) the interest rate to be charged in the rescheduled debt. In some early Paris
Club meetings, the creditor country representatives tried to establish a common moratorium interest rate. This was not possible, because interest charges to each creditor country's export credit guarantee agency had to cover the interest cost of refinancing export credit claims paid. Today, the understanding reached in the Paris Club regarding moratorium interest rates is that they would be related to market interest rates in each creditor country.

B. Early Experiences With Official Creditors

From 1956 through September 1990, there have been 204 multilateral debt relief agreements with official creditors, restructuring $132.6 billion of maturities. (See Annex Table 36-1) In the years prior to 1971, there were nine Paris Club agreements with Latin American countries, four with Indonesia, and three with Ghana. In addition, there were three debt relief agreements outside the Paris Club: two with Turkey under the auspices of the OECD and one agreement with India under the auspices of the World Bank Aid Consortium for India.

In the years 1971-80, the emphasis of the Paris Club shifted towards sub-Saharan Africa, with 11 agreements signed in this period. The nine agreements with Asian countries shown in Annex Table 36-1 were all outside the Paris Club framework. In the period 1981-90, the volume of Paris Club agreements intensified, with 96 agreements negotiated with sub-Saharan Africa and 40 with Latin American and Caribbean countries. Multilateral agreements outside the Paris Club framework were rare.

a. Early Latin American Agreements

The Paris Club established the format of its agreements and its basic rules through agreements with Latin American countries in the 1960’s and early 1970’s. The scope of debt relief was limited to guaranteed private export credits (except for Chile, where inter-governmental loans were rescheduled as well). Considerably less than 100% of eligible maturities were rescheduled. The first Argentine agreement, for example, consolidated only 50% of eligible maturities. Later agreements with Argentina and other countries in the 1960’s consolidated 60-75% of eligible maturities. The remaining balances were to be repaid on the original due dates. The terms of repayment were similar to those of the original commercial credits being rolled over. The maturity of consolidated debt on these agreements varied between 5-1/2 to 7 years with up to 2-years grace.

b. Ghana and Indonesia

Of the countries that achieved independence after the Second World War, Ghana and Indonesia were the first that had to seek debt relief. Both countries approached their creditors in 1966 seeking debt relief to help restructure their economies following programs of vast, unproductive public sector expenditures by recently deposed leaders. The Paris Club, in the first round of negotiations with each of these countries, tried to apply the terms established with Latin American countries, but it had to modify its approach to meet the special circumstances of Ghana and Indonesia.

In the end, highly concessional terms were extended to both countries - terms that have not since been repeated. For Indonesia, the entire outstanding balance of Paris Club eligible debt was consolidated and repaid over a thirty-year period, interest-free. There was no grace period, but the agreement carried a "bisque clause" that allowed 50% of payments due during each of the first six years to be repaid at the end of the 30-year amortization schedule. Such deferred payments bore interest at 4% per annum.

The negotiations with Ghana began were concluded in 1974 with an agreement of roughly the same concessionality as that extended to Indonesia in 1970: 100% consolidation of the Nkrumah debt, to be repaid over 28 years with 11 years grace and a moratorium interest rate of 2-1/2%.

c. Multilateral Debt Relief Outside the Paris Club

The largest agreement of this period was the 1959 Turkey agreement that consolidated commercial credits, including uninsured private credits. This agreement was reached under the auspices of the Organization for European Economic Cooperation (OEEC); $443 million of debts were restructured, to be repaid over 12 years in rising installments. The moratorium interest rate was 3%.

Debt relief to India and Pakistan was organized under the auspices of World Bank Aid Consortia. The terms of repayment varied between creditors, but all agreements had to reach an agreed grant element (for
India, this began at 49% in the 1968 agreement and rose to 70% in the 1976 agreement).

C. Paris Club Agreements with Sub-Saharan Africa, 1979-90

Sub-Saharan Africa was insulated temporarily from the shock of the four-fold rise in petroleum prices at the end of 1973 by the rise in primary materials prices. But commodity prices collapsed in the wake of the 1975 global recession. After a further increase in petroleum prices in 1979, most sub-Saharan African countries found themselves with serious balance of payments difficulties. Having borrowed heavily to continue public sector expenditures stimulated by the commodity price boom of the mid-1970’s, debt servicing difficulties were common for most sub-Saharan countries.

Approaches to the Paris Club soon followed. The Paris Club did not take the Ghana and Indonesian agreements as its point of departure. It regarded these accords as responses to exceptional circumstances. Instead, the Paris Club built on its earlier experience with Latin America.

In the five years, from 1976 through 1980, the Paris Club met only with five countries: Zaire (four times), Sierra Leone (twice) and then once each with Liberia, Sudan and Togo. Then, from 1981-85, the Paris Club had to deal with eleven additional sub-Saharan African countries plus the five countries that had met with the Paris Club prior to 1981: each of those sixteen countries returned with requests for further relief. The overall balance of payments difficulties of the countries concerned meant that their debt servicing difficulties could not be resolved in the context of meetings dealing with consolidation periods of one or two years. Thus, virtually every sub-Saharan African country that was to applied to the Paris Club was destined to return again and again. As of September 30, 1990, Zaire has had ten Paris Club agreements, Senegal and Togo, eight each; Madagascar and Togo, seven each; the Côte d’Ivoire and the CAR, five; Liberia, Mauritania, Sudan and Uganda, four agreements each.

a. An evolutionary approach

The Paris Club at first did not recognize the intractable nature of sub-Saharan Africa’s debt problem, but there was a steady, if slow, response to the needs for debt relief in the 1970’s and 1980’s. The first adaptation of Paris Club rules concerned the scope of debt relief. The Latin American agreements covered only commercial credits. The agreements with African countries covered, in addition, all inter-governmental loans, concessional and well as non-concessional. The proportion of maturities consolidated was also expanded. In 1976-80, the proportion of debt consolidated ranged between 80-85%. By 1987, 100% consolidation was common.

Beginning in 1981, the non-consolidated portion of the debt itself was deferred, being payable in annual installments during the grace period of the consolidated portion. For low-income African countries with poor balance of payments prospects, the period over which consolidated debt could be repaid was gradually extended to approximately 10 years, with a 5-year grace period. After the mid-1980’s previously rescheduled debt could be rescheduled if it formed a significant portion of total debt service. (Until then, meeting obligations on previously rescheduled debt as well as on new commitments had been obligatory).

In 1981, the Paris Club experimented with extending the consolidation period to two or more years by rescheduling the debts of Sierra Leone, Sudan, Togo and Zaire in a series of tranches. This experience was unsatisfactory. The IMF programs upon which these agreements were based collapsed, and the second tranche of debt rescheduling had to be cancelled. The Paris Club reverted to rescheduling debt one year at a time. Exceptions have been made only in the case of agreements made with the Côte d’Ivoire and with Ecuador parallel with commercial bank MYRAs (in 1985-86) or, more recently, for countries undertaking exceptionally strong commitments regarding conditionality.

b. Extended Terms

Unable to negotiate a further improvement in the scope or terms of debt relief through the Paris Club, the major creditor countries began to negotiate a new approach to the debt of low-income sub-Saharan African through the annual G-7 economic summit meetings. The low-income African countries that have returned to the Paris Club for 5 or more times each during the past decade have had to maintain during a prolonged period programs of adjustment sufficiently strong to qualify for support under IMF arrangements. Yet, in 19 of the 33 Paris Club follow up agreements
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signed between 1983 and 1986, it was necessary to reschedule previously rescheduled debt. There was a need to create a more viable form of debt relief.

c. Venice Terms

At the June 1987 G-7 Venice economic summit meeting, it was announced that:

For those of the poorest countries that are undertaking adjustment efforts, consideration should be given to the possibility of applying lower interest rates on their existing debt and agreement should be reached, especially in the Paris Club, on longer repayment and grace periods to ease the debt burden.

Following this communique, the Paris Club signed agreements with five countries providing for repayment of rescheduled debt over 20-years with 10-years grace. The Paris Club, in the agreed minutes for these countries, noted that each of these countries were eligible for special treatment because of the large debt service obligations, their poor balance-of-payments prospects and their low per capita income.

The basis of the required conditionality was changed in 1987. Beginning with the June 1987 Uganda agreement, the Paris Club agreed to reschedule debts for countries whose economic program was supported by the new IMF Structural Adjustment Facility (SAF) rather than the conventional upper-credit tranche stand-by arrangement. Despite the suggestion made in the Venice summit statement, there was no change in the basis of interest rate charges on rescheduled debt in these agreements.

d. Menu approach

During the latter part of 1987 and early 1988, the major creditor countries continued their explorations on how to offer more generous terms of debt relief through the Paris Club and particularly on how to deal with the troublesome question of moratorium interest rates. Unable to agree on a common formula owing to the constraints imposed by varying national systems of the administration of export credit insurance systems, the major Paris Club creditors agreed to a menu approach under which different approaches to liberalizing the terms of debt relief would be followed.

The principle of this arrangement was announced at the Toronto economic summit meeting in June 1988, and the arrangements were concluded during the IMF/World Bank annual meetings of September 1988 in Berlin. Under the new approach, it was agreed that rescheduled concessional debt would be repaid with exceptionally long maturities: 25-years including 14-years grace. Moratorium interest rates on consolidated concessional debt would continue to be at concessional rates, to be negotiated with each creditor country. Concerning non-concessional debt, creditor countries would choose from three options:

(a) Partial cancellation. One-third of the debt would be cancelled and the remainder consolidated with a 14-year maturity including 8-years grace. Moratorium interest would reflect borrowing costs to the creditor agency.

(b) Exceptionally longer maturities. All non-concessional debt would be consolidated and repaid with the same maturity as concessional debt: 25-years maturity including 14-years grace. Consolidated debt would bear moratorium interest rates that would reflect borrowing costs to the creditor agency.

(c) Concessional interest rates. Consolidated non-concessional debt would be repaid with 14-years maturity including 8-years grace. Moratorium interest rates would be either 3.5 percentage points below the market-based rate or would be one-half the market-based rate, whichever was the higher.

Like the Venice terms, the Toronto terms apply only to low-income countries that are following IMF-supported adjustment policies and have persistent debt management problems and poor balance-of-payments prospects. By September 30, 1989, nineteen countries had debts rescheduled on Toronto terms, seven of which twice (see Annex Table 36-2). While initially conceived as a special concession to low-income Sub-Saharan African countries, in 1990 the Paris Club also extended Toronto terms to Bolivia and to Guyana. Eighteen creditor country governments have participated in the Toronto menu-type agreements,
as of September 30, 1989. Nearly all countries have selected the same options in each agreement.

While the Toronto terms represent a major change in the approach of the Paris Club towards severely indebted low income countries, the gains through improved cash flows for the beneficiary countries are very small. First, the overall grant element of the rescheduling terms is low. Assuming that the average market related moratorium interest rate is 9%, and using this figure as the discount rate in the grant element calculation, the grant element of option B is zero. The grant element of option A is 33-1/3% and that of option C is 25%. Weighing these figures by the dollar value of creditor selections among the three options, the weighted average grant element is 20%.

The dollar value of debt consolidated under Toronto terms through September 1990 was US$5.6 billion. In the absence of the Toronto terms arrangement, debt would have been rescheduled on Venice Terms (20-years maturity with 10 years grace). The gains of Toronto terms over Venice terms during the consolidation period for all these agreements taken together would have been only US$0.1 billion. This is the amount by which moratorium interest due during the consolidation period would have been reduced owing to debt cancellation under option A and interest rate reduction under option C.

Of course, cash flows savings would continue after the consolidation period. If one compares the present value of debt service obligations between Venice and Toronto terms, under agreements signed through September 1990, the savings under Toronto terms would have been about 20% (US$0.8 billion). To secure further gains, moratorium interest rates on consolidated non-concessional debt would have to be reduced below market rates. To date, this has been difficult to arrange.

D. Paris Club Agreements with Middle-Income Countries

The Paris Club has improved the terms of rescheduling for middle income countries as well as for low income countries. During the 1980's, the Paris Club renegotiated debts to five oil-exporting countries: Congo, Ecuador, Gabon, Nigeria and Trinidad and Tobago. It also dealt with requests for relief from 2 middle-income African countries: Cameroon and Côte d'Ivoire, 10 Latin American and Caribbean countries (Argentina, Bolivia, Brazil, Chile, Costa Rica, Dominican Republic, Jamaica, Mexico, Panama and Peru) and 7 other countries (Egypt, Jordan, Morocco, The Philippines, Poland, Romania and Yugoslavia). Details of agreements with these countries may be seen in Annex Table 36-3.

At first, the terms of debt relief were very similar to the Latin American agreements of the mid and late 1960's: less than 100% of eligible maturities were rescheduled, and the repayment terms were comparable to those of medium-term suppliers credits. Maturities were between 6-7 years with 3-4 years grace. But towards the end of the decade, the coverage of debt relief advanced to 100% of eligible maturities, and terms of repayment were extended to 10-years maturity and 5-years grace. Exceptions were the 14-years maturity extended to the Côte d'Ivoire in its December 1989 agreement and the 15-years maturity to Poland in its February 1990 agreement.

a. Severely indebted lower middle-income countries

The Paris Club introduced a major change in the treatment of severely indebted middle-income countries at its September 1990 meeting. This followed an understanding reached at the Houston G-7 Economic Summit Meeting of July 1990. Under these arrangements, debtor countries will be able to repay consolidated ODA loans with 20-years maturity including 10-years grace. Consolidated export credits and official loans other than ODA will be repaid with 15-years maturity including up to 8-years grace.

A major innovation in the new arrangements is the provision for various types of debt conversions, such as "debt-for-nature", "debt-for-aid", and "debt-for-equity". These swaps are characterized as "voluntary" in the sense that they will be decided upon and defined in the bilateral implementing agreements rather than in the Agreed Minute signed at the Paris Club meeting. The Paris Club has set limits on the amount of the swaps of export credit claims so that the comparable treatment of creditors convention will be roughly upheld. In the first set of agreements signed under these arrangements in September 1990, the ceiling for each creditor country was expressed as 10% of the claims outstanding as of a date just prior to the meetings or $10 million (whichever is higher). There is no ceiling on the amount of ODA loans or other inter-governmental debt that may be converted.
The extended repayment terms and the possibility of swaps will be offered only to lower middle income countries that are indebted mainly to official creditors and that have a heavy debt service burden. While there are objective measures of these conditions, the Paris Club will determine eligibility on a case-by-case basis.

b. Agreements with Latin American Countries

The agreements with Latin American countries covered almost entirely officially-guaranteed private export credits. Argentina negotiated debt service falling due between January 1985 and March 1991 on loans contracted prior to December 10, 1983. This was arranged in three agreements, signed in January 1985, May 1987 and December 1989. Repayment terms were 9-1/2 years maturity and 5-6 years grace. Brazil has rescheduled debt service falling due from August 1983 and March 1990 on loans contracted prior to March 31, 1983 in three agreements (November 1983, January 1987 and July 1988), with repayment terms slightly shorter than those for Argentina. The second agreement expired in June 1988, and the consolidation period of the third agreement did not begin until January 1990, owing to a gap between IMF programs. The arrears outstanding as of August 1, 1988 had to be repaid with shorter maturities than debts falling due during the consolidation period.

Chile's agreements of July 1985 and April 1987 represented a reluctant participation in the Paris Club process. In 1985, Chile wanted to service outstanding suppliers credits while rescheduling commercial bank debt. However, the commercial bank steering committee insisted that Paris Club eligible debt be restructured if banking debt was to be rescheduled. In an effort to protect its creditworthiness, Chile asked the official creditors to schedule this meeting outside the Paris Club. Unlike other Paris Club agreements negotiated with middle-income countries in the mid and late 1980's, only principal was rescheduled and less than 100% (65% in the 1985 agreement and 85% in the 1987 agreement). Repayment terms were 6-1/4 years maturity with 2-1/2 years grace.

Mexico rescheduled principal due on Mexican private sector debt in a 1983 agreement (also outside the Paris Club framework). A September 1986 agreement rescheduled public sector debt due during an 18 month period, and a May 1989 agreement rescheduled debt falling due during a 36-month period beginning June 1989. The agreement was parallel with a Brady Plan agreement with commercial banks and was supported by an IMF Extended Fund Facility.

E. Outstanding Issues in the Paris Club

The Paris Club has provided a forum for an orderly restructuring of debts to official creditors. Debt relief is granted when it is needed to avoid imminent default, and the Paris Club mechanism reinforces conditionality imposed by the IMF. However, two major issues are outstanding from the point of view of the debtor countries: the requirement that moratorium interest on rescheduled debt other than ODA is related to market interest rates and the short consolidation periods.

Aside from introducing the reduced interest option in Toronto terms agreements, Paris Club participating creditor countries are reluctant to modify the interest arrangements. The problem for the creditor countries is that making substantial cuts in moratorium interest rates would create major refinancing requirements for export credit insurance companies: creditor-country governments are not prepared to make such budgetary allocations for to offset this revenue loss (on top of their regular foreign aid budgets) at the present time.

Another problem concerning debtor country governments - all countries, not just low-income Africa - is having to accept 12-18 month consolidation periods. By the time bilateral implementing agreements have been negotiated following one Paris Club accord, it is time to approach the Paris Club for the next request for relief. Financial planning is difficult with such a short negotiating horizon. After the unsatisfactory experience with phased debt rescheduling for African countries in 1981-82, Paris Club creditor governments have insisted on short consolidation periods to assure that adjustment programs are continued in effect and to assure that comparable terms of relief are being secured from other creditors.

One experiment with longer consolidation periods was the multi-year rescheduling agreement (MYRA). These were extended to Ecuador (April 1985) and to the Côte d'Ivoire (June 1986). Principal only was rescheduled over a 3-year period, debt relief to take effect in three annual tranches. The proportion of principal consolidated declined in each year. These
agreements were parallel with MYRAs extended by commercial bank creditors.

Both agreements had to be abandoned because of changing economic circumstances. The view of most creditor countries in retrospect that debt relief could be better tailored to fit debtor country circumstances if they were to be arranged in annual agreements.

More recently, consolidation periods of 2-years or more have been given to countries that are able to arrange stronger than the usual conditionality with the IMF (a one-year standby). In May 1989, both Mexico and the Philippines were able to arrange for 3-years debt relief on the basis of and IMF Extended Fund Facility program. Among low income countries, normally conditionality was either a stand-by or a Structural Adjustment Facility (SAF) credit. By arranging for an Expanded SAF (ESAF) or by arranging for a combination of a stand-by and a SAF, Mali, Mozambique, Togo, Niger and Guyana were able to secure Paris Club consolidation periods of 2-3 years.

In each case, the consolidation period was divided into separate periods, related to the expiration in a stage of the IMF program. Should the debtor country become ineligible for continued use of the IMF resources, the Paris Club debt rescheduling agreement would be cancelled. Thus, the Paris Club rewards countries able to make a relatively strong commitment to an adjustment program by lengthening the consolidation period.

III. Rescheduling Debts to Commercial Banks

In this section, we turn to the problem of restructuring debt owed to commercial banks. Following initial emergency measures, the commercial banking community took one major initiative after another in an attempt to deal with the obligations of the heavily-indebted middle-income countries. Each initiative was believed to provide a vehicle for restoring creditworthiness to at least a few countries with serious debt problems, but each failed in turn to meet its stated objective. These initiatives were: restructuring with concerted lending (1982-84), then multi-year debt relief agreements (1984-86), then the Baker Initiative (announced in September 1985) and the menu approach (1987-88).

The rescheduling, or restructuring, of debts to commercial banks in the 1980's amounted to about $410 billion, as compared with $100 billion of debts to official creditors. The debtor countries concerned have been almost entirely middle-income countries, mainly in Latin America. Their difficulties followed large build-ups of debt to banks in the late 1970's, the result of recycling the balance-of-payments surpluses of the oil exporting countries through the Euro-dollar market at very low real interest rates. The debt service burden of countries that had borrowed from banks increased severely in the early 1980's when nominal interest rates rose sharply, commodity prices declined and bank lending fell off. The problem came to a head in August 1982 with the Mexican debt moratorium.

Owing to intractable balance-of-payments difficulties and the lack of economic growth, debt servicing problems to banks persisted through the 1980's. The decline in real incomes and the continued need for austerity measures in the debtor countries resulted in political unrest. The conventional approach of the commercial banking community towards organizing debt relief broke down, and, for a time, the solvency of the major creditor banks was threatened. In a shift from continued rescheduling of maturities, in 1989, the financial community began to organize a program of voluntary reduction of debt and debt service obligations for selected countries, supported by the IMF, the World Bank and Japan (The Brady Plan). This followed a flexible "menu" approach with Argentina (1987) and Brazil (1988) and a series of debt conversion schemes, most importantly, debt-equity swaps.

A. The Negotiating Process

Multilateral debt relief is much more difficult to organize for commercial banks than for official creditors. Each national export credit insurer can negotiate on behalf of the many individual creditors. The Paris Club, with its permanent chairman and secretariat, brings the representative of these agencies, together with key Ministry of Finance and Foreign Affairs staff at almost monthly intervals. The individuals who represent the individual creditor countries are the same, and they provide continuity in the Paris Club decision-making process.

In contrast, when re-negotiating commercial bank debt, there is no way to consolidate national claims: each creditor bank must approve the resulting agreement. With loan syndication, the number of banks among which agreement must be reached is often in the hundreds.
To negotiate a debt relief agreement, the creditor banks form a steering committee (or bank advisory committee) of about a dozen people, who represent the major creditor banks. When organizing the committee, account must be taken of the nationality of the banks in the consortium so that the negotiations can make provision for the various tax and regulatory systems affecting the banks of different countries. The committee is normally formed and chaired by the largest creditor bank. Although the forum for re-negotiating developing country commercial bank is sometimes referred to in the press as the "London Club", each negotiation is completely separate from previous negotiations. There is no permanent "London Club" chairman or secretariat as there is with the Paris Club. However, the presence on most individual steering committees of the representatives of the world's largest banks does provide a continuity between the various country exercises.6

The steering committee negotiates an "agreement in principle" with the debtor country representatives. After all the creditor banks approve this agreement, it is signed. Because of the need to satisfy the demands of the many creditor banks (which may involve re-negotiating parts of the original agreement in principle), many months - even years - can pass before final signature. The agreement becomes effective when certain requirements are met, such as payment of fees, principal or interest in arrears. The agreement may consolidate less than 100% of eligible maturities, in which event the non-consolidated portion may be due before the agreement takes effect. To facilitate payment of fees, interest and principal, the debtor country makes all payments following a consolidated schedule to a bank that agrees to serve as the "agent" bank. It, in turn, distributes the proceeds to each creditor bank. The agent is normally not one of the creditor banks and so can act as a neutral party.

As with the rescheduling of debts to official creditors, debt relief is not negotiated unless the debt country has an adjustment program in effect under IMF supervision. IMF representatives may be invited to steering committee meetings, but their participation is not a standard part of the proceedings as in Paris Club negotiations.

B. Coordinated Relief and Restructuring in 1983-84

The major requests for relief began with the Mexican request following its moratorium on debt service payments imposed in August 1982.7 In the years 1981 and 1982, 14 agreements in principle were negotiated with commercial banks restructuring or deferring $10 billion of debt; in 1983 and 1984, 47 agreements were negotiated, covering $130 billion of debt.

What made 1983-84 different from the earlier years was not just the number of countries seeking relief or the volume of debt to be restructured. The problem was that, for several major debtor countries, the prospective financing gap could not be closed with debt restructuring plus use of IMF credits and other emergency official-source financial assistance, even after measures were taken by the debtor country to cut imports and expand exports. At the same time, failure to resolve the debt servicing difficulties of the countries concerned would have serious repercussions for the creditor banks themselves. Thus, the problem of debt relief took on an entirely new dimension.

For a debt relief agreement to be viable, the debtor government had to be in a position to meet interest payments on the rescheduled debt and on remaining obligations to the commercial bank creditors. Where short-term balance of payments forecasts demonstrated this was not possible, the creditor banks recognized that the prospective agreement could not be honored unless the debtor country had at its disposal substantial additional cash resources.

No creditor bank was willing to increase its exposure to the country concerned on its own. At the same time, the heads of the Bank steering committees remembered the impossibility of syndicating new loans for Zaire and Peru in connection with debt relief arrangements. What was needed was a mechanism under which all creditor banks provided the additional cash required following a formula that was generally accepted as being equitable, together with emergency assistance from official sources.

The IMF played a crucial role in coordinating emergency commercial bank financing with debt relief.
First, the IMF staff was able to provide bank steering committees with independent estimates of the debtor countries' balance-of-payments needs. This established the need for cash assistance beyond that already arranged through the IMF and other sources. Secondly, the IMF forced the banks to take action by refusing to make its own resources available to debtor countries who were also renegotiating commercial bank debt unless a "critical mass" of creditor banks had subscribed to the proposed debt relief agreement.

The banks' response was to offer fresh financial assistance as part of the debt relief agreement. Part of the assistance was in the form of new long-term loans, with each creditor bank participating in proportion to its exposure with respect to the debt consolidated ("concerted lending"). In addition, the creditor banks agreed to maintain, or expand, trade credit facilities or other short-term credit lines. As for the restructuring agreements themselves, they rescheduled principal falling due over a 1-2 year period. The terms of repayment were typically 8-years maturity with 4-years grace. The margins on rescheduled debts ranged between 1.75 - 2.50%.

C. Multi-Year Restructuring Agreements (MYRAs) and the Baker Plan

The debt crisis in the early 1980's saw a virtual cessation of voluntary commercial bank lending to affected countries, even following successful implementation of adjustment programs and the debt relief packages. In an effort to create an atmosphere for restoring the ability of countries that were making strong adjustment efforts to attract once again voluntary lending by commercial banks, commercial bank creditor groups introduced the Multi-Year Restructuring Agreement (MYRA). These agreements consolidated principal payments falling due over a three-to-five year period. The longer consolidation period was seen as a way to eliminate the uncertainties associated with year-by-year reschedulings.

a. The Multi-Year Agreements (1984-86)

MYRAs were negotiated mainly with Latin American countries: Venezuela and Mexico in 1984, the Dominican Republic, Ecuador and Yugoslavia in 1985 and Uruguay in 1986. Two African countries received MYRA's: the Congo and the Côte d'Ivoire (both in 1986). Ecuador and the Côte d'Ivoire negotiated MYRAs with the Paris Club parallel with their commercial bank MYRAs.

Countries receiving MYRAs were perceived to be working their way out of the payments difficulties that led to their debt servicing problems, and they were expected not to require additional debt relief after the expiration of the MYRA consolidation period. Formal agreements to monitor economic performance were essential parts of MYRAs. The debtor country was required to have an upper-credit tranche program in place with the IMF or to arrange for enhanced surveillance by the IMF (i.e., the economic reviews normally associated with the monitoring of a Fund program).

Debt restructured under MYRAs was repayable over much longer periods than under the earlier year-by-year agreements. The average maturity for MYRA's signed between 1984 and 1986 was 12-1/2 years in contrast with seven years for the rescheduling agreements of the early 1980's. Interest rate margins were also lower. A list of MYRAs is given in Annex Table 36-5.

b. The Baker Initiative

At the IMF/World Bank Annual Meeting of October 1985, US Secretary of the Treasury Baker proposed a new strategy for dealing with the debts of the highly indebted middle-income countries. There would be three inter-locking elements: (a) debtor country adjustment programs, (b) increased lending by commercial banks to support these policy efforts and (c) continued monitoring by the IMF plus enhanced lending by multilateral development banks. Specifically, Mr. Baker envisaged $20 billion in net commercial bank lending over the period 1986-88 and an additional $9 billion in net lending by multilateral development banks.

Net concerted lending by commercial banks during this period fell short of the Baker target. Despite commitments of $16.4 billion and disbursements of $15.0 billion from concerted lending, the net lending from commercial banks to the highly-indebted countries with respect to all long-term loans in 1986-88 was only $4.0 billion (based on debtor country reports to the World Bank). Official lending was in line with the Baker target.

These figures indicate that the renewal of private lending conceived of in the Baker plan did not take place. Partly because of this failure and also
because of adverse external developments and policy slippages, the MYRAs did not meet their main objectives: to solve the debt problem of the country concerned to restore normal private lending. The Mexican and Venezuelan MYRAs had to be recast in 1987. The Côte d'Ivoire was unable to service its MYRA and has been unsuccessful in bringing a new agreement into effect. Ecuador also has had to renegotiate its MYRA.

D. The Menu Approach - Agreements to Mid-1989

The process of combining concerted lending with debt restructuring was successful at the beginning of the decade in an atmosphere of emergency assistance designed to prevent defaults and their repercussions for banks. However, debt restructuring/new money packages became increasingly difficult to negotiate by the mid-1980's, as small banks that had been part of loan syndicates wished to reduce their exposure and were reluctant to loan fresh money. In addition, most syndication agreements required that debtor country interest payments be shared equally among all creditors. Thus, there was an incentive for individual banks not to participate in the new money package but to benefit from the interest payments that the new money makes possible (the "free rider" problem). As a consequence, sometimes over a year was required to bring the creditor banks together for signature after an agreement in principle was initialled between the creditor banks' steering committee and the debtor country. Details of agreements signed in this period are shown in Annex Table 36-6.

The Argentine agreement of April 1987 pioneered a menu approach, including debt reduction options, as an alternative to concerted lending. For example a creditor bank may purchase exit bonds (usually carrying a below-market interest rate) that are exempt from further calls for new money. Other alternatives were securitized claims that have enhanced tradeability and debt-equity swaps.

The Brazilian Financing Package of 1988 was the first agreement to take a specially designed "market-based menu approach" to the restructuring of government debts to commercial banks. The various aspects of this package were designed to meet the different needs and preferences of major groups of creditor banks. Its main components were:

(a) The restructuring of existing debt. About 95% of outstanding long-term debt to banks were consolidated in a "multi-year deposit" facility with the Central Bank of Brazil, maturing in 20 years with 7-years grace and bearing interest at LIBOR plus 13/16%.

Banks were allowed to denominate their claims in either US dollars or their "home" currency. Interest payments were shifted from a quarterly to a semi-annual basis, reducing Brazil's financing requirements for 1988-89 by over $1 billion (an amount equal to 20% of the New Money package). Deposits in this facility would be available for relending, and also would be eligible for debt/equity conversions.

(b) New money package. Creditor banks had to offer new money equal to 11.4% of their exposure as of a base date (which was shifted forward from 1982 to 1987). However, banks could choose between five new money facilities.

(c) Trade and Inter-bank credit lines. Participating banks were required to renew these facilities to the level agreed upon in connection with the 1986 agreement.

(d) Exit bonds. As an alternative to the restructuring and the new money provisions, banks would purchase "Brazil Investment Bonds". Lamdany observes that the idea of the exit bonds is to create a mechanism that enables banks with only a small exposure in Brazil and that are not intending to continue lending to Brazil be excused from further concerted lending. The exiting banks would share in the burden of debt restructuring by accepting a fixed interest rate of 6%. (The maturity was 25-years with 10-years grace.) While $5 billion BIB's were authorized, only $1 billion were subscribed. Nevertheless, this was viewed as a success from Brazil's point of view, because annual interest savings exceeded $30 million. Combined with the lengthening of maturities, the reduction in the net present value of debt service was in excess of $200 million over a 25-year period.
There was little general restructuring of commercial bank debt following the Brazil agreement. A menu-type agreement was initialed with the Côte d'Ivoire in April 1988; but, unfortunately, the Côte d'Ivoire was unable to meet interest payments due, and the agreement could not be signed and must now be completely renegotiated. Aside from the DSDR agreements described below, the agreements concluded between mid-1988 and September 1990, were all conventional debt rescheduling arrangements. An agreement with Chile, agreed in principle in September 1990, featured new money. The arrangements were unusual in that they were on a "voluntary participation basis", so as to serve as a transition away from concerted to regular market-based financing.

Concerning the terms of debt restructuring, in the mid-1980's, the larger middle-income countries were able to negotiate substantial increases in maturities and reduced spreads. Agreements with Argentina, Brazil, Mexico, the Philippines and Venezuela resulted in 15-20-year maturities with spreads of 13/16%. Aside from Nigeria, which received similar terms in the September 1988 agreement, sub-Saharan African countries had to accept much harder terms. Mozambique, in 1987, was offered 15 years maturity with 8-years grace, but the margin was 1-1/8%. (This agreement has not been signed.) Gabon, in 1987, was given 10-years maturity with 5-years grace but a spread of 1-3/8%. The smaller countries did worse: The Gambia (1987) and Malawi (1988) had to accept 8-years maturity with 1-1/4% margins.

E. Officially Supported Debt and Debt Service Reduction Agreements (The Brady Plan)

Even though the debt strategies that were built around the MYRA approach, the Baker initiative and the menu approach, did have some positive results for the highly indebted middle income countries, by early 1989 it was clear that a new approach to debt restructuring was required. This recognition came in a speech by US Treasury Secretary, Nicholas Brady, on March 10, 1989. He announced that the US Government would encourage debt and debt servicing reduction on a voluntary basis. In subsequent weeks, what became known as the Brady Plan took form, and the Executive Boards of the IMF and the World Bank agreed that these institutions would provide funds to support voluntary debt reduction schemes.

a. The Program

The problem was articulated in a speech by Michel Camdessus in May 1989. While the current account balances of highly indebted middle income countries had improved, their structure of economic activity had become more diversified, adjustment and reform policies had been implemented and the world financial system had strengthened, these improvements had been obtained at a severe cost. In many countries, economic growth was slow to recover, and inflation accelerated. The current account improvement had come at the expense of capital formation (as indicated by a reduction in the ratio of investment to GNP). Equally troubling, the ratio of debt to exports failed to decline. Mr. Camdessus noted that:

"... the vicious circle that is set in motion, with enforced cuts in investment leading to slower growth and, in turn, to reduced creditworthiness; and second, the encouragement that it gives to financing payments deficits through the accumulation of arrears. ... This also fuels a vicious circle in the financial area: arrears amplify the discount in the secondary market, which in turn feeds back to make it more difficult to put together financing packages. ..." 16

Developments in the secondary markets for commercial bank debt in which debts traded at very substantial discounts (95% for Sudan's and Zaire's) and the creation by creditor banks of large loan-loss provisions against certain third-world loans indicated that creditors were skeptical that debts would be repaid at their face value. The Brady initiative ratified the need for debt reduction programs in general and envisaged, specifically, debt reduction that would be supported by financial resources from official sources.

The mechanism for debt and debt service reduction (DSDR) agreements negotiated under the Brady Plan is for the debtor country either to buy-back outstanding loans at a discount or to exchange them for securities that result either in a reduction of principal or in a reduction of debt service obligations. Creditor banks are willing to accept such debt exchanges voluntarily if the price obtained is greater than the secondary
managing external debt in developing countries

market price or if the risk is less. To this end, the new debt instrument is often collateralized.

Before a DDrS agreement can be negotiated, the debtor country government must secure waivers from creditor banks with respect to key clauses of the original loan agreements designed to ensure equal treatment of lenders within a banking syndicate and between lenders in a syndicate and other creditors. DDrS agreements may also have provisions for renewing debt-equity swaps and for value recovery clauses. These enable creditor banks to recover some of the losses incurred through debt exchanges if certain conditions come about (see details of agreements.

The DDrS agreements result from cooperative actions by the debtor countries, international financial institutions, creditor governments willing to cofinance DDrS (to date, only Japan) and the commercial banks.

The role of debtor countries. They must put in place growth-oriented adjustment programs and take measures to encourage repatriation of flight capital.

The role of international financial institutions. The IMF and World Bank will provide funding to eligible countries for debt and debt-service reduction through: (a) 25 percent of normal Fund and Bank policy-based lending could be reallocated to help reduce the principal of debt outstanding, through debt buy backs and collateralized reductions of principal; and (b) additional special resources could be used to support interest payments on reduced-interest bonds traded for commercial bank debt.

Over a three-year period, the IMF and World Bank would be expected to provide up to $20 billion, divided roughly equally between new resources and set-asides. In October, 1990, the Inter-American Development Bank was authorized to finance DDrS agreements, and it is expected to provide $1.2 billion for this purpose. IDB participation will begin after guidelines have been drawn-up and approved.

The role of commercial banks. Commercial banks would provide debt reduction and new money, and support the accelerated reduction of debt and debt service through a temporary and conditional relaxation of some conditions on current debt.

The role of creditor governments. Creditor governments would continue to reschedule or restructure their own loans through the Paris Club and maintain export credit cover for countries with sound reform programs. Tax, accounting and regulatory impediments to debt reduction would be eliminated. Japan is envisaged as providing about $10 billion over the next several years as additional funding.

b. Implementation

In 1990, DDrS agreements were implemented with Mexico, the Philippines, Costa Rica and Venezuela, following negotiations that began in 1989. An agreement was also signed with Morocco making DDrS contingent on an IMF Extended Fund Facility being in place before end-1991, and an agreement in principle was initiated with Uruguay in September 1990.

The Costa Rican agreement was a pure debt reduction operation, as there was no expectation that commercial banks would renew lending. The Costa Rican authorities bought back 62% of its long-term banking debt (including past-due interest) at an 84% discount. The remainder was exchanged for bonds carrying a 6.25% fixed interest rate. The Philippine agreement featured a buy-back arrangement for banks wishing to exit, financed partly from Philippine reserves and partly from external sources. For banks with a continuing interest in the Philippines, there was a restructuring arrangement plus new money bonds, both at market interest rates. The Mexican and Venezuelan agreements were designed to bring in some new money while achieving a substantial reduction in debt service obligations through a series of exchanges of commercial bank debt for collateralized bonds, the collateral being financed in part by external resources. At the time of writing, the Venezuelan exchange was not yet complete.

c. Debt reduction for low-income countries

The World Bank's financial support for the Brady initiative was directed at middle-income countries eligible for IBRD resources. In response to the com-
Multilateral Debt Relief: Institutional Arrangements and Recent Trends

Commercial bank debt problems of low-income countries, shortly before the September 1989 Bank-Fund Annual meetings, the World Bank Executive Directors approved establishing a Debt Reduction Facility for IDA-only countries, and they agreed to authorize a transfer from the Bank to this Facility equivalent to $100 million. Allocations would be on a case-by-case basis, and beneficiary countries would have to have an adjustment program acceptable to the World Bank, a comprehensive plan for debt management and parallel arrangements for debt relief through the Paris Club.

Since debt of several low-income countries (virtually entirely sub-Saharan African), were trading at discounts of 95%, it is expected that debt reduction would be an effective use of funds. The program has a duration of three-years. While several countries would like to use this facility, at the time of writing no program has been completed.\textsuperscript{22}

G. Achievements of Commercial Bank Restructuring

The overhang of commercial bank debt of developing countries is gradually being brought under control by the restructuring measures introduced in the late 1980's. Debts to commercial banks of the countries classified by the World Bank as "debt burdened" was $329 billion at the end of 1988. This figure is net of debt-equity conversions of $22 billion through 1988. In 1989, there were an additional $12 billion. Additional conversions took place in 1990 and are expected in future years. Brady Plan debt reductions and conversions total $68 million to date. The bulk of the remaining debt of these countries has been restructured with long maturities: total rescheduling in the 1986 - September 1990 amounted to $255 billion.

Of the large severely-indebted middle-income countries, Brazil is in the process of re-negotiating its debt. Peru, after breaking off negotiations with banks in 1984, is in the process of restoring its relationship with the commercial banking community. Arrangements are being worked-out for smaller countries. Looking ahead, we can see a continuation of the approach that has been developed in 1988-90: debt restructuring agreements complemented by voluntary debt reduction programs and with a menu of options that will include new money possibilities for banks with a continuing interest in the debtor country concerned or alternatives for banks desiring to reduce their exposure.

IV. Bilateral Debt Relief

As was noted at the beginning of the paper, the Paris Club and the commercial banking negotiating fora are not all-inclusive. Certain debts must be renegotiated bilaterally.

b. Other swaps

Various organizations have leveraged their operations in developing countries by purchasing commercial bank debt at a discount and then redeeming it for local currency in the debtor country to be used in various "debt-for-nature" or "debt-for-health" programs. For example, Ecuador has permitted Harvard University to purchased $5 million of debt at an 85% discount and to redeem it at its face value for special bonds that are cashed at 50% of par to finance research activities in Ecuador.

\textsuperscript{22}
Managing External Debt in Developing Countries

not taken up in the Paris Club. These countries do not have a system of export credit insurance - the unifying characteristic of creditor countries taking part in Paris Club negotiations. Debts to most OPEC countries are also renegotiated outside the Paris Club. The debtor country must negotiate with these creditors one-by-one.

Such negotiations normally follow rather than precede a Paris Club meeting, because the Paris Club agreed minute provides the basis for negotiation. The debtor country informs non-participating creditor country governments that the agreement requires that comparable terms be secured from all creditors. The resulting agreements are very similar; the main difference between these agreements with CPE creditors and Paris Club creditors was that the moratorium interest rate was much lower.

b. Non-insured suppliers credits

When debts to uninsured suppliers are small, the debtor country will repay them on the original schedule. When they are relatively large, arrangements must be made for debt relieve. The Côte d'Ivoire and Zaire called special meetings of non-insured suppliers and negotiated agreements with the representatives who showed up (the "Abidjan Club" and the "Kinshasa Club"). Congo simply informed the non-insured creditors that the Paris Club agreement required that they secure identical terms of debt relief from other countries and informed them that their claims would be rescheduled in a similar matter. This unilateral approach is more common than conveying a special meeting.

Nigeria and Turkey have had to consolidate considerable amounts of short-term export credits. Since these had been arranged through commercial banks, it was most efficient to engage a major foreign bank to collect the claims and to organize verification prior to signing a debt consolidation agreement. That bank then served as a paying agent.

V. Concluding Observations

The Paris Club and the system of commercial bank advisory committees were created as ad hoc mechanisms to deal with requests for debt relief. In 1991, the Paris Club will celebrate its 35th anniversary, and twenty years have elapsed since the first major commercial banking consortium agreement took place with the Philippines. Considering that the debt servicer problems the Paris Club and commercial bank advisory committees initially had to resolve were seen as part of temporary international liquidity problems facing a handful of countries, these institutions have proved surprisingly durable.

During the 1970's, the Paris Club faced generalized and protracted debt servicing difficulties of African countries, and during the 1980's the commercial banking community gradually had to acknowledge the long-term nature of Latin American an other middle-income countries’ debt servicing difficulties. The Paris Club responded by increasing the coverage of debt relief agreements and offering longer repayment periods. A "menu approach" was adopted for low-income countries that incorporated some debt reduction. Agreements for certain lower-middle income countries provided for debt conversions.

However, the Paris Club has not continued the far-reaching debt arrangements that were extended to Ghana and Indonesia in the early 1970's, under which the entire stock of debt was rescheduled (as contrasted with the rescheduling of maturities falling due during a limited time period) to be repaid with terms having a very high grant element. The Paris Club creditor countries' position regarding moratorium interest is that moratorium interest must cover the cost of borrowing by export credit agencies. Consolidation periods are kept short, with a few exceptions, so that the Paris Club can assure itself that adjustment efforts are being sustained and that all creditors are being treated equally.

The pressure of commercial bank debt on developing countries has been relieved by the new approaches adopted in the late 1980's: debt conversion programs, debt and debt service reduction agreements under the Brady Plan and rescheduling debt with very long repayment periods and low interest margins.

That the Paris Club and system of commercial bank advisory committees could endure as mechanisms for organizing debt relief appears to be the result of two factors. First, key decisions on official support to the debt relief process were agreed upon at the highest levels of the creditor country governments, providing a framework for debt renegotiation in the new and difficult environment: the decision to apply relatively concessional terms to rescheduled debt owed by low-income African countries to official creditors (the Toronto Terms) and the decision to support the negotiating process with commercial banks by providing official support to debt reduction (the Brady Plan).
Secondly, the multilateral negotiating fora have dealt with the problems of debtor countries individually. Changes could be introduced in an agreement with one country and then to applied, if appropriate, to successive situations. It is this case-by-case approach, linked with country economic performance conditions and external financial assistance that has enabled the debt renegotiating institutions to adjust to changing circumstances and so to endure.
Annex Table B1: MULTILATERAL DEBT RESTRUCTURING AGREEMENTS WITH OFFICIAL CREDITORS, 1956-80
Part I - Agreements signed 1956-69

<table>
<thead>
<tr>
<th>Country</th>
<th>Date of Agreement</th>
<th>Type of Debt</th>
<th>% Agreed</th>
<th>Consolidated Debt</th>
<th>Terms of Repayment</th>
<th>Maturity</th>
<th>Interest</th>
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<td>114</td>
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<td>Jan-69 42</td>
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Notes: (+) indicates agreement outside the Paris Club. India: World Bank Consortium for India Turkey: OEEC (1959); OECD Consortium for Turkey (1965). Type of debt: CC = Commercial credits; Blt = Inter-government loans; P = Principal; I = Interest. % Consolidated = Proportion of eligible maturities consolidated. Maturity, grace or interest arrangements differ among creditors. Bil = Interest rate on rescheduled debt negotiated with individual creditors.
### Annex Table B1: MULTILATERAL DEBT RESTRUCTURING AGREEMENTS WITH OFFICIAL CREDITORS, 1956-80

**Part II - Agreements signed 1970-80**

<table>
<thead>
<tr>
<th>Country</th>
<th>Date of Agreed Minute</th>
<th>Type of Debt Incl Cnsol</th>
<th>Consolidated Beginning Length</th>
<th>Maturity</th>
<th>Grace Interest</th>
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<tr>
<td></td>
<td>Date (Mos)</td>
<td>(Yrs)(Mos)</td>
<td>(Yrs)(Mos)</td>
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<td>(%)</td>
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<tr>
<td>Gabon</td>
<td>20-Jun-78</td>
<td>CC+Blt P+I</td>
<td>Y 80 105 Arrears only.</td>
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<tr>
<td>Ghana</td>
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<td>Y 90 21 Jul-80 18</td>
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<tr>
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<tr>
<td>Sudan</td>
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<td>Y 90 945 Jul-79 18</td>
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<td>Chile</td>
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<td>CC+Blt P+I</td>
<td>Y 70 243 Nov-71 14</td>
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<td>90 573 Jan-79 24</td>
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<td>Cambodia</td>
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<td>Y 234 May-71 26</td>
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<td>Var 650 Jul-74 48</td>
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Source: World Bank, Debtor Reporting System

Notes: (*+) indicates agreements outside the Paris Club. India and Pakistan debt relief was negotiated through World Bank aid consortia, Turkey's agreements through the OECD Aid Consortium for Turkey. Agreements with Gabon and Cambodia were coordinated bilateral reschedulings owing to the small number of participating creditor countries.

For other notes, see Annex Table B1, Part I.
### Annex Table 82: MULTILATERAL DEBT RESTRUCTURING AGREEMENTS WITH SUB-SAHARAN AFRICA, 1981 - SEPTEMBER 1990

**Part I - Agreements signed 1981-85**

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**Source:** World Bank, Debtor Reporting System DR-182

**Notes:** ST debt = Short-term debt (maturity one year or less). PRD = Previously rescheduled debt.

See Annex Table 81, Part I for other notes.

**Part II - Agreements signed 1986 - September 1990**

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Notes: (a) Agreement with a Paris-Club designated "severely indebted lower-middle income country.
For other notes, see Annex Table B1.

See Annex Table B1, Part 1 for other notes.
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Source: World Bank, Debtor Reporting System DR-182

Notes: ST debt = Short-term debt (maturity one year or less). PRD = Previously rescheduled debt.
(a) Agreement with a Paris Club designated "severely indebted lower-middle income country. See text.
See Annex Table B1, Part I for other notes.
## Annex Table B3: MULTILATERAL DEBT RESTRUCTURING AGREEMENTS WITH OFFICIAL CREDITORS, 1981 - SEP 1990
### COUNTRIES OTHER THAN SUB-SAHARAN AFRICA

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Source: World Bank, Debtor Reporting System
Notes: See Annex Tables B1 and B2.
Annex Table B3: MULTILATERAL DEBT RESTRUCTURING AGREEMENTS WITH OFFICIAL CREDITORS, 1981 - SEP 1990
COUNTRIES OTHER THAN SUB-SAHARAN AFRICA

Part II - Agreements with Other Countries

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Source: World Bank, Debtor Reporting System
Notes: See Annex Tables B1 and B2.
## Annex Table B4: DEBT RESTRUCTURING AGREEMENTS WITH COMMERCIAL BANKS, 1970-84

### Part I - Agreements of Latin American Countries

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Notes: (*) Agreement in principle.
(d) Deferment.
Interest Margin: Percentage points above LIBOR.
Annex Table B4: DEBT RESTRUCTURING AGREEMENTS WITH COMMERCIAL BANKS, 1970-84
Part II - Agreements of all other countries

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Notes: See Annex Table B4, Part I.
Annex Table B5: MULTI-YEAR DEBT RESTRUCTURING AGREEMENTS WITH COMMERCIAL BANKS (MYRAs) 1986-90

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<th>Grace</th>
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<td>12</td>
<td>0</td>
<td>+1.3750 Cancelled.</td>
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<tr>
<td>Mexico</td>
<td>Aug-85</td>
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<td>Jan-85</td>
<td>72</td>
<td>0</td>
<td>+1.2500 Debt not yet rescheduled.</td>
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<tr>
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<td>Jan-87</td>
<td>14</td>
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<td>Jan-88</td>
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<tr>
<td>Uruguay</td>
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<td>1,547</td>
<td>Jul-86</td>
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<tr>
<td>Venezuela</td>
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<td>Jan-83</td>
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(*) = Agreement in principle.
### Annex Table B6: Debt Restructuring Agreements with Commercial Banks, 1985 - September 1990

#### Part I - Agreements Latin American Countries

<table>
<thead>
<tr>
<th>Country</th>
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<th>Terms of Repayment</th>
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<td>Amount</td>
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<td>3,593</td>
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<td>1,253</td>
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<td>320</td>
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<td>Chile</td>
<td>Sep-90</td>
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<tr>
<td>Colombia</td>
<td>Dec-85</td>
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<td>Aug-85</td>
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<td>Feb-90</td>
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<td>Trin &amp; Tob</td>
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Source: World Bank, Debtor Reporting System

Notes: See Annex Table B4.
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<th>Country</th>
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<th>Consolidated Money Maintenance Beginning Length</th>
<th>Maturity</th>
<th>Grace Interest</th>
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<th>ST Credit</th>
<th>Margin</th>
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</tr>
</tbody>
</table>


3. Before the Venice Communiqué, the Paris Club gave extended maturities to Zaire (May 1987) and to Uganda (June 1987).

4. France invariably has selected Option A. The countries that choose option B are: Belgium, Netherlands, Spain, Sweden and the United States. Option C has been selected by: Austria, Canada, Germany, Israel, Italy, Morocco, Norway, South Africa, Switzerland and the United Kingdom. Japan, in one agreement, selected Option A and in others a combination of A and B and A and C. Germany selected Option B in two agreements, in all others Option C.


7. The first multilateral negotiations by developing countries with commercial banks were incidental to Paris Club meetings for Argentina, Brazil and Chile in the 1960's. The Philippines was the first country requiring debt relief where the major component of foreign debt consisted of debt to commercial banks (1970). The first negotiations following the oil shock of 1973 were with Peru and Zaire in 1976. Between 1976 and 1982, there were calls for relief from Poland, Turkey, Jamaica, Bolivia, Nicaragua, Sudan and Togo.


10. Ibid., p. 16.

11. Ibid., p. 44.

12. Ibid., p. 47.


14. There were deferment agreements with Poland and Zaire in June 1989, rescheduling agreements with Jamaica (June 1989), Madagascar (May 1990), Chile and Morocco (September 1990).

16. Ibid., p. 178.

17. The major provisions are:
   
   **Sharing provisions:** If any bank obtains payment with respect to principal on a loan or interest owed to it that is proportionately greater than the payment obtained by any other bank with respect to principal or interest due, then the bank receiving such payment must share that payment with other co-lenders under the loan agreement on a pro rata basis.

   **Pari passu provisions:** The borrower states that the payment obligation will rank at least equally (pari passu) in priority of payment with all other external indebtedness, current or future, of the borrower.

   **Negative pledge provisions:** The borrower will not create any lien with respect to any of its present or future assets to secure payment to other external creditors.

   **Mandatory prepayment provisions:** If the borrower makes any prepayment under other loan agreements with external creditors, then the borrower must also make a prepayment to the creditors under the loan agreement where this provision is found.


18. The following section is based on an account published in Finance and Development, September 1989, p. 16.


20. Negotiating a DDSR agreement is more complex than an ordinary debt relief agreement. The debtor country government must negotiate with the creditor banks the specific elements of a DDSR agreement. At the same time, it must negotiate with the World Bank, the IMF and with possible bilateral donors to arrange any necessary financing for a DDSR operation. The two sets of negotiations are separate, but the outcome of each has implications of the other. There are five stages in the negotiation process, some of which overlap:

   **Agreement in principle.** The debtor country government normally approaches the creditor commercial bank's Bank Advisory Committee (BAC) to propose a DDSR agreement. The BAC is a group of 6-10 (sometimes fifteen or more) that negotiate for all commercial bank creditors, of which there may be several hundred. The result is a "term sheet" that records the creditor options that have been agreed upon by the debtor country government and the BAC. It is not binding on other banks at this point.

   The individual creditor banks, after receiving the term sheet, indicate their provisional choices among the options to the head of the BAC.

   **Waivers.** As explained above (see note 18), the debtor country must receive waivers from all or the required majority of creditor banks with respect to key clauses of the original loan agreements designed to guarantee equal treatment of creditors.

   **Financing.** As the DDSR agreement takes form, the debtor country must estimate the funds required to finance buybacks, or to purchase collateral or to arrange guarantees required for the exchange of debts for new financial instruments. To supplement the debtor country's own reserves, the country normally will request assistance from the World Bank and the IMF and bilateral donors. For use of Bank and Fund resources, the country must fulfill the specific requirements described above.

   As negotiations progress with the BAC, financing targets are established. At the same time, as the availability of financing becomes known, limits are set on the various options. There are restrictions on how some borrowed funds can be used, which are explained above.
Agreement with the Banks. For a DDSR agreement to be implemented, all creditor banks must ratify the "agreement in principle" negotiated by the BAC. Each participating bank must also indicate which option it has selected.

Exchange of instruments. On a date determined in the DDSR agreement, the debtor country implements the DDSR options either through a cash buy-back (which extinguishes debt) or through the issuance of new financial instruments in exchange for claims from the commercial banks. The financial resources required to implement this agreement must, of course, be in place before the exchange of instruments can take place. Thus, final approval of the use of any funds from international financial institution is a prerequisite to concluding a DDSR agreement.


22. On December 20, 1990, IDA approved a grant of $10 million to Niger to help buyback its commercial bank debt. This grant was accompanied by $3 million from Switzerland (disbursed through IDA) and $10 million from France. The buyback was at an 82% discount.


A number of proposals have been made and actions have been taken in the past year or so to reinvigorate the debt strategy. They include the Brady initiative, a Japanese plan for debt reduction, and French President Mitterrand's unilateral decision to forgive the official debt of 35 of the poorest countries. The International Monetary Fund has also moved quickly to adopt new operational guidelines to allow it to play an active and constructive role in the strengthened debt strategy. (The World Bank has also acted in this regard—see following article by Ishrat Husain.)

This article discusses the circumstances in which initiatives for the voluntary reduction of debt and debt service, supported by the international financial institutions, can be a useful means for some debtor countries to achieve a return to satisfactory economic growth and access to credit markets.

The reasons behind these moves on the part of the Fund and other interested parties are many and relate both to what has already been achieved in the global debt strategy as well as the goals that have not yet been fulfilled. The heavily indebted countries have shown an improvement in real terms in their external current account over 1981–87, despite a deterioration in their terms of trade. They have also diversified their economies. Meanwhile, commercial banks involved in the debt strategy have improved their financial performance, by most indicators. These improvements in both debtors and creditors have helped strengthen the international financial system.

But some areas of weakness remain. There has been a slower recovery of growth in the group of heavily indebted countries, and inflation has surged. More serious for their economic health, the improvement in the current account has often been at the expense of new domestic investment, which is needed for future growth so that these countries can continue to meet their commitments. Indeed, one reason for the problems facing the indebted countries has been the greater emphasis on the degree of external adjustment than on the level and quality of domestic investment or resource mobilization.

By early 1989, it had become clear that many debtor countries judged the likelihood of working their way out of debt, even with reasonably good policies, to be diminishing. Commercial banks had already indicated by building reserves against loan losses (provisioning), and by selling loans at deep discounts in the secondary market, that they also regarded the future economic performance of some debtor countries as highly uncertain. Each year that witnessed a further build up of debt, without conviction among foreign and domestic savers that there had been a decisive improvement in the prospects for sustained growth, would reduce the likelihood of any return to normal access to credit markets for indebted countries.

Against this background, there was a growing consensus that the debt strategy needed a new impetus with vigorous support from the international financial institutions. A major aim of the new approach was to be the reduction of external debt along with greater financial support for countries that undertake sound adjustment policies over the medium-term.

Call for action

At its meeting in Washington, DC, in April 1989, the Interim Committee agreed that the Fund should provide appropriate financing to help debt reduction operations in countries undertaking sound economic reforms. The Committee also requested the IMF Executive Board to consider, as a matter of urgency, the question of limited interest support by the Fund for transactions involving significant reduction of debt or debt service.

The Executive Board adopted, on May 23, 1989, broad guidelines for the Fund's role in the evolving debt strategy and, in particular, for Fund support for operations that aimed to reduce debt or debt service. This support would be linked to medium-term adjustment programs with a strong element of structural reform. Such programs would be undertaken under regular stand-by or extended arrangements with the Fund. Particular emphasis is to be given to measures that will improve the climate for saving and investment in borrowing countries, help reverse capital flight, and attract private capital inflows and direct investment. Fund support for debt and debt-service reduction operations in conjunction with appropriate flows of new financing from other sources would lay great importance on the sustained implementation of policy reforms. The World Bank moved in parallel to establish guidelines to provide support over three years for the reduction of countries' debt and debt-servicing payments.

The case for incorporating debt and debt-service reduction in an adjustment program rests on the assessment that such operations can help break the pessimistic cycle of rising debt and poorer prospects for growth. Debt reduction alone will not bring about a change in expectations. Therefore, any official support of debt reduction should only be given when effective policies are being implemented to strengthen growth, address structural problems, and re-establish financial and economic balance in debtor countries. Strong macroeconomic and structural policies are also needed to encourage an inflow of foreign direct investment and a return of flight capital. Debt reduction that helps eliminate a debt overhang (which could be defined as the portion of debt which, if forgiven, would allow the remaining debt to trade near par in secondary markets) and eventually opens up access to the credit market would help governments of debtor countries gain support for sustained adjustment efforts.

Analyzing the relationships between savings, investment, and growth on the one  

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1 This article is reprinted from Finance and Development September 1989. pp. 8-11.
Managing External Debt in Developing Countries

hand, and debt reduction on the other, and incorporating the analyses into financial plans and projections, poses difficult technical issues. There appear to be several important linkages between debt reduction and increasing the likelihood of a successful adjustment program. To the extent that the private sector perceives a debt overhang, it may question the debtor country's ability to meet its obligations and may, therefore, not participate in voluntary new lending. A reduction of this overhang would mean that potential investors, both resident and nonresident, would anticipate lower and less variable "taxes" on their future income as well as more predictable economic policies in debtor countries (see accompanying article by Eduardo Borensztein). Debt reduction may, therefore, reduce a source of uncertainty for private investment and lead to new investments in real productive capital. Creditors, who continue to hold existing claims and contribute through the effective refinancing of part of their interest payments rather than sell or exchange their claims, benefit from good economic performance in debtor economies following debt reduction.

The amount of possible debt reduction will depend, in part, on the flexibility allowed the debtor in finding the required financing. In connection with interest support, in particular, the official lenders have stressed the importance of debtor countries contributing, as feasible, from their own resources to such financing. Once the funding for debt reduction is established, a quantitative assessment is needed of the amounts of debt and debt-service reduction that are feasible with the available resources. This is relevant both because of funding limitations and because of the need to consider opportunity costs (alternative returns to such investments) of this use of resources. In this regard, a relatively conservative estimate of the amount of debt reduction possible with any given pool of resources would appear prudent. It may be useful to review a few key techniques.

Applications and technical issues

For simple buybacks, the amount of gross debt reduction would be roughly what is suggested by the market price observed after the scope and terms of the buyback are announced or generally known. One can estimate this in advance, but not with precision. The net debt reduction can then be calculated, taking account of the new borrowing incurred to finance the buyback.

For debt exchanges involving new debt enhanced by collateralized interest or principal, the market will establish an exchange ratio between old and new debt. This ratio will tend to equalize the risk-adjusted present value of the old and new assets voluntarily exchanged, and it is likely that in making this assessment, the market will view the "country risk" on the country's portion of both old and new instruments as identical, that is, there is not credible subordination of older debt relative to new debt.

The debt strategy envisages that creditors would not be forced to accept debt reduction instruments at exchange ratios that do not reflect market values. Similarly, official support for debt reduction will be conditioned on the efficient use of these resources, in other words it will be used to fund operations that are market-based, or at market-related prices, involving substantial discounts. The range of uncertainty about the amount of debt reduction possible with given resources is an issue that requires further study: estimates of how creditors will value different options will vary because of uncertainty about portfolio preferences of banks and other investors.

It is important that countries be free to explore with their creditors different possibilities for combining interest rate reduction and principal reduction (through a single instrument or a combination of instruments). They would do so in ways that would distribute cash flow relief optimally over time, based on their prospective financing needs and the effectiveness of different approaches in light of bank portfolio preferences, and the regulatory and tax environment in which they operate. However, noting the importance of principal reduction in easing a member's debt burden, the Fund Executive Board agreed that amounts for debt reduction under standby or extended arrangements with the IMF should be set aside to support operations involving the reduction of principal. Additional Fund resources are to be used for interest support in connection with debt or debt-service reduction.

In addition to outright debt and debt-service reduction, debt-equity and other conversions are likely to remain important elements in the menu for some participants. Debt-equity conversion of public sector liabilities involves both flows of direct investment and a complex debt exchange. In essence, the government's external debt is refinanced by domestic debt, in proportions determined by the ratio at which the debt-equity conversion takes place. Countries with strong fiscal positions (and broad domestic financial markets) have been those best able to accommodate the increases in domestic debt and liquidity created through such conversions. It is, of course, important to safeguard the objectives of economic programs against the inflationary effects of domestic debt and liquidity creation involved in such conversion operations, by promoting stronger fiscal and monetary adjustments as necessary.

It will also be important to be clear on what types of debt are to be excluded from debt reduction schemes. Traditionally, many debtor countries have excluded from the rescheduling process certain categories of debt to private creditors, such as short-term trade related debt, interbank credit, and bonds (in addition to categories of debt to official sources including the international financial institutions).

Even with some voluntary and market-based debt reduction, the provision of new financing for investment and growth will remain essential. A debt reduction initiative may, in many cases, not reduce contractual interest payments to the level that can be serviced without new bank financing; hence the underlying economic program would still require significant foreign financing to support growth. Thus, as in recent years, existing creditors are likely to continue to be called upon to provide new money. Good faith on the part of the debtor country in seeking to conclude such negotiations is part and parcel of living up to its commitments under an internationally supported adjustment program. The object of all parties in the strategy must be to promote an orderly and cooperative evolution of debtor countries' relations with both private and official creditors.

IMF guidelines

In light of the considerations set out above, eligibility for Fund support for debt reduction has been defined initially in terms of (1) the strength and implementation of economic policies; (2) the judgment that there is scope for voluntary debt reduction in each country case that would help restore access to credit markets and attain external viability with growth; and (3) an assessment, based
37. Reinvigorating the Debt Strategy

on the rates of return involved, that the approach in each case represents an efficient use of scarce resources. Provision of financing for debt reduction may not always be the most efficient technique for the use of scarce resources, in the case of countries facing debt problems. The relative merits of applying resources to productive investment need to be assessed on a case-by-case basis, as alternative domestic opportunities are likely to vary.

The Executive Board has clearly defined Fund support for debt and debt-service reduction. Specifically, the Executive Board decided that, in appropriate cases, part of a member’s access under an extended or a standby arrangement could be set aside to support operations involving the reduction of principal, such as debt buybacks or exchanges. The exact size of the amount set aside would be determined on a case-by-case basis, but would be around 25 percent of the member’s arrangement, determined on the basis of existing access policy. The set-aside amounts would generally be made available gradually, in line with program performance. Where warranted, some front-loading or advance payments could be considered, or purchases (borrowings from the Fund) could be phased, in accordance with the specific financing needs of the member’s debt reduction program.

Also, in appropriate cases, the Fund would be prepared to approve requests for additional resources of up to 40 percent of a member’s quota, where such support would be decisive in facilitating further cost-effective operations and encouraging the flows of other resources, consistent with significant further progress toward external viability. The additional resources from the Fund are to be used for interest support (i.e., guarantees by the debtor of interest) in connection with debt reduction or debt-service reduction operations. The amount of additional resources to be provided would also be determined on a case-by-case basis. This would be done in light of the magnitude of the member’s balance of payments need and the strength of its adjustment program as well as its own efforts to contribute resources, as feasible, in support of the operations. Access would be additional to that determined under existing guidelines for enlarged access to Fund resources.

It will be important for the Fund to be able to give its prompt support for a country embarking on an appropriate economic program. In some cases, countries and banks may need time to agree on increasingly complex financing packages. The Fund has already been experimenting with a more flexible approach to what is known as "financing assurances" (i.e., the availability of firm commitments of support from other parties at the outset of a program). In the period ahead, it will continue to provide timely support for a country's economic reforms, together with the World Bank and the Paris Club. This approach should clearly support a negotiated approach between countries and banks.

Recognizing the need for cautious adaptation of its policy on financing arrangements in light of the changed financial environment, the Fund may, on a case-by-case basis, approve an arrangement outright before an appropriate package is agreed between the member and commercial bank creditors. This will happen when the Fund is convinced that such support is essential for program implementation, that negotiations between the member and the banks have begun, and that it expects an appropriate financing package to be agreed within a reasonable period of time. Progress in the negotiations with bank creditors will be closely monitored. When circumstances warrant, the practice of seeking a "critical mass" of financial support, as well as the possibility of approving an arrangement in principle, will continue to be followed.

In promoting orderly financial relations, every effort will be made by the Fund to avoid arrears. Nevertheless, an accumulation of arrears to banks may have to be tolerated within limits where negotiations are in progress and the country's financing situation does not allow them to be avoided. The Fund's policy of not tolerating arrears to official creditors remains unchanged.

While recognizing that this is an experimental phase in the debt strategy, the adoption of the above guidelines provides a clear and sound basis for the Fund to begin their implementation. Fund arrangements including set-aside amounts for debt reduction have been approved for four countries (see box on new arrangements) as of end-June 1989, and the Executive Board has indicated its readiness to consider an augment-
The debt crisis that emerged in the early 1980s continues to be a dominant economic policy issue for a group of developing countries. Some advances have been made since then toward finding a satisfactory resolution of this problem. The international financial system is more stable today than it was in 1982, and a number of developing countries have embarked on policy reforms to restructure their economies. But the debt overhang has made it difficult for the highly indebted middle-income countries to resume stable economic growth. It is in this context that the recent initiatives to reduce the debt of these countries mark a new phase in the evolving debt strategy (see box on initiatives, page 16).

The earlier phase of this strategy, begun in 1985 and known as the Baker plan, had three main ingredients: (1) the pursuit of adjustment policies in the debtor countries; (2) concerted new lending by commercial banks; and (3) public loans, particularly by the international institutions. The stumbling block in its implementation has been a serious shortfall in commercial bank lending to the highly indebted countries (HICs) and the uneven progress made by these countries in their adjustment efforts. For a growing number, the past few years have brought declining net resource inflows, persistent payments difficulties, and low rates of domestic investment. In 1986, net lending to these countries was negative, and the 1988 net figure, while positive, was only a quarter of that for 1984, even though interest payments to banks were almost as high as those made in 1984.

Commercial banks have responded to the debtors' calls for debt reduction by asking for increased credit or guarantees by official creditors to improve the quality of new loan assets that will result from debt reduction schemes. Some commentators are calling for comprehensive international debt facilities to help write off much of the commercial debt with guaranteed multilateral financing. Both types of proposals involve substantial costs for the governments of industrial countries, and although the use of public funds could well play an important catalytic role in certain cases, the volume of multilateral financing is still limited relative to some $260 billion currently owed by the HICs to commercial banks.

Against this background, and in light of the recent new moves to reduce the debt burden of the HICs, this article reviews experience with the debt strategy following the Baker plan. Various debt reduction techniques are also examined.

Recent resource flows

Developing countries' access to external finance continued to falter in 1988; preliminary estimates show an 8 percent drop in their net flows of all types of long-term external resources over 1987 (see Table 1). For the HICs, the decline was even larger, at more than 18 percent.

Total net lending by all creditors (including multilateral agencies) to developing countries was highly concentrated in a few large creditworthy countries and in the HICs. In 1988, 80 percent of total net lending went to China, India, and Indonesia. The most important source of debt finance to developing countries continued to be multilateral lending, which accounted for roughly half of net lending.

Net flows to developing countries from financial markets (i.e., commercial bank loans and bonds) are estimated to have been $2.3 billion in 1987 and $2.1 billion in 1988. The increase in outstanding interest arrears was estimated by banking industry sources at nearly $5 billion in 1987. In 1988, some $1.5 billion of outstanding arrears was liquidated.

The very low level of new borrowing by developing countries from international capital markets can be traced to two factors. First, most of these countries were (and continue to be) excluded from new voluntary financing because of creditworthiness considerations. Second, some countries have deliberately limited borrowing or have made prepayments on earlier loans.

For highly indebted countries, the importance of nondebt-creating flows (direct investment and debt-equity swaps) rose significantly. Between 1986 and 1988, while net lending to these countries from all sources fell to $4.4 billion, the total value of nondebt-creating flows more than doubled, to almost $10 billion. The bulk of the increase, however, came from a rise in foreign direct investment, accomplished in part through debt-equity swaps (see "New Financing Approaches in the Debt Strategy," by Klaus Regling, Finance and Development, March 1988).

Secondary markets for developing country debt expanded dramatically in 1988. The total value of debt conversions—transactions that actually reduced external bank debt—is estimated by the World Bank at more than $21 billion, compared with some $8.2 billion in 1987. Debt-equity swaps, accounting for the largest portion of debt conversion activity, were almost 42 percent of the total. Informal conversions and exit bonds accounted for nearly equal parts of an additional 45 percent of the face value of retired debt. The rest, roughly 13 percent, comprised official debt buybacks and conversions to domestic debt (see box on debt reduction techniques, page 16).

As the number of participants has grown, secondary markets for developing country debt have become more liquid and more active. But transactions have still been highly concentrated. In 1988, nearly 93 percent of the total value of secondary market transactions involved just four countries—Argentina, Brazil, Chile, and Mexico—and over 72 percent was accounted for by transactions in the debts of Brazil and Mexico alone.

Growth in informal debt conversions, conducted outside the purview of official

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1 This article is reprinted from Finance and Development September 1989. pp. 12-15.
programs, was another important feature of the market in 1988. Such transactions made up a large share of the debt retired in Brazil, Mexico, and the Philippines.

Cash transactions, including asset swapping among commercial banks, to realign their portfolio of developing country debt, increased significantly in volume. Many banks raised their provisioning levels sufficiently to cover losses stemming from such sales. An increasing number used the secondary market to shed their developing country claims, clean their balance sheets, and avoid participation in rescheduling and new loan ("new money") arrangements.

Commercial bank lending

The debt strategy emerging from the Baker plan stressed the importance of increased net lending by commercial banks to the HICs. But the large flows of voluntary finance from commercial banks have not resumed. The amount of net new financing that private creditors provided to highly indebted countries over 1986–88 has been a subject of controversy.

Commercial banks have pointed to the amount of "new money" they provided to HICs, claiming they have contributed between a quarter and a third of the financing provided to these countries during 1986–88. Indeed, according to IMF estimates, total commitments during this period under concerted lending arrangements (involving many lenders acting in unison) amounted to $16.3 billion, of which almost $15 billion was actually disbursed. The commercial banks use these gross disbursement figures to support their contention that they came close to the Baker plan targets. A more meaningful indicator, however, is net disbursements or net flows that have contributed to financing current account deficits.

Data on the stocks of commercial bank claims on HICs support a different conclusion. These claims include short-term credits and represent the net effect of new lending, repayments, arrears, write-offs, debt conversions, and other balance sheet adjustments, including exchange rate effects. When corrected for identified debt conversions and arrears, these changes show that between January 1986 and September 1988, the net financing provided to highly indebted countries by commercial banks was only slightly more than $6 billion.

Meanwhile, debtor country data show that during 1986–88, commercial bank creditors provided only $4 billion in net new financing on long-term public and publicly guaranteed debt to the highly indebted countries (see Table 2). If the private nonguaranteed debt is taken into account, there were net repayments to commercial banks amounting to $2.4 billion. The general trends outlined above conceal great differences across countries, but in no case did commercial banks provide more net financing than they received in interest payments. The contribution of commercial banks in meeting the external financing requirements of HICs during 1986–88 did not, therefore, live up to the expectations of the proponents of the Baker plan.

One reason for commercial banks' unwillingness to lend has been poor country performance. (This is also reflected in the deep discounts on HIC loans in the secondary market.) But there are other factors, such as banks' concern with building their capital bases; the competitive pressures they face in increasingly deregulated and liberal domestic financial markets; and the effect on their ability to raise new shareholder equity in the markets of their exposure (outstanding loans) in developing countries.

US banks have been the most active in reducing their developing country exposure. Between mid-1987 and the end of the third quarter of 1988, these banks reduced their claims on all developing countries by more than $20 billion. More than half of this represented a reduction in claims on highly indebted countries. These banks remain the largest commercial creditors of the highly

Table 1

<table>
<thead>
<tr>
<th>Net Resource Flows to Developing Countries, 1986-88¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>All countries</td>
</tr>
<tr>
<td>Aggregate net resource flows²</td>
</tr>
<tr>
<td>Of which</td>
</tr>
<tr>
<td>Direct investment</td>
</tr>
<tr>
<td>Net lending²</td>
</tr>
<tr>
<td>Total external resource balance⁶</td>
</tr>
</tbody>
</table>

¹ Source: IMF and Debt & International Finance Division, World Bank.
² Includes net long-term capital flow, foreign direct investment, net official transfers, net lending from private and official sources, and the change in arrears calculated as difference between projected interest due and paid. (Net lending is on a cash basis and is not affected by principle arrears.)
³ Including IMF.
⁴ Current account plus change in reserve assets minus official transfers.

Table 2

<table>
<thead>
<tr>
<th>Commercial Bank Lending to Highly Indebted Countries</th>
<th>(In billions of US dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>All countries</td>
<td>1986</td>
</tr>
<tr>
<td>Concerted new money¹</td>
<td></td>
</tr>
<tr>
<td>Commitments</td>
<td>8.3</td>
</tr>
<tr>
<td>Disbursements</td>
<td>3.2</td>
</tr>
<tr>
<td>Change in exchange rate adjusted claims²</td>
<td>3.5</td>
</tr>
<tr>
<td>Net disbursements³</td>
<td>-0.4</td>
</tr>
</tbody>
</table>

¹ Source: See footnote below.
² Including IMF.
³ These claims take into account identified debt conversions, arrears, and other balance sheet adjustments.
⁴ Debt and International Finance Division, World Bank.
indebted countries and their assets are extremely concentrated in those countries. In contrast, Japanese banks have shown a marginal increase in their exposure in developing countries. Even though the total developing country claims of French, German, and British banks are not much smaller than the US banks, the vulnerability of those banking systems appears to be considerably less than some of the large money center US banks or a few Japanese banks. The smaller share of each bank’s claims on highly indebted countries in the total loan portfolio and the generally higher levels of provisioning defunctibility of provisions have minimized their risks.

The recent rapid increase in international interest rates also acted as a deterrent to new borrowing by some developing countries that found their debt servicing capacity stretched to intolerable limits. The six-month Eurodollar LIBOR (London Interbank offered rate) reached almost 11 percent in mid-March 1988, compared to around 8 percent in 1986. A jump of this size in interest rates translates into a roughly $18 billion increase in developing countries’ annual interest obligations.

The virtual halt in commercial bank lending is particularly threatening to the debtors other than the big four. Their debts do not represent a significant claim on banks’ balance sheets, but additional borrowing may be relatively more important for them in maintaining the momentum of growth or helping sustain adjustment.

### Official Creditors

Official creditors continue to be the most important source of net lending to developing countries. In 1988, total net official lending rose from $17.5 billion in the previous year to $21.8 billion despite a rise in prepayments by some countries and large repayments on earlier loans. In contrast to commercial banks, official creditors’ share in net disbursements to highly indebted countries were several times their share in total claims on this group of countries. Official creditors’ net lending of $3.5 billion amounted to 38 percent of the interest payments they received from these countries on earlier loans (see Table 3) and was responsible for positive total net flows to HICs of $2.9 billion.

The heavy involvement of official creditors in several countries led to a rise in the share of official creditors in total debt outstanding. During 1986–88, six countries (Argentina, Bolivia, Chile, Ecuador, Mexico, and Nigeria) received more in net disbursements than they needed to refinance their interest payments to official creditors. IBRD net lending was well above interest payments due to the IBRD in eight countries. Two countries—Venezuela and Yugoslavia—made net repayments to the Bank.

Among the bilateral official creditors, the Japanese Government proposed the recycling of up to $30 billion of Japan’s external surplus over the three years 1987–89 to developing countries. This was an encouraging development. But other official bilateral creditors (e.g., export credit agencies) also need to do more if financing requirements for the resumption of even minimal per capita growth in the highly indebted countries are to be met.

### Voluntary Debt Reduction

The constraints to mobilizing adequate flows of new money, especially from the commercial banks, are likely to remain strong. If net flows from commercial banks are unlikely to rise significantly, how else could the external financing requirements of this group of countries be met? The debtor countries themselves have to continue to take primary responsibility for their fate through further adjustment. Favorable economic policies and good economic management will attract new project and trade financing, multilateral lending, export credits, and direct foreign investment. But this will still not suffice in all cases, and for several of these countries, reduction in the stock of debt or debt servicing followed by refinowls of flight capital would be important in filling the financing gaps.

One reason for the persistence of slow growth is that the debt overhang acts as a severe tax on increases in current and future income (see article by Eduardo Borensztein in this issue). Debt reduction, on the other hand, should encourage investment and increase the incentive to implement better policies which, in turn, would boost exports and debt-servicing capacity.

Though the debt strategy has turned more and more openly to market-based voluntary debt reduction during 1988, these techniques have not yet been fully translated into debt relief for the debtor countries. Only in cases where the debtor country exchanges its external debt for equity or converts external debt into local currency debt has the country been able to capture the discount. But these transactions account for less than one half of the total volume of secondary market transactions. The other problem with voluntary debt reduction is the existence of “free riders,” who may hold out in the expectation that the value of their claims would rise if other creditors participate in the reduction of debt, thereby getting a “free ride.”

The third issue inhibiting the fuller use of voluntary debt reduction techniques is the determination of the appropriate market value of the existing debt. The difficulty in negotiating the price of existing claims suggests that many creditors do not regard the prevailing secondary market discounts as a true reflection of the underlying value of their claims.

### Table 3

**Official Lending to Highly Indebted Countries, 1986-88**

<table>
<thead>
<tr>
<th>Year</th>
<th>Disbursements</th>
<th>Principal repayments</th>
<th>Net lending</th>
<th>Interest payments</th>
<th>Net lending as percent of interest payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>15.0</td>
<td>8.9</td>
<td>6.1</td>
<td>7.0</td>
<td>87</td>
</tr>
<tr>
<td>1987</td>
<td>14.6</td>
<td>10.7</td>
<td>3.9</td>
<td>7.5</td>
<td>52</td>
</tr>
<tr>
<td>1988</td>
<td>15.8</td>
<td>12.3</td>
<td>3.5</td>
<td>9.2</td>
<td>38</td>
</tr>
</tbody>
</table>

The World Bank's Role in Debt Reduction

The Executive Directors of the World Bank approved the operational guidelines and procedures for use of IBRD resources to support debt and debt-servicing reduction on May 31, 1989. It was decided that:

- All member countries that had a clear need for debt or debt-service reduction in order to achieve reasonable medium-term economic growth objectives and that had adopted a sound medium-term economic policy framework would be eligible for Bank support. However, Bank support for debt or debt-service reduction would be decided on a case-by-case basis, taking into account the strength of the medium-term economic program for adjustment, the severity of the debt burden, the scope for voluntary market-based operations, the medium-term financing plan, and the potential benefits from Bank support, particularly for investment and growth. All transactions to be supported by the Bank should result in a substantial discount leading to a significant reduction in the present value of future debt-service obligations. Bank resources are to be provided for this purpose over a period of approximately three years.

- Around 25 percent of a country's adjustment lending program over a three-year period, or around 10 percent of its overall lending program where the Bank was concentrating its support on investment lending and where the country had an acceptable medium-term economic policy framework, would be set aside to support operations involving significant reduction of the principal. Where additional resources are justified, an increment of up to 15 percent of the overall three-year lending program could also be made available for interest support. The incremental lending should not be more than $6 billion over the next three years. FY1990-92.

- The Bank would provide support for debt and debt-service reduction primarily through direct lending arrangements on normal IBRD terms, which the borrower would use for approved debt reduction and credit enhancement programs. Guarantees of interest payments should not be used unless there were exceptional circumstances providing strong justification. In cases where the Bank does not have a substantial adjustment lending program, support may be provided through special operations devoted to debt and debt-service reduction with appropriate policy conditionality.

On June 29, 1989, the Executive Directors of the IBRD agreed to recommend to the Board of Governors a transfer of $100 million of IBRD's net income during FY1989 to the International Development Association (the Bank's affiliate that lends to the poorest countries) to be held in a special facility. These resources would be made available to facilitate commercial debt reduction at countries that borrow from IDA alone. To avail themselves of these resources, eligible countries must have:

- an appropriate medium-term adjustment program.
- a debt management strategy that includes (1) a program for addressing the commercial debt problem in a manner that offers a realistic prospect for reducing debt-service payments to a sustainable level, and (2) provides for substantial debt relief from official bilateral creditors through an agreement with the Paris Club.

Number of large creditor banks have converted their debt at much higher prices than the secondary market price and are thus reluctant to recognize the losses inherent in the deep discount of the market. Further, the coverage of loan loss provisions varies across banks and across countries—and thus the lower limit of these provisions and the tax deductibility considerations determine the extent to which the banks can reasonably afford to reduce the value of their claims. While the Swiss and German banks have comfortable levels of provisioning, equal to 70-75 percent of their exposure to problem debtor countries, the Japanese banks have only 15 percent, and the major US banks, about 25 to 30 percent. Meanwhile, the average discounts in the secondary market are 60 to 65 percent, implying a loss greater than that covered by provisioning against bad loans.

In 1988, private corporate restructuring in debtor countries and opportunities for informal conversions to fund local subsidiaries aroused interest in secondary market transactions and stimulated voluntary debt reductions. For example, the amount of Brazilian debt traded in 1988 was nearly five times the amount transacted in the previous year. The introduction of new debt conversion programs was largely responsible for the increase in activity. Similarly, the privatization program in Mexico, the debt conversion program in Chile, and the debt-equity program in Argentina contributed to a rise in secondary market transactions.

The total value of debt reduction, taking into account conversions of one type of external debt (usually loans) into other debt instruments or equity, or through buybacks, amounted to over $43 billion in 1988. The net reduction, however, is estimated to be only some $17 billion, or less than 5 percent of the stock of commercial bank debt to the highly indebted countries. Because of the large amount of debt-to-equity conversions, the impact on these countries' total external liability is less. A rough estimate, taking into account the increase in debt and equity investment liabilities, puts the net reduction of external liabilities in 1988 at $8.5 billion, or 40 percent of the retired debt.

Conclusion

The final verdict on the Baker plan is a mixed one. A number of HICs made progress in adjusting their external sector during 1986-88 and the threat to the international banking system abated. But external financing in support of adjustment programs remained scarce. Net resource flows to developing countries, particularly from commercial banks, continued to fall. Moreover, they were insufficient in meeting the investment needs of these countries and in helping them meet their debt service obligations.

Against this background, indebted countries had to cut back on investment. Their growth did not resume and living standards either stagnated or fell. The heavy debt burden continued to impede the mobilization of domestic resources, discourage repatriation of flight capital and direct foreign investment, and eroded the credibility of adjustment programs. This situation called for a strengthening of the ability of countries to sustain their adjustment efforts through a renewed debt strategy (see article by Michael P. Dooley and C. Maxwell Watson in this issue).
39. Debt Reorganization/Debt Reduction

Summary of the Discussion

Rapporteurs:
- Dr. Ahmad Hassan Mustafa, Jordan
- Mr. Syed Qmar Ibrahim Eltahir, Sudan
- Mr. Khalid Alaboodi, Saudi Arabia
- Dr. Hadenan Jalil, Malaysia

I. Introduction

The session on debt reorganization and debt reduction was included in the seminar to provide information and share the experiences of countries that had gone through the exercise of debt rescheduling. It was stated that debtor countries were not able to meet their debt obligations due to Balance of Payment problems in the mid-1970s. In view of the fact that the inability of developing countries to service and meet their debt obligations may affect the international financial conditions and financial institutions of developed countries, concerted efforts were made by creditor countries to solve this problem.

The seminar participants were exposed, in detail during this session, to the various initiatives that had been taken to reschedule and reduce debt of developing countries. The experiences of two countries - Sudan and Jordan - in rescheduling their debt were also highlighted during the session. The role of The World Bank and IMF was also covered.

II. Debt Rescheduling: Institutional Arrangements and Recent Trends

Countries faced with difficulties in servicing their external debt can seek debt relief through the multilateral fora of Paris Club and of London Club. An important prerequisite, however, to obtain debt relief is to have an arrangement with the IMF.

Paris Club is the forum for renegotiation of external official obligations including loans extended or guaranteed by creditor. The two parties to debt relief negotiation conclude an agreement called an Agreed Minute which specified the consolidation period, the types of loans reschedulable and other general terms. As regards to the rate of interest, it is negotiated bilaterally.

The London Club is the forum through which commercial credit can be renegotiated. A Steering Committee representing major creditor banks is formed to reach an agreement in principle with the debtor country called the Heads of Terms. The agreement becomes effective upon final approval by individual creditor banks. Negotiations with the London Club usually take a longer period than the Paris Club.

The seminar was informed that the debt crisis in its initial stages was seen as a liquidity problem requiring relief through limited refinancing. However, initiatives for more generous debt relief were subsequently advanced as the debt crisis persisted longer than was anticipated. One initiative was introduced by commercial bank creditors known as Multi-Year Restructuring Agreement [MYRA]. These agreements consolidated principal payments falling due over a 3-5 years. However, such agreements achieved little success.

In 1985 the Baker initiative was advanced with emphasis on debt relief for the highly indebted middle-income countries. The plan attempted to mobilize resources for new lending amounting to $20 billion from commercial banks and $9 billion from multilateral institutions. However, net lending under the plan was less than envisaged.

The limited success of combining debt restructuring with new lending led to a market related menu approach. This approach consisted of several alternatives such as buyback debt, exchange of claims, debt-equity swap and exit bonds. The benefits of this approach to debtor countries were rather limited.
The debt strategy was further enhanced in 1989 by the Brady Plan which emphasized debt reduction on voluntary basis by commercial banks. The reduction is either achieved through debt buy backs at a discount, or through exchange of debt for collateralized bonds with reduced interest or reduced principal. These transactions are to be financed by the IMF, The World Bank and Japan in addition to the resources from the debtor countries themselves.

III. Role of The World Bank and IMF in Debt Reorganization and Reduction

The seminar participants were briefed on the role of The World Bank and IMF [especially The World Bank] in helping countries to reschedule and reduce their debt. Both institutions work closely together, with the IMF has a more direct role in helping debtor countries to negotiate in the Paris Club. It was stated that the World Bank being a multilateral institution with ownership by both debtor and more so the creditor countries need to maintain its neutrality.

The World Bank’s efforts can be grouped as follows:

(a) provide support to stabilization programs of debtor countries;
(b) establish structural adjustment lending programs;
(c) mobilize funds from other sources for future development of debtor countries; and
(d) providing technical assistance in debt management.

It was elaborated during the seminar that for structural adjustment lending programs, both IMF and The World Bank work closely together. IMF concentrates on the monetary and exchange rate policies and The World Bank is more interested in long-term macroeconomic policies. It was stated that debtor countries which have implemented structural adjustment programs will be more likely to receive favorable response from creditor countries and commercial banks. To be qualified for structural adjustment loan, debtor government has to accept a package of agreed policies on the following areas:

(a) domestic resource mobilization that includes ways to increase revenue;
(b) improvement of resource allocation by public sector;
(c) reform economic incentives that should increase productivity and effective resource utilization;
(d) institutional reforms; and
(e) social cost of structural adjustment.

It was stated that the efforts on The World Bank to improve debtor countries through structural adjustment programs have mixed results. For countries that undertook long-term reforms and continue to borrow under the program, growth performance has been encouraging. On the other hand The World Bank observed that its efforts have been negated by these factors:

(a) countries are not able to retain the commitment towards the policies indicated earlier;
(b) institution changes are slow; and
(c) burden of debt is too 'deep' making it impossible for any benefit of adjustment to be recognized in the short-term as it may not exist at all.

IV. Experience in Debt Rescheduling

The experiences of two countries i.e. Sudan and Jordan, with the Paris Club were highlighted in the seminar. Sudan's relation with the Club began in 1979 and up-to-date four negotiations had been held between Sudan and the Club. As a result of the negotiations, debt totalling US$1480 million had been rescheduled. The terms and conditions for the rescheduled exercise had been attractive to Sudan with grace period up to 6 1/2 years. In addition, agreement with the Club has been extended to cover short-term insured credit and arrears of the earlier Paris Club agreements. As for Jordan, the need to go to the Paris Club arises out of economic depression and decline of oil prices for the period 1982-1983. With the reduction of remittance from overseas, massive foreign borrowings and the
draw down of reserves were undertaken to finance budget deficit. The agreement between Jordan and Paris Club was finalized in June 1989 which cover 100% of principal amount due. A grace period of 5 years was given under the agreement.

In addition to the Paris Club, the two countries had also renegotiated with the commercial banks. The magnitude of debt with the commercial banks remained to be substantial as shown in the case of Sudan which is at the level of US$1.8 billion. The seminar was informed by the delegate from Jordan that negotiations with commercial banks was a complex exercise and can lead to additional cost. While Jordan has completed one negotiation with the commercial bank, an agreement is yet to be concluded by Sudan.

V. Conclusion

It was noted from the discussion during this session that debt rescheduling and debt reduction is a complex issue that may take a long time to arrive at a conclusion. As a result of the deliberation, the following issues need to be addressed in future:

(a) Commitment by both creditor and debtor countries to the effort in solving the debt problem. The success of initiatives drawn up to overcome debt problem has often been frustrated by lack of support, for example, new money that are due from commercial banks were not forthcoming. Similarly, debtor countries failed to continually follow adjustment policies;

(b) Efforts to conclude a rescheduling agreements take a long time due to sheer number of parties involved in the negotiations; ways must be found to shorten the time period;

(c) Experiences in some countries show that debtor countries may not be able to meet their new obligations under a debt relief agreement since they are "too deep" in debt. Efforts must be directed to overcome this issue;

(d) The seminar participants noted that The World Bank and IMF have played important role in the area of helping debtor countries. Views have been expressed that The World Bank should provide avenues for negotiators of debtor countries to acquire skill in negotiating with creditor countries and commercial banks; and

(e) In the process of implementing structural adjustment programs within debtor countries, the conditions should not create unreasonable impact on the social, economic and political framework of a debtor country. The World Bank or the IMF should review the conditionalties from time to time.
Seminar Program

Saturday, May 12th

9:00 - 10:30 Opening ceremonies

Keynote address

Speaker: Mr. Osman Sek, Vice President, Islamic Development Bank

Administrative matters

11:00 - 12:30 EXTERNAL FINANCE AND DEVELOPMENT; THE CURRENT DEBT PROBLEM
[An overview of the relationship between external finance and development; an examination of the patterns and trends of external capital movements in the 1980s; the evolution of the debt problem as it affects various groups of developing countries.]

Speaker: Mr. Husain


Ishrat Husain. "External Debt and Development" (May 1990)

1:15 - 2:30 AN OVERVIEW OF DEBT MANAGEMENT
[Introduction to the problems of debt management: Limits to borrowing, the choice of finance, knowing the debt. Discussion of organization of debt management - participants prepare oranigrams of how debt management is organized in their countries.]

Speaker: Mr. Husain


Ishrat Husain and Manuel Trucco, "A Model for Effective External Debt Management" (March 1990)

5:00 - 6:30 DISCUSSION OF DEBT AND DEBT MANAGEMENT PROBLEMS IN IDB COUNTRIES PARTICIPATING IN THIS SEMINAR
ANNEX A

Sunday, May 13th

9:00 - 10:30 MACROECONOMIC ISSUES: THE BALANCE-OF-PAYMENTS, THE BUDGET AND DEBT
[Inter-relationship between macroeconomic variables; internal and external shocks]

Speaker: Mr. Michalopoulos

Readings: Rudiger Dornbusch and F. Leslie C. H. Helmers, "The Open Economy"

John Underwood, "Debt in a Macroeconomic Context" (Feb 1989)


11:00 - 12:30 POLICIES FOR STABILIZATION AND STRUCTURAL ADJUSTMENT:
IMPLICATIONS FOR DEBT MANAGEMENT
[Problems of restoring growth and maintaining price stability; external and internal adjustment; country experiences]

Speaker: Mr. Michalopoulos


Constantine Michalopoulos and Ishac Diwan, "Debt and Adjustment in EMENA" (July 1988)


1:15 - 2:30 EXTERNAL LOAN FINANCING: SOURCES, TERMS, DIRECTION AND PROSPECTS
[The outlook for concessional official, official and officially-guaranteed export credits, and commercial bank lending to developing countries.]

Speaker: Mr. Husain

Readings: Anthony Lanyi, "Issues in Capital Flows to Developing Countries", Finance and Development (Sep 1987)
ANNEX A

Miranda Xafa, "Export Credits and the Debt Crisis", Finance and Development (March 1987)

Joint Ministerial Committee of the Boards of Governors of the World Bank and the International Monetary Fund on the Transfer of Real Resources to Developing Countries (Development Committee), "The Adequacy of Resource Flows to Developing Countries" (Sep. 1988)

5:00 - 6:30 ALTERNATE SOURCES OF FINANCING: TRENDS AND OUTLOOK FOR IDB MEMBER COUNTRIES
(at Hotel) [Panel discussion: Messrs Husain and Michalopoulos and participants from Malaysia and Turkey]


Andrea Gubitz, "Foreign Direct Investment: Recent Trends and Policy Issues" (May 1990)

Stijn Claessens, "Alternative Forms of External Financing for Developing Countries" (May 1990)


Monday, May 14th

9:00 - 10:30 DEBT RESCHEDULING: INSTITUTIONAL ARRANGEMENTS AND RECENT TRENDS [Multilateral debt relief through the Paris Club and commercial bank steering committees; country experiences]

Speaker: Mr. Klein
Mr. Abu Ghazaleh (Jordan); Mr. Eltahir (Sudan)

Readings: Thomas Klein, "Multilateral Debt Relief: A Retrospective View" (May 1990)
### ANNEX A

**11:00 - 12:30 DEBT RESTRUCTURING: VOLUNTARY DEBT AND DEBT SERVICE REDUCTION**

[The Toronto summit approach for official claims on low income countries; the market based menu approach and officially-supported DDSR for commercial bank claims on developing countries]

**Speakers:** Mr. Klein and Mr. Husain

**Readings:**
- Michael Blackwell and Simon Nocera, "The Impact of Debt to Equity Conversion", *Finance and Development* (June 1988)
- Stanley Fischer and Ishrat Husain, "Managing the Debt Crisis in the 1990s", *Finance and Development* (June 1990)
- Ishrat Husain, "Recent Experience with the Debt Strategy", *Finance and Development* (Sep 1989)

**1:15 - 2:30 ROLE OF THE IMF AND WORLD BANK IN EXTERNAL DEBT STRATEGY.**

[The work of the Bank and the Fund and what they do to support debt management efforts of member countries.]  

**Speaker:** Mr. Michalopoulos

**Readings:**
- David Bock, "The Bank's Role in Resolving the Debt Crisis", *Finance and Development* (June 1988)
- Vinod Thomas and Ajay Chhibber, *Adjustment Lending: How it has Worked and How it can be Improved*, The World Bank: 1989
5:00 - 6:30  THE ADMINISTRATION OF FOREIGN BORROWING  
(at Hotel)  [Essential features of organization for foreign borrowing.  
Comparison of country experiences.]  
Speaker: Mr. Klein  
Readings: Lars Kalderen, "Institutional Aspects of External Debt Management" (Oct 1986)

Tuesday, May 15th

9:00 - 10:30  DEBT INFORMATION SYSTEMS  
[The underlying sources of national data on external debt and capital flows; how to diagnose and seek remedies to statistical problems]  
Speaker: Mr. Klein  
Readings: Thomas Klein, "External Debt Information Systems" (1990)  
Rachel Weaving, "Measuring Developing Countries' External Debt" Finance and Development (Mar 1987)

11:00 - 12:30  THE WORLD BANK'S DEBTOR REPORTING SYSTEM  
[Debt reporting to the World Bank: Reporting procedures; problems and issues; potential feed-back of information for country use; the World Debt Tables; technical assistance possibilities for improving debt statistics]  
Speakers: Mr. Klein  

1:15 - 2:30  USE OF COMPUTERS FOR MANAGERS OF EXTERNAL DEBT  
[Integration of computerized methods in debt management with respect to accounting, statistics and analysis; recent focus of software development on developing managerial tools; how the computerization of managerial functions can be implemented.]  
Speakers: Mr. Klein  
Mr. Khanani (Islamic Development Bank)  
Mr. S. S. Hussain Zaidi (Pakistan)  
Readings: Hugh Dowsett, "The Use of Computers in Debt Management" (June 1986)
ANNEX A

David Hunsberger, "How to Computerize a Debt Office" (April 1987)


5:00 - 6:30 FURTHER DISCUSSION OF COMPUTERIZATION ISSUES
(at Hotel)

Wednesday, May 16th

9:00 - 10:30 ORGANIZATION FOR DEBT MANAGEMENT
[Comparison of organizational structure of debt management. Presentation and discussion of two country systems.]

Moderator: Mr. Husain

Country Presentations:

11:00 - 12:30 GROUP WORKING SESSIONS
[Participants meet in separate groups to prepare reports.]

1:15 - 2:30 SUMMATION
Participant groups make their reports; discussion.

Seminar evaluation
Closing ceremonies
List of Speakers

Mr. Ishrat Husain
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Mr. Anwar Khanani
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Mr. Thomas Klein
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