
INTERNATIONAL FINANCIAL MARKETS AND THE EXTERNAL DEBT OF DEVELOPING COUNTRIES

A. Recent trends in private external financing

During 1996 there was a continuation of the previous year's expansion of most major categories of external financing from international financial markets. This is exemplified in table 10 for selected instruments involving international issuance or syndication, but a similar expansion also characterized cross-border transactions in domestically issued securities of several countries. An especially large increase was recorded by issues of external bonds, but it may well have been linked to some extent to the reduced recourse by borrowers to syndicated credits, which is also evident from the table. The shares of developing countries and transition economies in most categories of financing remain fairly small but have substantially risen since the early 1990s for issues of both external bonds and international equities. Moreover, as is illustrated by the remarks which follow, not only the financial markets but also the economies more generally of several such countries are increasingly experiencing effects of global financial integration.

In recent issues of *TDR* attention has been drawn to the way in which such integration has been accompanied by changes at the level of transactions, with implications for the categorization of different financial flows, and by the emergence of sources of private external financing for developing countries in emerging financial markets themselves. In *TDR 96*, for example, there was a

discussion of the progressive blurring of the distinction between international bonds and Euro-medium-term notes (EMTNs), and attention was drawn to the growing importance to portfolio investment in developing countries of purchases of domestically issued instruments by mutual funds and of cross-border flows originating in other developing countries, mainly in East Asia. Both these trends continued to be evident in 1996. For example, the Bank for International Settlements (BIS) recently noted that over 60 per cent of drawings made under EMTN programmes consisted of international bonds.¹ Funds flowing directly into the stock markets of developing countries of East Asia, which already accounted for more than 60 per cent of total portfolio equity investment in the region in 1995, continued to increase in 1996.² Banks and individuals in Asian countries other than Japan have become significant purchasers of debt as well as equity instruments issued not only by Asian entities but also by Latin American ones. This trend is likely to be accelerated by the establishment of more mutual funds holding bonds in their portfolios (a recent phenomenon in Asia) and diversification of their portfolios by the institutions in the region managing pension schemes.³ Similar developments are evident in Latin America, though they are at an earlier stage. For example, Chilean investments abroad during the last six years are estimated at \$12 billion, of which much the greatest part is in other Latin American countries.⁴

Table 10

**SELECTED CATEGORIES OF INTERNATIONAL FINANCING AND SHARES
OF DEVELOPING AND TRANSITION ECONOMIES THEREIN, 1992-1996**

(Billions of dollars and percentage shares)

| Category | 1992 | 1993 | 1994 | 1995 | 1996 |
|--|-------|-------|-------|-------|-------|
| External bond offerings | | | | | |
| Total (\$ billion) | 333.7 | 481.0 | 428.6 | 467.3 | 710.6 |
| Share of developing countries ^a | 5.5 | 10.6 | 11.5 | 10.2 | 14.4 |
| Syndicated credits | | | | | |
| Total (\$ billion) | 117.9 | 136.7 | 236.2 | 370.2 | 343.4 |
| Share of developing countries ^a | 16.4 | 16.4 | 10.3 | 11.5 | 12.0 |
| Eurocommercial paper programmes | | | | | |
| Total (\$ billion) | 28.9 | 38.4 | 30.8 | 55.9 | 80.6 |
| Share of developing countries ^a | 11.8 | 7.8 | 6.5 | 15.9 | 3.8 |
| Other non-underwritten facilities^b | | | | | |
| Total (\$ billion) | 99.0 | 113.6 | 222.1 | 346.1 | 375.0 |
| Share of developing countries ^a | 4.6 | 6.2 | 5.4 | 5.1 | 6.2 |
| International equity^c | | | | | |
| Total (\$ billion) | 23.5 | 40.7 | 45.0 | 41.0 | 57.7 |
| Share of developing countries ^a | 15.3 | 18.9 | 23.6 | 25.1 | 24.1 |

Source: OECD, *Financial Market Trends*, March 1997; UNCTAD secretariat estimates.

a Including the transition economies of Eastern Europe.

b Non-underwritten syndicated borrowing facilities, including medium-term note (MTN) programmes but excluding Eurocommercial paper.

c Including international placements of equity for privatizations.

The internationalization of financial markets is also blurring distinctions between international and certain domestically issued bonds. The distinctions long used for this purpose, with some exceptions due to the peculiarities of certain countries' regulatory regimes, resulted in the traditional categorization of bonds issued by non-residents in a particular country's financial market and denominated in its currency as foreign bonds, and of bonds issued by residents or non-residents in foreign currency as eurobonds. International bonds consisted of foreign bonds and eurobonds. Other bonds (i.e. those issued by residents in domestic currency) were classified as domestic. This categorization fails to take account of other features shared by international and certain domestic bonds such as

an investor base consisting of non-residents as well as residents and arrangements for listing, issuing, trading and settlement - features whose importance has tended to increase with internationalization. As a result, bond issues in domestic currency, those by both non-resident and resident issuers which are targeted at non-resident investors, are now widely defined by major reporting organizations as eurobonds, while foreign bonds are defined as those issued by non-residents and targeted at residents and domestic bonds as those for which both the issuers and the targeted investors are residents.⁵

As shown in table 11, there was continued growth during 1996 (the first three quarters) for the third consecutive year in the total external

Table 11

| EXTERNAL ASSETS OF BANKS IN THE BIS REPORTING AREA^a VIS-A-VIS DEVELOPING AND TRANSITION ECONOMIES, 1994-1996 | | | | |
|--|--|-------------|-------------|-------------------------------|
| | <i>Percentage increase^b</i> | | | <i>Stock in Dec. 1996</i> |
| | 1994 | 1995 | 1996 | \$ billion |
| Total^c | 7.4 | 14.4 | 13.0 | 845 |
| <i>of which in:</i> | | | | |
| Latin America | 0.9 | 7.1 | 8.8 | 267 |
| Africa | -6.4 | -8.8 | -5.9 | 37 |
| West Asia | -2.7 | -5.3 | 5.3 | 93 |
| East and South Asia | 20.5 | 30.4 | 19.4 | 439 |
| Central Asia | 102.0 | 30.6 | 38.9 | 2 |
| Eastern Europe | -15.5 | 3.9 | 11.9 | 93 |
| Other Europe ^d | 4.7 | 8.4 | 24.8 | 7 |
| All borrowers ^e | 4.2 | 9.6 | 6.2 | 8290 |

Source: BIS, *International Banking and Financial Market Developments*, various issues.

a Including certain offshore branches of United States banks.

b Based on end-year data after adjustment for movements of exchange rates.

c Excluding offshore banking centres, i.e. in Latin America: Bahamas, Barbados, Bermuda, Netherlands Antilles, Cayman Islands and Panama; in Africa: Liberia; in West Asia: Bahrain and Lebanon; and in East and South Asia: Hong Kong, Singapore and Vanuatu.

d Malta, Bosnia and Herzegovina, Croatia, Slovenia, The former Yugoslav Republic of Macedonia, and Yugoslavia.

e Including multilateral institutions.

claims on developing countries other than offshore centres of banks in the BIS-reporting area (after adjustment for the effect of fluctuations in exchange rates), and only Africa, of the regions specified, experienced a decrease. In the case of export credits, as shown in table 12, overall increases in net flows to developing countries and transition economies in 1995 and the first half of 1996 were accompanied by contractions for Africa and Latin America, and in 1995 for Eastern Europe.

As in other recent years, financing from the international capital markets was heavily concentrated on a limited number of developing countries, although 1996 and early 1997 were also notable for first-time or renewed access to the market for internationally issued debt instruments for several countries. For example, eight developing countries or territories of East and South-East Asia⁶ accounted for almost two thirds of the exchange-

rate-adjusted increase during 1996 in external claims on developing countries (other than offshore centres) of banks in the BIS-reporting area. The same eight countries, except Taiwan Province of China, accounted for 40 per cent of net international debt issues by developing countries and economies in transition, while five Latin American countries were recipients of more than 50 per cent of net flows in this form.⁷

Since mid-1996 a number of countries have issued international bonds for the first time or returned to the market for such bonds after long absences. They include Jordan, Tunisia, Panama, Croatia, Estonia, Latvia, Lithuania, Poland, Romania, Russian Federation and Kazakhstan. Moreover, after an earlier small private placement of \$10 million, Ecuador issued a eurobond of \$400 million. The Russian issue was for more than \$1 billion, and was followed by another for a still

Table 12

TOTAL EXPORT CREDITS^a TO DEVELOPING AND TRANSITION ECONOMIES, BY REGION

| A. Prevalence of negative flows | | | | | | | | | |
|---|--------------|--------------|--------------|-------------|----------------------|--------------------|-----------|-----------|-----------|
| (Percentage of the number of countries in the region ^b) | | | | | | | | | |
| Region | 1992 | | 1993 | | 1994 | | 1995 | | 1996 |
| | 1st half | 2nd half | 1st half | 2nd half | 1st half | 2nd half | 1st half | 2nd half | 1st half |
| Total | 41 | 38 | 38 | 48 | 43 | 34 | 36 | 51 | 47 |
| <i>of which in:</i> | | | | | | | | | |
| Africa | 42 | 48 | 52 | 58 | 64 | 42 | 52 | 56 | 56 |
| Latin America | 51 | 46 | 38 | 43 | 38 | 30 | 30 | 57 | 54 |
| West Asia | 57 | 36 | 14 | 50 | 57 | 36 | 36 | 57 | 14 |
| East and South Asia ^c | 17 | 17 | 30 | 45 | 27 | 21 | 30 | 42 | 36 |
| Central Asia ^d | .. | .. | .. | .. | 12 | 12 | - | 12 | 37 |
| Eastern Europe ^e | 43 | 29 | 43 | 29 | 29 | 43 | 36 | 50 | 50 |
| B. Net flow and stock in mid-1996 | | | | | | | | | |
| (Millions of dollars) | | | | | | | | | |
| Region | | | | | Net flow | | Stock | | |
| | 1992 | 1993 | 1994 | 1995 | 1996 (first half) | (end-June 1996) | | | |
| Total | 25216 | 20903 | 17398 | 6466 | 3103 | 316189 | | | |
| <i>of which in:</i> | | | | | | | | | |
| Africa | 2583 | 2164 | -65 | -617 | -1131 | 62365 | | | |
| Latin America | 4641 | 3869 | 1740 | -3562 | -760 | 65648 | | | |
| West Asia | 1687 | 2173 | 2042 | 1224 | 1815 | 45974 | | | |
| East and South Asia ^c | 8348 | 6058 | 16404 | 10235 | 3047 | 88504 | | | |
| Central Asia ^d | .. | .. | 532 | 345 | 40 | 1433 | | | |
| Eastern Europe ^e | 8015 | 5929 | -2704 | -1552 | 187 | 48533 | | | |

Source: BIS and OECD, *Statistics on External Indebtedness, Bank and Trade-related Non-bank Claims on Individual Borrowing Countries and Territories*, new series, various issues.

a After adjustment for movements of exchange rates.

b Excluding countries for which data are not available.

c Including Oceania; and from 1993 also China, People's Democratic Republic of Korea, Mongolia and Viet Nam.

d Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan.

e Up to 1993: the former socialist countries of Eastern Europe; 1994-1996: Bulgaria, Czech Republic, Hungary, Poland, Romania, the Baltic States and countries members of CIS (excluding those listed in note **d**).

larger amount (\$2 billion). The initial Russian and Polish issues have been followed by municipal as well as corporate issues: for example, St. Petersburg recently raised \$300 million.

These first-time issues and returns to the bond market were accompanied by the first-time assignment of credit ratings to the foreign currency debt of a number of countries by the major credit rating agencies as well as by several upward and downward movements in ratings of other countries. Amongst the countries receiving ratings from Moody's and Standard and Poor's for the first time were Egypt (whose rating from Standard and Poor's in January 1997 was of investment grade),⁸ Kazakhstan, Lebanon, Panama, Republic of Moldova, Romania, Russian Federation, and Trinidad and Tobago. Hungary received a rating of investment grade from Standard and Poor's (after having earlier received such a rating from other

agencies), Tunisia received such ratings from Moody's and Standard and Poor's, Uruguay such a rating from Moody's, and Lithuania from Standard and Poor's. An interesting development in April 1977 was the assignment by Standard and Poor's to a number of Argentine corporations of a rating higher than that of the country's sovereign entities. This was justified by the agency's belief that Argentina's monetary regime, whose linking of the money supply to foreign exchange reserves had withstood strains imposed by capital outflows in the aftermath of the Mexican crisis in 1995, had reduced the importance of country risk⁹ sufficiently for borrowing entities in both the public and the private sector to be evaluated purely for their credit risk.¹⁰ Other major rating agencies have yet to depart from the more traditional approach which, for the great majority of loans, assigns to sovereign entities a rating which sets a ceiling to those accorded to other borrowers.

B. Capital flows and policy responses in selected developing countries

1996 and early 1997 witnessed significant shifts in capital flows to emerging financial markets and in recipient countries' policies towards such flows. With the exception of the period following the crisis of Mexico's external payments at the beginning of 1995, policies in these countries during the 1990s have been directed more to overcoming the problems caused by large capital inflows than to the traditional preoccupation of earlier years, namely the attraction of inflows adequate to cover deficits on current account, while none the less ensuring that investment in certain activities or sectors was reserved partly or wholly for residents.¹¹ The inflows were largely the effect of the changes in the portfolios of institutional investors associated with the process of integrating selected developing countries and transition economies into the global network of financial markets. Now that this integration has become well established (though the number of countries affected is likely to continue to increase in future), all the fi-

ancial markets involved can expect to experience the effects of changing perceptions among international investors in both favourable and unfavourable directions. Developments in international financial markets since mid-1996 exemplify this situation: unfavourable shifts in investors' perceptions regarding countries only recently in receipt of large inflows, in response partly to substantial current account deficits but also to domestic developments (especially, in one case, the proliferation of the financial sector's non-performing loans), have led to large outflows and periods of strong downward pressure on exchange rates. Policy reactions in the countries affected have included measures directed at the balance of payments as well as others with a primarily internal focus. Elsewhere, policy towards the capital account has included both restrictive measures and more accommodating stances, depending on whether the primary concern of the country in question was to moderate or to sustain capital inflows.

Table 13

**EXTERNAL FINANCING FOR SELECTED DEVELOPING AND TRANSITION ECONOMIES
BY MAJOR CATEGORIES, 1991-1995**

| Country | Cumulative total | Loans ^a | Internationally issued portfolio investments | | Net FDI |
|----------------------------|---------------------|--------------------|---|---------------------|---------|
| | | | Debt ^b | Equity ^c | |
| | (\$ billion) | | (Per cent of total) | | |
| Latin America | | | | | |
| Argentina | 46.4 | 10 | 45 | 12 | 33 |
| Brazil | 37.7 | 20 | 49 | 9 | 22 |
| Chile | 13.5 | 36 | 5 | 21 | 38 |
| Colombia | 10.5 | 36 | 17 | 5 | 43 |
| Mexico | 74.4 | 19 | 28 | 18 | 35 |
| Peru | 5.0 | 23 | 0 | 3 | 74 |
| East and South Asia | | | | | |
| China | 152.6 | 23 | 4 | 7 | 65 |
| India | 11.9 | 24 | 2 | 51 | 24 |
| Indonesia | 26.3 | 30 | 8 | 17 | 45 |
| Malaysia | 27.8 | 33 | -4 | 7 | 64 |
| Philippines | 8.9 | -19 | 27 | 38 | 54 |
| Republic of Korea | 74.6 | 68 | 28 | 10 | -6 |
| Thailand | 91.8 | 84 | 4 | 5 | 7 |
| Eastern Europe | | | | | |
| Czech Republic | 11.0 | 30 | 36 | 0 | 33 |
| Hungary | 12.3 | -35 | 50 | 6 | 79 |

Source: BIS, *International Banking and Financial Market Developments*, various issues; IMF, *International Capital Markets, World Economic and Financial Surveys* (Washington D.C.: IMF), various issues; World Bank, *Global Development Finance*, Vol. 1 (Washington D.C.: World Bank, 1997); and UNCTAD, *World Investment Report, 1996* (United Nations publication, Sales No. E.96.II.A.14).

a Estimated exchange-rate-adjusted changes in the external positions of assets of BIS-reporting banks vis-à-vis individual countries.

b Net issues of international debt securities by country of residence, including euronotes and international bond issues.

c International equity issues and the change in the year-end net asset value of international emerging market equity funds.

During the first half of the 1990s, there was substantial variation in both the scale and the character of recipient developing countries' dependence on major categories of debt and non-debt external financing from the international financial markets, as shown in table 13. For example, for the Latin American countries in the table bank lending tended to be less important as a share of such financing than for the Asian countries, with the outstanding exception of the Philippines. This reflected the

continuing effects of the debt crisis of the 1980s, which included restraints on new lending by banks and reductions in their outstanding exposure resulting from restructuring agreements. The relatively high shares of internationally issued bonds and other debt instruments for some Latin American countries is a result of their recent return to international financial markets.¹² Two Asian countries (China and Malaysia), one Latin American country (Peru), and one Central European country

(Hungary) depended to an exceptional extent on FDI in comparison to the other countries in the table.¹³ In Hungary and the Czech Republic (as well as in Poland, which is not shown in the table) substantial shares of the FDI were associated with the purchase by external investors of shares in privatized enterprises, and relatively small shares (only about 20 per cent according to OECD estimates) were associated with “green field” operations involving the creation of new facilities from scratch.¹⁴

Since 1996 net flows of FDI and of debt securities to both Latin America and East and South-East Asia have continued to increase. Figures for debt financing in 1996 and early 1997, however, point to improvements in the perceptions of international investors regarding the position of the main borrowing countries of Latin America but greater caution regarding some of the Asian recipients. Thus, whilst there was an acceleration of the growth in the exposure of banks in the BIS-reporting area (after adjustment for changes in exchange rates) to Latin America (\$16.4 billion in 1995 and \$21.8 billion in 1996), the growth in exposure to East and South Asian countries slackened from \$86.3 billion to \$72.3 billion.¹⁵ Moreover, the greater caution noted above probably also contributed to depressing issues of debt instruments by East and South-East Asian entities in the first quarter of 1997.¹⁶

Table 14 makes possible a preliminary review of trends in the external financing of selected developing countries from the international financial markets. One country shown (Venezuela) ran a surplus on current account in 1996. As in other recent years, the shares of external financing in the form of net FDI (generally regarded as being associated with a more durable commitment by investors to recipient economies) varied widely, as did the proportions of deficits on current account covered by such inflows. The deficit on current account of China, which, as in other recent years, was the largest recipient of FDI,¹⁷ was covered eight times by its net inflow in this form. Other countries whose current account deficits were covered by net FDI were Mexico (more than three times), Poland (three times), and Hungary (for which the ratio of net FDI to the deficit was one). For the remaining countries other than the Republic of Korea (which was a net provider of FDI) the proportion of the deficit covered by net FDI ranged from above 75 per cent (Malaysia: 98 per cent, Peru: 94 per cent, Chile: 88 per cent, and Indone-

sia: 78 per cent) through 50-70 per cent (Colombia: 54 per cent, and Argentina: 50 per cent) to below 40 per cent (Czech Republic: 31 per cent, Brazil: 23 per cent, and Thailand: 21 per cent).¹⁸

Other, more disaggregated, data concerning the external financing in 1996 and early 1997 from the international financial markets of the countries shown in table 14 provide additional information as to the context of the policy measures associated with their capital inflows and outflows (discussed below). As can be seen from table 15, in 1996 all the Asian countries except Thailand increased their net borrowing (after adjustment for changes in exchange rates) from banks in the BIS-reporting area and the Republic of Korea replaced Thailand as the largest net borrower, the decrease in the figure for the latter amounting to \$30 billion. Moreover, all these countries (including Thailand) increased their net issues of international debt securities. For all the Latin American countries in table 14 except Venezuela the growth in the (exchange-rate-adjusted) exposure of BIS-reporting banks was positive in 1996, but not always at levels higher than in 1995. However, with the exception of Venezuela and Peru, these countries were recipients of greater amounts of money through net issues of international debt securities, Argentina, Brazil and Mexico all being net borrowers of more than \$10 billion in this form.¹⁹ As regards the countries of Central and Eastern Europe the (exchange-rate adjusted) exposure of BIS-reporting banks increased during 1996 for the Czech Republic and Hungary but contracted for Poland (which, however was the recipient of \$0.4 billion in net issues of international debt securities).

As in other years since the beginning of the 1990s, borrowing during 1996 in the form of both bank loans and debt securities by the countries in table 14 was driven partly by arbitrage operations of banks in the recipient countries, for onward lending domestically at higher interest rates of funds raised in international markets. Countries for which such arbitrage was particularly important (and for which indications of the differentials between domestic interest rates and those in major OECD countries are given in table 16) included Brazil, for which 64 per cent of the increase in its (exchange-rate-adjusted) liabilities to BIS-reporting banks and almost 30 per cent of its net issues of international debt securities were inter-bank, the Republic of Korea (for which the corresponding percentages were 76 per cent and 56 per cent),

Table 14 (concluded)

| | EASTERN EUROPE (cont.) | | | | | | LATIN AMERICA | | | | | | | | | |
|---|------------------------------|------|------|-------------------|------------------|-------|---------------|-------------------|------|-----------|-------|-------------------|------|------|------|-------------------|
| | Poland | | | Argentina | | | Brazil | | | Chile | | | | | | |
| | 1994 | 1995 | 1996 | 1997 ^e | 1994 | 1995 | 1996 | 1997 ^e | 1994 | 1995 | 1996 | 1997 ^e | 1994 | 1995 | 1996 | 1997 ^e |
| Current account balance | -2.6 | -4.2 | -1.4 | -1.5 | -9.4 | -2.4 | -4.0 | .. | -1.2 | -18.1 | -24.3 | -6.8 | -0.6 | 0.2 | -2.5 | .. |
| Per cent of GDP | -2.8 | -3.6 | -1.0 | .. | -3.3 | -0.9 | -1.4 | .. | -0.2 | -2.5 | -3.3 | .. | -1.2 | 0.2 | -3.3 | .. |
| Net direct investment | 1.8 | 3.6 | 4.2 | .. | 0.5 | 1.2 | 2.0 | .. | 2.0 | 3.5 | 5.5 | .. | 0.8 | 1.0 | 2.2 | .. |
| Net portfolio investment ^a | -0.6 | 1.2 | .. | .. | 3.7 | 4.7 | 11.5 | .. | 44.7 | 9.4 | 10.5 | .. | 0.9 | - | 3.1 | .. |
| Short-term debt ^b | 0.2 | 1.1 | 1.2 | .. | 12.2 | 14.5 | 15.9 | .. | 36.4 | 43.7 | 46.5 | .. | 3.9 | 3.5 | 3.3 | .. |
| Import cover (months) ^c | 3.1 | 5.2 | 5.0 | 4.9 | 6.7 | 7.2 | 7.9 | 6.7 | 10.2 | 9.4 | 10.5 | 9.9 | 11.5 | 9.4 | 8.9 | 9.2 |
| Short-term debt plus current account deficit (percentage of reserves ^d) | 48 | 36 | 14 | .. | 151 | 118 | 110 | .. | 101 | 124 | 121 | .. | 34 | 23 | 39 | .. |
| Interbank debt (percentage of total bank debt ^f) | 21 | 24 | 32 | .. | 29 | 31 | 32 | .. | 38 | 45 | 48 | .. | 43 | 37 | 31 | .. |
| | LATIN AMERICA (cont.) | | | | | | | | | | | | | | | |
| | Colombia | | | Mexico | | | Peru | | | Venezuela | | | | | | |
| | 1994 | 1995 | 1996 | 1997 ^e | 1994 | 1995 | 1996 | 1997 ^e | 1994 | 1995 | 1996 | 1997 ^e | 1994 | 1995 | 1996 | 1997 ^e |
| Current account balance | -3.2 | -4.1 | -4.8 | .. | -29.4 | -0.7 | -1.8 | 0.4 | -2.2 | -4.2 | -3.6 | .. | 2.5 | 2.3 | 7.4 | .. |
| Per cent of GDP | -4.7 | -5.1 | -5.7 | .. | -7.0 | -0.2 | -0.5 | .. | -4.3 | -7.2 | -5.8 | .. | 2.8 | 1.4 | 11.4 | .. |
| Net direct investment | 1.5 | 2.2 | 2.6 | .. | 11.0 | 7.0 | 6.4 | 0.9 | 2.9 | 1.9 | 3.4 | .. | 0.1 | 0.6 | 1.4 | .. |
| Net portfolio investment ^a | 0.4 | - | .. | .. | 7.6 | -10.8 | 20.6 | 2.8 | 0.6 | 0.2 | 1.0 | .. | 0.3 | 0.3 | .. | .. |
| Short-term debt ^b | 3.6 | 4.6 | 5.0 | .. | 59.7 | 43.1 | 45.0 | .. | 3.9 | 4.5 | 4.9 | .. | 2.1 | 2.8 | 3.2 | .. |
| Import cover (months) ^c | 6.7 | 6.0 | 7.2 | .. | 0.8 | 2.5 | 2.4 | 4.3 | 11.8 | 10.2 | 12.9 | .. | 7.3 | 4.6 | 9.2 | 11.7 |
| Short-term debt plus current account deficit (percentage of reserves ^d) | 87 | 107 | 102 | .. | 900 ^f | 267 | 241 | .. | 87 | 106 | 80 | .. | -5 | 8 | -32 | .. |
| Interbank debt (percentage of total bank debt ^f) | 24 | 24 | 28 | .. | 32 | 26 | 24 | .. | 29 | 38 | 44 | .. | 15 | 17 | 16 | .. |

Source: BIS, ECLAC, IMF, World Bank, J.P. Morgan, Union Bank of Switzerland, and UNCTAD secretariat estimates. For more details see the notes to this chapter.

^a Externally issued bonds, other securitized debt instruments and equities.

^b At end of year.

^c Import cover is reserves divided by imports times the number of months in period. Reserves are international reserves minus gold at the end of the period (end of February 1997 for Indonesia, Malaysia and Peru).

^d For reserves see note c.

^e First quarter.

^f Based on a mid-December estimate of reserves.

Table 15

**INTERNATIONAL BANK LENDING AND
OTHER DEBT FINANCING FOR
SELECTED COUNTRIES,
1995 AND 1996**

(Billions of dollars)

| Country | Internationally issued debt securities ^a | | Change in outstanding bank loans ^b | |
|-------------------|---|------|---|------|
| | 1995 | 1996 | 1995 | 1996 |
| China | 0.3 | 1.5 | 10.2 | 13.4 |
| Indonesia | 0.1 | 1.9 | 6.9 | 8.1 |
| Republic of Korea | 8.6 | 17.2 | 22.5 | 25.9 |
| Malaysia | 1.4 | 4.6 | 3.2 | 7.2 |
| Philippines | 0.5 | 3.1 | 1.5 | 5.4 |
| Thailand | 1.3 | 4.4 | 38.8 | 8.9 |
| Czech Republic | .. | .. | 3.6 | 1.9 |
| Hungary | 1.9 | -0.8 | -0.3 | 0.8 |
| Poland | 0.2 | 0.4 | 0.2 | -0.4 |
| Argentina | 7.6 | 11.5 | 1.9 | 3.3 |
| Brazil | 6.0 | 11.8 | 12.0 | 10.0 |
| Chile | 0.1 | 2.3 | 1.4 | 0.5 |
| Colombia | 0.7 | 1.8 | 1.5 | 3.1 |
| Mexico | 0.9 | 14.1 | -4.2 | 1.0 |
| Peru | .. | .. | 1.6 | 2.6 |
| Venezuela | -0.4 | -0.4 | -1.7 | -0.8 |

Source: BIS, *International Banking and Financial Market Developments*, May 1997, tables 5A and 10A.

a Net issues of euronotes and international bonds.

b Change in exchange-rate-adjusted exposure of BIS-reporting banks to the country.

Malaysia (80 per cent and 4 per cent), and Thailand (82 per cent and 42 per cent).²⁰

The problems for policy caused by large capital flows (inward and outward) have led since mid-1996 to various responses from the governments of countries affected by them. In Latin America these responses continue to be character-

ized by markedly different degrees of interventionism. Argentina, for example, has opted for a largely non-interventionist approach. Its principal policy measure directed towards the capital account of its balance of payments has been the establishment of a stand-by financing facility of more than \$6 billion from private international banks for the purpose of helping to avoid a liquidity crisis in the event of major capital outflows. Under Argentina's currency regime the money supply is closely linked to foreign exchange reserves, and the central bank's capacity to operate as lender of last resort is correspondingly limited. In 1995 an outflow of about \$8 billion (or approximately 20 per cent of bank deposits) put a severe strain on the financial system, and the new facility is designed to provide protection against such difficulties in the event of large outflows in future.²¹ Chile and Mexico introduced measures which increased central-bank flexibility regarding intervention in the currency markets. Chile adjusted the band within which its currency floats, in order to allow for further appreciation of the peso. Mexico established a scheme designed to enable reserves to be accumulated without putting upward pressure on the exchange rate during periods when its currency is strong. Under the scheme the central bank periodically auctions to banks options whereby they can sell to it dollars for pesos at the exchange rate of the previous day but on conditions permitting exercise of the options only if the exchange rate is at a premium to its 20-day moving average.²²

In Colombia and Brazil, where policy approaches to capital inflows (as in Chile) have been interventionist and involved a number of different measures of control, changes were made in the tax and regulatory regimes for international capital transactions, designed in Colombia to reduce upward pressure on the exchange rate and in Brazil to facilitate the financing of the persistent deficit on current account (and, through one measure, to reduce this deficit). Colombia imposed a tax on foreign borrowing at a rate which varies with the difference between domestic interest rates and international inter-bank interest rates after allowance for the extent of devaluation of its currency during the previous 12 months.²³ Brazil reduced taxes on foreign borrowing in the form of both securities and bank loans,²⁴ and relaxed restrictions on the use by foreigners for hedging of derivatives traded on Brazilian exchanges - restrictions which had originally been introduced to prevent foreign investors using the creation of synthetic financial instruments to avoid taxes previously imposed as

Table 16

**REPRESENTATIVE SHORT-TERM INTEREST RATES IN SELECTED COUNTRIES,
1995-1997**

(Period average in per cent per annum)

| Country | 1995 | 1996 | | | | 1997 |
|--------------------------------|------|---------------|----------------|---------------|----------------|------|
| | | First quarter | Second quarter | Third quarter | Fourth quarter | |
| United States ^a | 6.0 | 5.4 | 5.5 | 5.6 | 5.5 | 5.6 |
| France ^a | 6.7 | 4.5 | 4.0 | 3.9 | 3.5 | 3.4 |
| Germany ^a | 4.5 | 3.4 | 3.4 | 3.3 | 3.2 | 3.2 |
| Japan ^a | 1.3 | 0.7 | 0.7 | 0.7 | 0.5 | 0.6 |
| United Kingdom ^a | 6.7 | 6.3 | 6.0 | 5.8 | 6.3 | 6.3 |
| Republic of Korea ^b | 14.0 | 11.1 | 12.7 | 16.9 | 14.1 | 12.6 |
| Malaysia ^c | 6.8 | 7.1 | 7.2 | 7.4 | 7.3 | 7.4 |
| Thailand ^d | 11.5 | 11.5 | 10.2 | 9.3 | 10.5 | 12.9 |
| Brazil ^e | 38.8 | 31.0 | 26.7 | 25.5 | 24.1 | 22.1 |

Source: United States, France, Germany, Japan and United Kingdom: IMF, *International Financial Statistics*; Republic of Korea, Malaysia, Thailand, and Brazil: J.P. Morgan, *Emerging Markets: Economic Indicators*, 6 June 1997.

a For the United States, France, Germany, Japan and the United Kingdom, the interest rate is the London interbank offered rate (LIBOR) on three-month deposits.

b Overnight call money rate.

c Three-month interbank rate.

d One-month interbank rate.

e Overnight interbank rate.

a disincentive to capital inflows.²⁵ It also introduced selective controls on import financing in order to reduce its trade deficit, with exemptions for imports from MERCOSUR countries.²⁶

When last year's *TDR* was under preparation, it seemed that some Central European countries might increasingly have to face problems for macroeconomic policy caused by large capital inflows similar to those recently experienced in East and South-East Asia and Latin America.²⁷ In the event, capital inflows into two of the countries principally affected, the Czech Republic and Poland, slowed. The deficit on current account of the first of those two countries has been increasing since 1994, and in 1996 reached 8.6 per cent of GDP. According to preliminary estimates, the deficit remained above \$1 billion in the first quarter of 1997,

and was eventually associated with a series of speculative attacks on the currency. As a result, the central bank abandoned the fluctuation band for the koruna of 15 per cent vis-à-vis a basket of five currencies, which had been widened as recently as February 1996 in response to large capital inflows, and substituted a managed float in which it appears that intervention will in future be designed to keep the exchange rate against the Deutsche mark within a target range.²⁸

Countries of East and South-East Asia have been the recipients of very large capital inflows since the beginning of the 1990s. The flow has been not only to countries or territories which ran surpluses on current account during much or all of this period (such as China, Singapore and Taiwan Province of China) but also to those which ran

deficits (such as Indonesia, Malaysia, Philippines and Thailand). As in Latin America, both the extent and the nature of the policy response to these inflows has varied, among countries and through time. In the Philippines, for example, where the central bank intervenes to maintain the stability of the exchange rate with the dollar, heavy reliance is placed on the sterilization of capital inflows. Sterilization has also been an important feature of the response of Thailand and Indonesia. But in the latter case it has been combined with a currency band which has varied in width with the strength of the inflows, and in Thailand with a number of ad hoc measures intended to reduce the influence of such inflows on domestic short-term interest rates. Malaysia's response also initially relied heavily on sterilization, but as the scale of the capital inflow increased, the Government resorted to various more direct controls, which have been gradually relaxed as the inflows diminished after 1995. The Republic of Korea, which has traditionally maintained a restrictive regime for capital transactions and has in recent years been a net supplier of FDI to other countries (including some members of OECD), has relaxed a number of its controls over inflows since mid-1996. This relaxation is partly due to commitments made in the context of its accession to OECD but also reflects the need to finance an increased deficit on current account.²⁹

In the countries mentioned above, where capital transactions continued to be characterized by large net inflows, policy has since mid-1996 followed broadly the lines already described.³⁰ However, Thailand has experienced periods of substantial capital outflows and downward pressure on the exchange rate, which were accompanied by a series of policy packages directed at both internal and external economic difficulties.

The concerns leading to the capital outflows appear to have focused on the combination of a number of unfavourable developments in both the domestic and the external sectors, such as the worsening of the balance of payments on current account (due partly to a slowdown of export growth), an increase in short-term external debt in 1996 (both shown in table 14), and the proliferation of non-performing loans of banks and finance companies, particularly due to their exposure to the property sector. The weaknesses of financial firms are concentrated above all among finance companies,³¹ many of which had in June 1996 outstanding loans amounting to between 20 per cent and 40 per cent of the total to a property sector characterized by

high vacancy rates, and of which no less than 25 per cent did not meet internationally recognized capital standards in early 1997.³² The position of major banks was stronger, with lower percentages of outstanding non-performing loans (though there remains some uncertainty as to the extent of their exposure to affiliated finance companies).³³ The Government's policy packages have been directed at the financial and property sectors as well as the balance of payments. In May 1997 it introduced a programme of export incentives and increased tariffs on imported consumer goods. Its initiatives in respect of the financial sector include a credit line of more than 8 billion baht to troubled institutions, attempts to rationalize the sector's existing structure through the encouragement of mergers, and tighter enforcement of the provisions which financial institutions have to make against loan losses. In order to reduce the property sector's vacancy rates, in April 1997 the Government lifted restrictions on foreign ownership of condominiums and loosened those on foreign ownership of land for residential purposes. During early 1997 there has been some improvement in Thailand's major economic indicators such as the trade balance and the amount of short-term external debt.³⁴ But at the time of writing the economy remained vulnerable to imbalances in the markets for financial and non-financial assets, and to the consequent loss of confidence among domestic and foreign investors.

Thailand's current difficulties appear to be of a primarily domestic origin, although the speculative boom in asset prices was fuelled to a significant extent by capital inflows.³⁵ In this context various indicators of Thailand's external financial position in table 14 are of interest: while the current deficit increased slightly from 1995 to 1996, certain other indicators were relatively favourable. For example, the ratio of short-term debt plus the deficit to reserves, a figure to which some analysts attribute special importance as a pointer to the likelihood external payments problems, stood at a level of only 150 per cent (compared to about 900 per cent for Mexico in 1994). However, the shift in investors' sentiment is capable of putting severe pressure on the external payments position if sales of assets and withdrawals of bank deposits by non-residents are sufficiently large.³⁶ The resulting situation could have implications for the capital accounts of other countries in East and South-East Asia. Booms in property prices with speculative components in this region have not been limited to Thailand, and since mid-1996 there has been some dumping by foreigners of shares in the Philippines

owing to reports of banks' high property exposure.³⁷ Other countries in the region have demonstrated their awareness of the dangers of speculative property financing: Malaysia and the Philippines, for example, have introduced various measures designed to restrict lending to the sector and to tax capital gains therein. Moreover, currency intervention in support of the baht by other central banks of certain East and South-East Asian

countries is an indication of their determination to contain the threat that difficulties in one country will generate destabilizing capital flows in the region.³⁸ This support appears to have been motivated partly by concern that currency misalignments and the other problems of macroeconomic policy which such flows might cause could have unfavourable effects on economic prospects more generally.

C. The terms of export credits and trade financing arrangements

As noted in section A, net flows of export credits to developing countries increased in 1995 and the first half of 1996 but not all regions shared in this expansion. Net flows to Africa and Latin America were negative throughout this period, as were those to Eastern Europe in 1995. The relative importance of export credits as a source of external financing varies among recipients. However, the conditions on which this category of external financing is made available are of more general interest as an indicator of countries' creditworthiness, and the same is true of the conditions attached to credit insurance from the private market. Thus, for example, these conditions are generally correlated with the costs of financing and payments arrangements other than credit insurance for imports, such as charges on letters of credit. The prevalence of high costs and restrictive conditions on credit insurance for developing countries serves to bring out in another way the general point already made in section A that, in spite of the recent revival of external financing for certain developing countries and economies in transition, access to such financing is unevenly distributed, and for the great majority of these countries remains restricted.

The level of net flows of private export credits³⁹ is influenced by both supply and demand, and the official insurance provided by ECAs generally covers only part of the transactions with which the credits are associated (for large, complex contracts sometimes only a limited part). Thus these flows respond not only to costs but also to economic con-

ditions in recipient countries, and in particular to the pace of investment, given the role of export credits in the financing of capital goods. The discussion which follows focuses on the cost side and its relation to financing and payments arrangements more generally.

The costs of private export credits consist of interest, premiums on official insurance, and various other transaction costs associated with restrictive conditions on which such insurance cover is made available (of which examples are discussed below). The interest rates on the financing of exports to developing countries are either commercial rates (linked to the rates at which the providers of the finance can borrow) or minimum rates for lending in different currencies under the OECD Arrangement on Guidelines for Officially Supported Export Credits, the so-called OECD Consensus. The insurance premiums typically consist of a basic rate, which varies with characteristics of the credit such as the payments arrangements used and the maturity of the loan, supplemented by additional premiums that vary according to a country's creditworthiness, particularly its recent record of making international payments. Maximum and minimum levels for these so-called Commercial Interest Reference Rates for different currencies in 1996 and the first five months of 1997 are shown in table 17.

For less creditworthy borrowers official insurance is generally provided only subject to various restrictive conditions relating to the pro-

Table 17

COMMERCIAL INTEREST REFERENCE RATES^a

| Currency | 1996 | | 1997 (up to May) | |
|-------------------------|----------------------|-----|---------------------|------|
| | High | Low | High | Low |
| Australian dollar | 9.6 | 8.0 | 8.6 | 7.9 |
| Austrian schilling | 6.9 | 6.0 | 5.9 | 5.5 |
| Belgian franc | 7.7 | 6.9 | 6.8 | 6.4 |
| Canadian dollar | (1) ^b 7.6 | 5.9 | 6.5 | 5.4 |
| | (2) ^c 8.1 | 6.7 | 7.1 | 6.2 |
| | (3) ^d 8.5 | 7.2 | 7.5 | 6.8 |
| Danish krone | 7.5 | 6.6 | 6.7 | 6.2 |
| Finnish markka | 7.8 | 6.2 | 6.1 | 5.8 |
| French franc | 7.5 | 6.1 | 6.0 | 5.6 |
| Deutsche mark | 6.7 | 6.0 | 6.0 | 5.7 |
| Irish punt | 8.1 | 7.0 | 7.0 | 6.6 |
| Italian lira | 10.8 | 7.5 | 7.3 | 6.2 |
| Japanese yen | 3.4 | 2.4 | 2.5 | 2.3 |
| Korean won ^e | . | . | 12.5 | 12.5 |
| Netherlands guilder | (1) ^b 6.2 | 5.6 | 5.7 | 5.3 |
| | (2) ^c 7.0 | 6.3 | 6.3 | 6.0 |
| | (3) ^d 7.8 | 7.3 | 7.1 | 6.7 |
| New Zealand dollar | 10.0 | 8.1 | 8.9 | 7.9 |
| Norwegian krone | 7.3 | 6.7 | 6.4 | 5.6 |
| Spanish peseta | 11.6 | 8.0 | 7.6 | 6.8 |
| Swedish krona | 9.7 | 7.3 | 7.2 | 6.3 |
| Swiss franc | 5.3 | 4.8 | 4.8 | 4.3 |
| Pound sterling | 8.6 | 7.9 | 8.4 | 7.9 |
| United States dollar | (1) ^b 7.5 | 6.1 | 7.4 | 6.6 |
| | (2) ^c 7.7 | 6.4 | 7.5 | 6.8 |
| | (3) ^d 7.8 | 6.5 | 7.7 | 6.9 |
| ECU | 7.2 | 5.8 | 5.8 | 5.3 |

Source: OECD press releases and publications.

a Minimum interest rate for officially supported export credits denominated in specified currencies or weighted averages of currencies advanced by participants in the OECD Arrangement on Guidelines for Officially Supported Export Credits (the OECD Consensus). New rates are set on a monthly basis, and highest and lowest of these rates during specified years are shown.

b Maturity of less than five years.

c Maturity of from five to eight-and-a-half years.

d Maturity of more than eight-and-a-half years.

e Included only as from 15 May 1997.

portion and amount of the credit for which cover is available, the limit on the amount of money below which the exporter or bank can exercise discretion in granting insured credits, the length of the period after the occurrence of non-payment

before claims are met (the claims-waiting period), and the types of security required (which may consist of a guarantee from a national public entity in the importing country or a letter of credit issued by one of its banks and confirmed by a bank in an

Table 18

**TERMS^a OF INSURANCE COVER TO SELECTED REGIONS
FROM SELECTED EXPORT CREDIT AGENCIES^b**

(Number of instances^c in which EXIM or ECGD applied specified terms)

| Region/period | Normal terms ^a | | No cover ^a | | Restrictive conditions ^a | |
|--|---------------------------|------------------------------------|-------------------------|------------------------------------|-------------------------------------|------------------------------------|
| | Short-term ^d | Medium- and long-term ^e | Short-term ^d | Medium- and long-term ^e | Short-term ^d | Medium- and long-term ^e |
| Africa | | | | | | |
| Late 1996/early 1997 | 9 | 13 | 16 | 45 | 11 | 14 |
| Latin America | | | | | | |
| Early 1997 | 8 | 14 | 5 | 16 | 13 | 22 |
| East and South Asia^f | | | | | | |
| Early 1997 | 11 | 19 | 4 | 11 | 11 | 22 |
| Eastern Europe | | | | | | |
| Late 1996 | 2 | 3 | 6 | 13 | 4 | 8 |

Source: Payments and credit surveys in *Project and Trade Finance*, various issues.

- a** Normal terms apply when cover is available to a borrower subject to no restrictive conditions. Such conditions include surcharges and restrictions on the availability of insurance cover and reflect mainly the perceived riskiness of the provision of financing to the borrower in question. The number and stringency of the conditions vary. For some borrowers cover is not available on any terms.
- b** The Export-Import Bank (EXIM) of the United States and the Export Credits Guarantee Department (ECGD) of the United Kingdom.
- c** Each country for which information is available corresponds to one instance for the terms on its insurance for short-term credits from EXIM, and to two instances for the terms on its insurance cover for medium- and long-term credits, one for EXIM and one for ECGD.
- d** Insurance cover for credits with maturities up to 180 days, except in the case of credits from EXIM for certain equipment goods and bulk agricultural commodities, for which maturities up to 360 days are also classified as short-term.
- e** Insurance cover for credits other than short-term.
- f** Including Oceania.

OECD country). Although the effect on the costs of export credits may be hard to quantify, such restrictions all entail increases. If perceptions of a country's creditworthiness become sufficiently unfavourable, export credit insurance may cease to be available even at high premiums and with extremely restrictive conditions. The availability of official export credit insurance, on the one hand, and interest rates, on the other, should not be regarded as independent determinants of the cost of export credits. The risk premiums included in interest rates on trade financing, which can represent a substantial proportion of total rates, may well be

significantly reduced for credits carrying official insurance or guarantees.⁴⁰

The data on terms of export credits in tables 18 and 19 refer to those available from EXIM and ECGD (the latter for medium- and long-term credits only). The terms of export credit insurance vary substantially among the agencies of OECD countries. This variation is evident, for example, in the average premiums charged for credit insurance by a sample of 10 such agencies in 1996, which are shown in table 20. The range of these premiums was frequently large, sometimes exceeding by sub-

Table 19

CHANGES IN TERMS^a ON INSURANCE COVER AVAILABLE TO SELECTED REGIONS FROM SELECTED EXPORT CREDIT AGENCIES^b

(Number of instances)

| Region | From late 1995/early 1996 to late 1996/early 1997 | |
|----------------------------------|---|------------------------------------|
| | More favourable terms ^a | Less favourable terms ^a |
| Africa | 2 | 0 |
| Latin America | 2 | 2 |
| East and South Asia ^c | 0 | 2 |
| Eastern Europe | 0 | 2 |

Source: Payments and credit surveys in *Project and Trade Finance*, various issues.

- a** All instances in which there has been a change in the terms of export credit insurance available from EXIM or ECGD between the categories, "normal cover", "no cover", and "restrictive conditions". (For "instances" and these three categories see notes **a** and **c** to table 18.) Such changes are recorded separately for short-term and for medium- and long-term credits.
- b** The Export-Import Bank (EXIM) of the United States and the Export Credits Guarantee Department (ECGD) of the United Kingdom.
- c** Including Oceania.

stantial amounts the means of those charged by the different agencies included in the table.⁴¹ In spite of such variation the data on terms, on which tables 18 and 19 are based, do give broadly representative indications as to the perceptions of countries' creditworthiness affecting the costs and other terms of financing and payments arrangements for their imports.

As is shown in table 18, for the majority of developing countries and economies in transition credit insurance cover from EXIM and ECGD continues to be available only on restrictive conditions or not at all. Even for the countries of East and South Asia, the region which has had the greatest concentration of creditworthy countries in recent years, cover was available on normal terms (i.e. without restrictions) in only 42 per cent of instances⁴² for short-term credits and in only 37 per

Table 20

PREMIUMS OF PRINCIPAL ECAs FOR SELECTED DEVELOPING AND TRANSITION ECONOMIES, 1996

(Percentage points)

| Economy | Average premium | Range |
|--------------------|-----------------|----------|
| Algeria | 9.2 | 6.9-12.1 |
| Argentina | 7.7 | 4.3-12.5 |
| Brazil | 8.6 | 5.7-12.9 |
| Bulgaria | 10.3 | 6.2-16.3 |
| Chile | 2.9 | 1.1-3.9 |
| China | 2.9 | 1.7-4.7 |
| Colombia | 4.3 | 2.8-5.7 |
| Côte d' Ivoire | 10.8 | 9.0-12.1 |
| Cuba | 10.8 | 9.0-12.1 |
| Czech Rep. | 3.0 | 1.1-4.6 |
| Egypt | 10.8 | 7.8-16.3 |
| Estonia | 6.8 | 3.1-11.7 |
| Ghana | 8.4 | 6.9-10.0 |
| Hong Kong | 2.0 | 1.1-3.9 |
| Hungary | 5.8 | 3.7-9.3 |
| India | 5.3 | 3.6-9.6 |
| Indonesia | 4.6 | 3.6-6.4 |
| Kenya | 10.2 | 7.8-12.1 |
| Malaysia | 2.3 | 1.1-3.9 |
| Mexico | 6.3 | 3.7-12.2 |
| Morocco | 6.6 | 4.3-10.7 |
| Nigeria | 10.8 | 9.0-12.1 |
| Pakistan | 7.7 | 4.5-17.5 |
| Peru | 10.2 | 7.3-12.1 |
| Philippines | 7.5 | 4.6-11.5 |
| Poland | 6.6 | 4.6-9.6 |
| Romania | 9.0 | 6.0-14.0 |
| Russian Federation | 11.2 | 6.9-16.2 |
| South Africa | 4.8 | 2.8-6.9 |
| Slovakia | 6.2 | 3.6-9.3 |
| Slovenia | 5.0 | 2.8-6.9 |
| Thailand | 2.5 | 1.1-3.9 |
| Venezuela | 9.7 | 5.9-14.6 |
| Viet Nam | 10.0 | 7.4-14.0 |

Source: R.Kelsey, "Getting better terms from EKN", *Project and Trade Finance*, October 1996.

Table 21

**PROPORTION OF EXPORT CREDIT AGENCIES^a IN SELECTED OECD COUNTRIES^b
THAT INCURRED CASH-FLOW DEFICITS, 1987-1996**

(Percentage)

| | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|-------------|------|------|------|------|------|------|------|------|------|------|
| Proportion: | 83 | 65 | 65 | 71 | 83 | 83 | 54 | 33 | 27 | 26 |

Source: Information supplied by the Berne Union.

a 1987-1989: 23 agencies ; 1990-1991: 25 agencies ; 1992-1994: 24 agencies; 1995: 26 agencies; 1996: 27 agencies.

b Some of these countries have more than one export credit agency.

cent of instances for medium- and long-term credits; for Latin America the corresponding proportions were 31 per cent and 27 per cent, for Eastern Europe 17 per cent and 13 per cent, and for Africa 25 per cent and 18 per cent. Total unavailability of insurance cover continued to apply to medium- and long-term credits more frequently than to short-term credits, the proportion being 63 per cent for Africa (as opposed to 44 per cent for short-term credits), 54 per cent for Eastern Europe (50 per cent for short-term credits), 31 per cent for Latin America (19 per cent for short-term credits), and 21 per cent for East and South Asia (15 per cent for short-term credits).

Generally, the conditions associated with the availability of official credit insurance are characterized by a fairly high degree of inertia, and this is evident for 1996 in the small number of changes shown in table 19. The terms associated with the provision of private credit insurance also shift slowly, and here 1996 was no exception either.⁴³

The prevalence of restrictive conditions for both official and private credit insurance cover reflects not only perceptions of borrowers' creditworthiness but also restrictions on supply due to operating constraints of the institutions writing the insurance. For private insurers the effects of such constraints are not easy to document. For ECAs they reflect partly the agencies' long-term obligations to be self-supporting in their commercial operations. Widespread interruptions of debt service had a strongly adverse effect on the profit

performance of ECAs during much of the 1980s and the early 1990s, but table 21 shows that this performance has been improving since 1992. Thus it is reasonable to assume that pressures on ECAs from this source to impose restrictive conditions have begun to diminish, although this shift may now to some extent be offset by greater emphasis on profitability as an objective for public-sector institutions.

Perceptions of borrowing countries' creditworthiness and their relation to transactions costs in their trade are also evident from data other than the conditions associated with official export credit insurance, such as the preferred payment terms in the export credit and collection surveys in the bi-weekly *Financial Times* newsletter, *International Trade Finance*. The preferred payment terms in these surveys are "open account", "sight draft" or "cash against documents (CAD)", "unconfirmed letter of credit", "confirmed letter of credit", and "cash in advance" (see box 1).

As shown in table 22, for developing countries and economies in transition the greatest concentration of preferred payments terms is to be found in the categories of confirmed and unconfirmed letters of credit, the proportions being 90 per cent or more for Africa, Eastern Europe and Latin America and 76 per cent for East and South Asia.⁴⁴ By contrast, for a group of 21 OECD countries preferred payments terms for all but two (90 per cent) were "open account" and "sight draft" or "cash against documents", the others being assigned to "unconfirmed letter of credit."⁴⁵ As might

Box 1**PRINCIPAL PAYMENT TERMS IN INTERNATIONAL TRADE**

Under *payment on open account* an invoice is sent to the importer at the same time as the shipping of the goods, payment being specified within a predetermined period. This arrangement requires no intermediary, so that the associated transaction costs are at a minimum. However, it is also based on trust and is used mainly in trade between entities (such as inter-related companies) with a history of satisfactory transactions.

The terms *sight draft* and *cash against documents (CAD)* refer to transactions in which the documents conferring title to goods are released to the importer only against payment by sight draft or on his acceptance of a time draft. A sight draft or bill of exchange is an unconditional order addressed by one party to another, requiring the latter to pay a specified sum on demand or at a fixed future date. Since such a bill is a negotiable instrument (which can be turned into cash immediately), the exporter thus obtains greater security than in the case of payment on open account. This arrangement does not require the interposition of a bank, and the associated costs are low. In the case of a time draft, payment is to be made at a specified time in the future (so that there is an additional risk that the accepted draft may not be paid at maturity).

A *letter of credit* is a written undertaking by a bank in response to the instructions of the applicant (the importer) to make payment to the beneficiary (the exporter) against prescribed documents. It provides the exporter with insurance against the commercial risk of non-payment by the importer since its validity is independent of the underlying transaction. However, especially when the bank issuing the letter of credit is a local institution in the importer's country, the exporter is not protected from political risk resulting from events in the importer's country such as the unavailability of foreign exchange or the imposition of foreign exchange controls which make fulfilment of the contractual obligation impossible. This risk can be removed by a *confirmed letter of credit* under which another bank, typically in the exporter's country, adds its commitment to pay to that of the issuing bank. Confirmation of the letter of credit results in charges by the confirming bank additional to those of an unconfirmed letter of credit (which consist of the fees of the issuing bank and others associated with arranging for the payment to be made).

In the case of *cash in advance*, delivery of the goods is authorized by the exporter only after actual receipt of money from the importer. This arrangement is used for transactions with a particularly high risk of non-payment.

The first two of the preferred payment terms in the surveys of *International Trade Finance* are appropriate for transactions carrying low degrees of payments risk, and the latter three for successively greater degrees. See, for example, D. Briggs and B. Edwards, *Credit Insurance: How to Reduce the Risks of Trade Credit* (New York, etc.: Woodhead Faulkner, 1988), pp. 25-26.

be expected, the correspondence between rankings of individual countries' creditworthiness on the basis of recommended payments terms in *International Trade Finance*, on the one hand, and the restrictiveness of conditions associated with official credit insurance, on the other, is far from perfect. Nevertheless, the distribution of coun-

tries according to the former provides a further indication of differences in perceptions of creditworthiness, and helps to explain the prevalence in the majority of developing countries and economies in transition of the relatively high costs of financing and payments arrangements for their imports.

Table 22

**RECOMMENDED PAYMENT ARRANGEMENTS^a FOR SELECTED DEVELOPING AND
TRANSITION ECONOMIES**

(Number of countries)

| Region | Open account | CAD ^b / sight draft | Unconfirmed letter of credit | Confirmed letter of credit | Cash in advance |
|---------------------|-----------------|-----------------------------------|------------------------------------|----------------------------------|--------------------|
| Africa | 0 | 0 | 14 | 13 | 3 |
| Latin America | 0 | 2 | 21 | 2 | 0 |
| East and South Asia | 1 | 3 | 7 | 6 | 0 |
| Eastern Europe | 0 | 0 | 5 | 6 | 1 |

Source: *International Trade Finance*, 28 February 1997.

a Data refer to the situation in early 1997. For explanation of these arrangements see box 1.

b Cash against documents.

D. Renegotiation and reduction of bank debt

Restructuring of developing countries' bank debt due to the difficulties that started in the 1980s continued to decline in importance, and agreements since those discussed in last year's *TDR* included a number of economies in transition and African countries. Among the agreements reported in last year's *TDR* that have progressed or reached final conclusion,⁴⁶ mention should be made of the following: Panama and Peru, which concluded agreements to restructure \$3.9 and \$8 billion, respectively; the Russian Federation, which is moving slowly toward conclusion of its earlier agreement in principle to restructure \$33 billion; and The former Yugoslav Republic of Macedonia, which reached agreement in principle to restructure \$280 million. Viet Nam will conclude its restructuring of \$750 million of debt this summer. There have only been two new London Club⁴⁷ agreements since mid-1996. In early 1997, Côte d'Ivoire reached an agreement with its creditors to restructure debt

of \$7.2 billion, and Senegal an agreement to restructure debt of \$118 million. Two low-income countries concluded debt buyback agreements with assistance from the IDA Debt Reduction Facility,⁴⁸ namely Mauritania in August 1996 and Senegal in December 1996. In operations intended to improve the structures of their liabilities, Mexico, the Philippines and Brazil completed swaps of uncollateralized long-term bonds for Brady bonds.

In April 1996, Panama finalized its earlier agreement to restructure \$2 billion of principal and \$1.9 billion of past-due interest. Under the menu of options, principal was exchanged for \$88 million in 45-per-cent discount bonds, \$268 million in par bonds and \$1,612 million in front-loaded interest-reduction bonds. The discount and par bonds are collateralized by 30-year United States Treasury zero-coupon bonds, and the interest payments on all three bonds are collateralized on a

rolling basis. For the restructuring of the past-due interest, \$130 million was paid at the conclusion of the agreement, \$590 million was forgiven (by the recalculation of interest and the waiving of penalties) and the remaining \$1,248 million was exchanged for past-due interest bonds. The cost of the cash payments and bond collateral was \$226 million, of which 60 per cent was funded by Panama and the remainder by the Inter-American Development Bank, the World Bank and IMF.

In November 1996, Peru finalized its earlier agreement to restructure \$4,181 million in principal and \$3,809 million in past-due interest. Under the menu of choices, Peru bought back \$1,266 million of the principal at 38 cents per dollar of the debt's face value, and the remainder was exchanged for \$947 million in 45-per-cent discount bonds, \$189 million in par bonds and \$1,779 million in front-loaded interest-reduction bonds. As for Panama, the discount and par bonds are collateralized by 30-year United States Treasury zero-coupon bonds and the interest payments on all three bonds are collateralized on a rolling basis. For the restructuring of the past-due interest, \$308 million was paid at the conclusion of the agreement, \$1,217 million was repurchased at 38 cents per dollar of face value, and the remaining \$2,284 million was exchanged for past-due interest bonds. The cost of the cash payments, buybacks and bond collateral was \$1.4 billion. Peru itself financed 45 per cent of the cost, Eximbank-Japan funded 7 per cent and the remainder was equally shared by the Inter-American Development Bank, the World Bank and IMF.

As reported in last year's *TDR*, in November 1995 the Russian Federation agreed in principle with its creditors to repay \$25.5 billion of eligible principal and \$7.5 billion in past-due interest. The agreement followed lengthy negotiations over the status of the country's commercial bank debt following the breakup of the USSR. At the time of writing final conclusion of the agreement was still pending, but the likely terms are as follows: the \$25.5 billion of eligible principal will be paid back over 25 years, with a seven-year grace period at an interest rate linked to LIBOR. In late December 1996, the Russian Federation completed the upfront payment of \$2 billion for past-due interest into an escrow account, and the remaining past-due interest is to be paid by interest notes over 14 years.

There has been progress in the difficult negotiations over the sharing out of the commercial bank

debt of former Yugoslavia. Slovenia and Croatia recently concluded agreements with the commercial banks involved. In October 1996, The former Yugoslav Republic of Macedonia agreed in principle to restructure its 5.4 per cent share of the principal and 3.7 per cent share of the past-due interest owed by former Yugoslavia - a total amount of \$280 million. In exchange for principal and past-due interest, it will issue 15-year bonds, paying fixed rates of interest in the first four years and a rate of interest linked to LIBOR thereafter.

Viet Nam's debt renegotiation is nearly concluded: more than 90 per cent of its creditor commercial banks have accepted the proposed agreement on its debt of \$750 million. Of the menu of options, most banks have selected the 30-year par bond, which was issued in June.

Côte d'Ivoire reached agreement with its creditors to restructure \$2.6 billion in principal and \$4.6 in past-due interest. In the menu of options, principal is to be bought back at 24 cents per dollar of its face value (with past-due interest cancelled) or exchanged for either 30-year discount bonds (collateralized by United States Treasury or French Treasury zero-coupon bonds at a below-market rate of interest for the first 10 years) or 20-year front-loaded interest reduction bonds (at a below-market rate of interest). To restructure past-due-interest, the Government is to issue 20-year past-due interest bonds (at a below-market rate of interest for the first 16 years). The agreement is expected shortly to be signed and will reduce the present value of the country's commercial bank debt by 79 per cent.

In August 1996, Mauritania concluded an agreement with its commercial banks to restructure \$92 million of debt, of which \$37 million in past-due interest was written off and \$55 million was bought back at 10 cents per dollar of its face value. Much of this debt was assumed by the Government following the privatization of a development bank. The total cost was \$5.3 million, of which the World Bank paid \$3.2 million through the IDA Debt Reduction Facility.

In December 1996, Senegal concluded an agreement with the assistance of the Debt Reduction Facility to restructure \$118 million of debt, of which \$75 million consisted of principal and \$43 million of past-due interest. The two options were a buyback at 16 cents per dollar of its face value or exchange for a long-term zero-coupon bond is-

sued by the Government and collateralized by United States Treasury zero-coupon bonds with a similar maturity. Total costs are estimated to be \$13.4 million, of which the World Bank would pay \$7.7 million through the Debt Reduction Facility and the remainder would be funded by the Netherlands and Switzerland.

Mexico and the Philippines made offers to swap uncollateralized long-term bonds for outstanding Brady bonds during 1996. They would thus be able to benefit both from access to the collateral required for the Brady bonds and from the

discounted price of the bonds to be retired, though the former holders of the Brady bonds would receive higher interest on the uncollateralized long-term bonds. In May and September Mexico retired \$3.6 billion of Brady bonds at an average discount of 24 per cent, thus also freeing \$0.4 billion in collateral. In September the Philippines issued a \$0.7 billion eurobond in exchange for Brady bonds as a first step in a series of swaps. In the spring of 1997 Brazil used part of a bond issue of \$3 billion to retire \$2.7 billion of Brady bonds, also freeing \$0.6 billion in collateral. Argentina and Venezuela are reported to be considering similar operations.

E. Official debt

1. *The HIPC Initiative: first steps*

The external debt situation of developing countries has improved. A rise of 7.2 per cent in their debt stock in 1995 was more than offset by a strong increase in their exports and combined GNP⁴⁹. The ratio of debt-to-exports for developing countries as a whole declined from nearly 180 per cent in 1993 to 170 per cent in 1994 and 151 per cent in 1995.

However, the debt problem of low-income countries is still a matter of concern. The debt-to-exports ratio of the severely indebted low-income countries remains high. In 1995, it stood at 421 per cent, while for countries classified by the World Bank as heavily indebted poor countries (HIPCs) it was 447 per cent. The ratio of actual debt service payments to exports in 1995 was respectively 17.0 per cent for developing countries as a whole, 18.6 per cent for the severely indebted low-income countries and 20.4 per cent for the HIPCs. Over the period 1985-1994 actually paid debt service on long-term debt for the last group of countries averaged about one third of their scheduled debt service (see table 23).

Almost the entire debt of the HIPCs is owed to official creditors, bilateral and multilateral. While Paris Club bilateral official creditors have gradually improved the terms of debt rescheduling and increased the percentage of debt reduction, the remaining official debt, namely debt owed to non-OECD bilateral official creditors and to multilateral financial institutions, has not been tackled in any formal framework⁵⁰. The gravity of the debt problem of the HIPCs has attracted increasing attention from the international community, and in 1996 a proposal was put forward by IMF and the World Bank to alleviate their burden in a comprehensive way. The HIPC Initiative, which was endorsed by the Interim and Development Committees in September 1996, represents an important contribution towards resolving the debt problems of HIPCs and helping these countries to exit from the vicious circle of debt reschedulings (see box 2).

The total cost of the Initiative was tentatively estimated by the Fund/Bank staff between \$5.5 billion and \$8.4 billion. The World Bank established the HIPC Trust Fund in November 1996, and has subsequently allocated \$500 million from its IBRD surplus to this Trust Fund as an initial

Table 23

MAIN DEBT INDICATORS FOR HEAVILY INDEBTED POOR COUNTRIES, 1985-1994

(Percentage)

| Country | Debt to exports ratio ^a | | Per capita GDP growth rate | Gross resource flows ^b / exports | Paid debt service/ exports | Paid debt service/ government revenue ^c | Government revenue ^c / GDP | Paid debt service/ scheduled debt service | Reserves/ imports (Months) |
|----------------------|------------------------------------|------------------|----------------------------------|--|----------------------------------|---|---|--|----------------------------------|
| | Nominal value | Present value | | | | | | | |
| | (Annual average) | | | | | | | | |
| Angola | 302 | 278 | -3.7 | 33.1 | 7.0 | 14.2 ^d | 27.4 ^d | 28.7 | .. |
| Benin | 272 | 142 | -0.7 | 38.9 | 7.4 | 13.8 ^d | 12.0 ^d | 28.2 | 2.0 |
| Bolivia | 457 | 332 | 1.2 | 71.8 | 37.3 | 39.4 | 15.3 | 59.7 | 4.7 |
| Burkina Faso | 201 | 104 | 0.1 | 57.8 | 8.1 | 11.9 ^e | 12.4 ^e | 42.9 | 4.5 |
| Burundi | 891 | 388 | -1.1 | 166.0 | 32.0 | 21.3 | 16.4 | 84.8 | 4.4 |
| Cameroon | 303 | 250 | -6.9 | 31.5 | 20.8 | 14.1 ^f | 18.5 ^f | 54.8 | 0.3 |
| Central African Rep. | 464 | 243 | -2.3 | 83.8 | 12.5 | 15.7 ^g | 11.9 | 36.4 | 4.0 |
| Chad | 400 | 195 | 0.9 | 108.0 | 5.9 | 12.2 ^g | 8.4 ^g | 18.4 | 2.1 |
| Congo | 434 | 370 | -2.3 | 32.9 | 32.1 | .. | .. | 34.6 | 0.1 |
| Cote d'Ivoire | 557 | 486 | -4.4 | 34.6 | 34.4 | .. | .. | 40.2 | 0.2 |
| Dem. Rep. of Congo | 706 | 594 | -7.6 | 30.6 | 15.7 | 43.1 | 10.8 | 15.5 | 1.2 |
| Equatorial Guinea | 435 | 308 | 1.2 | 103.2 | 11.4 | 8.5 ^h | 18.5 ^h | 9.9 | 0.5 |
| Ethiopia | 608 | 383 | -12.2 | 126.3 | 23.6 | 15.8 | 17.1 | 54.3 | 2.4 |
| Ghana | 392 | 242 | 1.4 | 93.1 | 34.1 | 41.0 ^f | 13.6 ^f | 64.6 | 3.9 |
| Guinea | 402 | 255 | 0.5 | 49.0 | 15.3 | 35.7 ⁱ | 13.4 ⁱ | 26.0 | 0.8 |
| Guinea-Bissau | 1934 | 1280 | 2.0 | 252.8 | 26.1 | 28.8 ^e | 13.6 ^e | 8.5 | 1.4 |
| Guyana | 479 | 345 | 1.0 | 48.3 | 35.0 | 49.6 | 39.9 | 22.9 | 2.3 |
| Honduras | 347 | 271 | 0.5 | 55.0 | 30.5 | 45.2 | 18.2 | 47.5 | 0.9 |
| Kenya | 307 | 225 | 0.5 | 56.4 | 34.8 | 34.2 | 21.8 | 78.6 | 1.5 |
| Lao P.D.R. | 791 | 214 | 2.2 | 131.5 | 9.1 | 9.5 ^h | 13.7 ^h | 77.7 | 1.2 |
| Liberia | 374 | 339 | -3.2 | 16.5 | 3.7 | 12.5 ^j | 17.1 ^j | 2.5 | 0.1 |
| Madagascar | 694 | 495 | -1.9 | 85.4 | 34.3 | 58.1 ^k | 9.2 ^k | 28.0 | 1.9 |
| Mali | 523 | 288 | 0.6 | 80.1 | 14.6 | 19.2 | 15.5 | 31.0 | 2.4 |
| Mauritania | 469 | 327 | -0.1 | 56.7 | 23.4 | 55.0 ^j | 23.1 ^j | 32.2 | 1.1 |
| Mozambique | 1367 | 1039 | 4.0 | 286.1 | 23.8 | 37.2 ^d | 16.7 ^d | 7.1 | 1.2 |
| Myanmar | 600 | 442 | -1.3 | 44.6 | 24.7 | 6.3 | 9.0 | 35.5 | 3.6 |
| Nicaragua | 2879 | 2579 | -1.3 | 198.3 | 32.9 | 19.4 | 29.5 | 3.3 | 1.3 |
| Niger | 544 | 322 | -2.4 | 97.5 | 31.4 | 22.4 ^d | 8.5 ^d | 61.0 | 4.8 |
| Nigeria | 277 | 250 | 1.5 | 18.7 | 23.9 | 50.5 | 12.6 | 57.0 | 2.6 |
| Rwanda | 1142 | 533 | -2.4 | 171.1 | 14.1 | 8.2 ^l | 10.6 ^l | 61.0 | 2.7 |
| Sao Tomé & Princ. | 2085 | 1101 | -1.2 | 324.5 | 26.0 | 28.0 ^l | 19.8 ^l | 13.7 | 0.0 |
| Senegal | 253 | 166 | -0.7 | 49.5 | 21.2 | .. | .. | 76.2 | 0.3 |
| Sierra Leone | 835 | 637 | -0.3 | 80.9 | 24.0 | 51.4 | 6.9 | 6.6 | 0.7 |
| Somalia | 4711 | 3745 | -0.4 | 544.5 | 21.8 | .. | .. | 1.1 | 0.6 |
| Sudan | 3384 | 3057 | -0.4 | 78.5 | 10.7 | 2.6 ^m | 14.5 ^m | 1.2 | 0.3 |
| Togo | 1285 | 733 | -3.0 | 34.7 | 16.0 | 37.7 ^a | 28.4 ^a | 62.3 | 5.2 |
| Uganda | 1005 | 719 | 2.9 | 187.1 | 52.9 | 74.8 ^g | 4.7 ^g | 32.7 | 1.3 |
| U.. R. of Tanzania | 367 | 226 | 1.8 | 163.8 | 32.7 | 29.7 | 16.7 | 10.3 | 1.0 |
| Viet Nam | 638 | 524 | 4.1 | 21.7 | 12.4 | .. | .. | 33.7 | 0.0 |
| Yemen | 239 | 189 | .. | 28.5 | 8.1 | 8.8 ^f | 52.6 ^f | 18.8 | 1.8 |
| Zambia | 592 | 465 | -2.4 | 66.8 | 26.5 | 61.4 | 15.7 | 12.8 | 1.3 |
| All HIPC's | 540 | .. | -0.9 | 103.4 | 22.2 | 28.8 | 17.0 | 34.7 | 1.8 |

Source: UNCTAD secretariat calculations, based on World Bank, *World Debt Tables*; IMF, *International Financial Statistics*; United Nations, *National Accounts* database.

Note: All debt and debt service figures relate to public and publicly guaranteed long-term debt.

a 1992-1994.

b Net resource flows plus principal repayments plus IMF purchases.

c Excluding grants.

d 1990-1994.

g 1985-1992.

j 1988-1994.

m 1991-1994.

e 1986-1992.

h 1985-1988.

k 1986-1994.

f 1985-1987.

i 1985-1993.

l 1989-1994.

contribution. The IMF established the ESAF-HIPC Trust Fund for financing special ESAF operations under the HIPC Initiative. Until resources are secured to finance the full costs of the Initiative and the continuation of ESAF, it has been decided that an amount of up to SDR 180 million⁵¹ can be transferred from the ESAF Trust Reserve Account to be used for ESAF operations. Bilateral donor countries will also make contributions to the Trust Fund, in amounts as yet unknown.

In April 1997, the Executive Boards of IMF and the World Bank agreed, in principle, to extend debt relief to Uganda, the first country to complete the first stage of the debt relief process and thus reach its decision point (see box 2). The total relief package in present-value terms would amount to \$338 million, of which the World Bank would contribute \$160 million. IDA has agreed to advance a portion of this relief during the next 12 months through the provision of \$75 million in the form of IDA grants. The IMF will be providing in present value the equivalent of \$70 million, which will reduce Uganda's nominal debt service to the Fund by about \$90 million over the next nine years. The remaining debt relief will have to be shared by other multilateral creditors (up to 40 per cent) and bilateral creditors, including the Paris Club.

Three other countries are likely to have their decision points determined in 1997: Bolivia, Côte d'Ivoire and Burkina Faso. Three more countries (Benin, Guyana and Mali) have agreed stock-of-debt operations on Naples terms with Paris Club creditors and can be considered to have established the first three-year track record.

Within the debt relief package for Uganda alone, the World Bank share represented about one third of the Bank's total contribution to the HIPC Trust Fund, and the IMF share about 27 per cent of the resources allocated to ESAF operations (as mentioned above). As the three other possible candidates for debt relief (Bolivia, Côte d'Ivoire and Burkina Faso) had a combined external debt at the end of 1995 more than seven times that of Uganda⁵², the resources made available so far to the HIPC Trust Fund seem likely to fall short of the debt relief required by these countries. Should that prove to be the case, there could be a delay in the provision of debt relief. In this context, the issue of the partial sale of IMF gold to finance the Initiative again deserves to be given careful consideration.⁵³

2. Framework issues and modifications

The HIPC framework in its original form called for a six year time-frame, strict criteria concerning eligibility and debt sustainability, and strong performance conditionalities. Over the past year, a more flexible stance has evolved as a result of the application of exceptional treatment to some HIPCs, in particular Uganda, Bolivia and Côte d'Ivoire. Framework modifications to date include the addition of other debt indicators, such as debt-to-fiscal revenue, to determine eligibility; a shorter time-frame for countries with a strong track record; extension of the one-year export calculation to a three-year export average; and a combination of debt reduction and additional interim financing by the World Bank to compensate through cash flow savings for a delay in the completion point.

There is also discussion about the possibility of introducing an additional conditionality, related to social and human development. However, while social and human development concerns are well justified, these concerns should not be encapsulated in an additional set of conditionality criteria linked to the implementation of the Initiative. This could deny many HIPCs the benefit of timely access to debt relief, if they are unable to meet these criteria because of limited resources and weak institutional capacity.

As regards increased framework flexibility, one change that has been introduced concerns the number of years necessary to reach the completion point. The Initiative now allows for flexibility in regard to countries which have already demonstrated a strong track record of adjustment. For Uganda and Bolivia, for example, the time frame for the provision of debt relief has been shortened from three years to one, or at most, two years.

Another example of flexibility is the recent broadening of the criteria for HIPC eligibility for assistance. Previously, debt sustainability was to be primarily measured in relation to a country's export base, so that HIPCs with relatively large export sectors were less likely to qualify for debt relief than less outward-oriented economies with similar debt burdens. As relatively high export receipts could conceivably coexist with inadequate budgetary revenues, eligibility criteria have been expanded to include fiscal constraints as an indicator of ability to meet external debt obligations (see box 3). ■

Box 2**THE HIPC INITIATIVE: KEY FEATURES**

The HIPC Initiative provides a very useful framework for implementing a strategy of burden-sharing among all creditors to reduce the debt of the HIPCs to a sustainable level. The objective is to help them achieve overall debt sustainability, on a case-by-case basis, thus providing an exit from the rescheduling process. Debtor countries will have to show a track record of good policy performance as monitored by IMF and the World Bank. The six-year performance period under the Initiative consists of two stages of implementation.

First stage

During this first three-year stage (corresponding roughly to the duration of an ESAF agreement), the debtor country will have to establish a track record of good performance and the Paris Club will provide flow rescheduling on Naples terms (67 per cent reduction of Paris Club eligible debt on a present-value basis). Other bilateral and commercial creditors will provide at least comparable treatment. Bilateral donors and multilateral institutions will continue to provide support in the framework of World Bank/IMF-supported adjustment programmes. The end of the first phase is the **decision point**, reached after a three-year track record of good performance. A few months before the decision point, a debt sustainability analysis will be undertaken to determine whether the debtor country is eligible for further debt relief. Three alternative situations can occur:

- If a Paris Club stock-of-debt operation on Naples terms is sufficient to achieve debt sustainability within three years (i.e. by the completion point - see below), the country would be able to exit from the debt rescheduling process;
- If such a stock-of-debt operation is not sufficient to achieve debt sustainability, the country would be eligible for further debt relief;
- In borderline cases, where there is doubt about whether sustainability would be achieved by the completion point, the country would receive further flow rescheduling under Naples terms, with the assurance of additional action at that point, if needed.

Second stage

If the country is deemed eligible for support under the Initiative, it will go through a second stage, of normally three years¹, during which the Paris Club will provide more relief through flow rescheduling (up to 80 per cent of the present value of Paris Club debt). Other bilateral and commercial creditors will provide at least comparable treatment. The country will have to establish a second track record of good performance under World Bank/IMF programmes. The performance criteria during this second stage include macroeconomic indicators and progress on structural reforms and social reforms. Donors, bilateral creditors and multilateral institutions

Box 2 (concluded)

will also provide enhanced support in the form of grants and concessional loans. The end of the second stage is the **completion point**.

At the completion point, provided that the country has met the performance criteria under the Initiative, Paris Club creditors will provide a stock-of-debt operation of up to 80 per cent reduction in present-value terms. Other bilateral and commercial creditors will provide at least comparable treatment. Multilateral institutions will provide the committed reduction in present-value terms of their claims necessary for the total debt to reach a sustainable level. The World Bank, for instance, would provide assistance for this purpose through the HIPC Trust Fund, while IMF would provide assistance through a special ESAF grant or loan that would be paid into an escrow account and used to cover debt service to the institution.

Eligibility criteria

To qualify for exceptional assistance under the Initiative, countries will have to be ESAF-eligible and IDA-only. The debt sustainability analysis (DSA) will determine the eligibility of debtor countries, and eventually the amount of debt relief necessary for the country to achieve a sustainable level of debt, on the basis of the following criteria:

- (i) The ratio of the present value of debt to exports should fall within a range of 200-250 per cent or below, by the completion point;
- (ii) The debt-service-to-exports ratio should fall within a range of 20-25 per cent or below, at the completion point;
- (iii) Within the prescribed ranges, debt sustainability would be determined on the basis of various measures of vulnerability, including the burden of external debt on the government budget, the diversity of the country's export base, its reserve coverage, its resource balance and other relevant factors;
- (iv) In April 1997, the Executive Boards of IMF and the World Bank approved the introduction of an additional sustainability criterion, captured by a ratio of the present value of debt to fiscal revenue of 280 per cent, provided that two other criteria are met: an export-to-GDP ratio of at least 40 per cent and a minimum threshold ratio of fiscal revenue to GDP of 20 per cent.

¹ Exceptionally, the second stage could be shortened for countries that have demonstrated a record of sustained strong performance.

Box 3**DEBT SUSTAINABILITY CONCEPTS**

The implementation of the HIPC Initiative rests on the debt sustainability analysis of debtor countries. The sustainability criteria are based on concepts of debt overhang¹ and foreign exchange constraint. The debt overhang is captured by the ratio of the present value of debt to exports, while the foreign exchange constraint is reflected in the debt service to exports ratio. More recently, a fiscal constraint, measured by the ratio of the present value of debt to fiscal revenue, is also being taken into account.

In the HIPC Initiative, the calculation of the present value of debt is a determining factor in fixing the amount of debt relief granted. The present value of debt is obtained by taking all future debt service obligations (including interest payments at the original rate of the loan and amortization payments) until full repayment of the debt, and dividing them by a factor based on a given discount rate. If the discount rate is equal to the original interest rate of the loan, the present value will be equal to the face value of debt. If the discount rate used is higher than the original interest rate of the loan, the present value will be lower. The present value can be used to measure the grant element of a concessional loan - i.e. a loan with a rate of interest below the prevailing market rate. In that case, the debt service flow is calculated at the concessional rate but is discounted at the higher market rate. The present value of the debt is lower than its face value, and the difference is the grant element.

However, the concept is less useful when calculating the debt burden of debtor countries. Indeed, the present value of debt, if obtained by discounting the flow of debt service by the market rate of interest prevailing in creditor countries, does not truly reflect the debt servicing burden of debtor countries². The prevailing market rate of interest has no bearing on the amount of actual debt service because the loans made to HIPCs invariably carried concessional interest rates. Applying a discount rate which is higher than the original rate on a loan gives a present value which is lower than the face value of the loan, thus understating the true burden of debt for debtor countries.

It is, therefore, necessary to reconcile the concepts of debt overhang and cashflow constraints to determine a level of debt which debtor countries will be able to service. One possibility would be to use the debt stock as a target for reduction, instead of the present value. The stock of debt would be reduced to a level which would produce a stream of future debt service payments commensurate with the cashflow constraints. For the purpose of burden sharing, the present value calculations would then be used to make debt service reductions equivalent to the desired reduction of the stock of debt, when some creditors provide relief through debt stock reduction while others do it through interest rate reduction. In this case, the flow of debt service should be calculated at the new interest rate, i.e. after relief, while the discount rate should be the original, higher, interest rate of the loan. The difference between the face value and the present value of the debt will give the right measure of the relief provided.

A similar problem appears, in the framework of the HIPC Initiative, in connection with the fiscal constraint, which is measured by the ratio of the present value of debt to fiscal revenue. This ratio might not, however, accurately reflect the fiscal constraint, which is more in the nature of a cashflow constraint. In the same way as the foreign exchange constraint is measured by the ratio of debt service to exports, the fiscal constraint would be more appropriately measured by the ratio of debt service to government revenue (excluding grants). There is, therefore, a justification for using threshold values of these two debt-service ratios to reflect the capacity of debtor countries to service their debt through export earnings and fiscal revenue.

¹ The literature on the debt overhang provides evidence of the negative effect of a large amount of debt on economic growth. A high level of debt creates uncertainty about the country's capacity to service its debt and discourages private (domestic and foreign) investment. Furthermore, high debt service is perceived by investors as a form of "tax" on the future income of the country, thus dissuading new investment. A high level of debt can also be an obstacle to economic reforms and high debt service may crowd out productive expenditures (public and private). The debt overhang argument, therefore, supports explicit debt reduction, as opposed to continuous debt reschedulings.

² See *TDR 1995*, p.36, for a critique of the present value concept.

Notes

- 1 BIS, *International Banking and Financial Market Developments*, August 1996, p. 17.
- 2 World Bank, *Global Development Finance 1997*, Vol.1: *Analysis and Summary Tables* (Washington, D.C.: The World Bank, 1997), p. 104. ("East Asia" in that volume comprises Cambodia, China, Fiji, Indonesia, Lao People's Democratic Republic, Malaysia, Mongolia, Myanmar, Papua New Guinea, Philippines, Solomon Islands, Thailand, Tonga, Vanuatu, Viet Nam, Samoa, Kiribati and Democratic People's Republic of Korea.)
- 3 G. Evans, "Asian investors: growing appetite", *Euromoney*, Feb. 1997.
- 4 *Latin American Economy and Business*, April 1997, p.2. (According to these estimates, Argentina accounted for 48 per cent of these investments, Peru for 14 per cent, and Colombia for 8 per cent.)
- 5 BIS, *International Banking and Financial Market Developments*, Feb. 1997, pp. 21-22.
- 6 China, India, Indonesia, Republic of Korea, Malaysia, Philippines, Taiwan Province of China and Thailand (*ibid.*, May 1997, table 5A).
- 7 *Ibid.*, table 10A. The Latin American countries are Argentina, Brazil, Chile, Colombia and Mexico.
- 8 Debt instruments of less than investment grade are not permitted to be held by certain institutional investors under the regulatory regimes of some countries.
- 9 Country risk refers to the risk of failure to meet the obligations on a loan for reasons other than the solvency of the borrowing entity (which is covered by credit risk). In particular, it includes risk due to the actions of the government of the country of the borrowing entity (such as the imposition of foreign exchange controls which impede or delay the meeting of these obligations) or to the legal regime.
- 10 Standard and Poor's new approach was also extended to a Panamanian bank which received a rating higher than that of the country's sovereign entities (*International Insider*, 28 April 1997).
- 11 For typical pre-1990 policies in developing countries towards capital inflows see *TDR 1994*, Part Two, annex to chap. II, sect. B.2.
- 12 International investors have also become large buyers and sellers of the domestically issued short- and long-term debt instruments of some developing countries.
- 13 Two of the countries included in table 14 (Venezuela and Poland) are not covered by table 13. For the first total external financing was a small negative figure (-\$0.1 billion), and for the second the total was dwarfed by a large contraction in banks' exposure partly due to a debt restructuring agreed with its creditors.
- 14 See D.M. Sobol, "Central and Eastern Europe: financial markets and private capital flows", *Federal Reserve Bank of New York Research Paper No. 9629*. FDI associated with privatization has generally been a smaller share of total FDI in Asia and Latin America, figures for which during the period 1991-1994 can be found in UNCTAD, *World Investment Report 1996* (United Nations publication, Sales No. E.96.II.A.14), table I.3.
- 15 BIS, *International Banking and Financial Market Developments*, May 1997, table 5A.
- 16 Net issues of international debt securities by East and South-East Asian countries fell from \$14.3 billion in the last quarter of 1996 to \$6.3 billion in the first quarter of 1997, while net issues by Latin American countries rose from \$9.5 billion to \$10.3 billion (*ibid.*, table 10A.)
- 17 Figures for net FDI in China are generally considered inflated by flows which are misreported, often thanks to opportunities available to investors owing to the close integration of its economy with that of Hong Kong (which is the source of more than 50 per cent of the country's FDI). Thus, for example, some of the FDI is believed to consist of funds sent out of the country and then reinvested in ways that take advantage of preferences available only to certain enterprises which are recipients of foreign investment. Moreover, Chinese enterprises' foreign borrowing is apparently sometimes repackaged as FDI in order to circumvent controls on their accumulation of foreign debt. See J.P. Morgan, *Emerging Markets Data Watch*, 31 Jan. 1997, p. 3.
- 18 Alternative recent estimates of net FDI in 1996 for some of the countries covered in table 14 are preliminary and show considerable variation. For example, estimates for Argentina vary between \$2 billion and \$3.2 billion, for Brazil between \$5.5 billion and \$10.5 billion, and for Chile between \$6.4 billion and \$7.6 billion.
- 19 There was an increase from 1995 to 1996 in the share of total Latin American issues of international debt securities accounted for by private-sector entities (financial and non-financial enterprises) as opposed to public-sector ones (governments and state

- agencies) from a little over 25 per cent to almost 40 per cent. This increase was due mainly to private-sector issuers in Brazil and Chile (BIS, *op. cit.*, tables 10A, 10B, 10C, 10D, and 14).
- 20 *Ibid.*, tables 5A, 5B, 10A, and 10B.
- 21 See J.P. Morgan, *Emerging Markets Data Watch*, 23 August 1996, p. 8, and K. Warn, "Argentina to expand \$6 bn loan facility", *Financial Times*, 21 May 1997.
- 22 J.P. Morgan, *Emerging Markets Data Watch*, 2 Aug. 1996, p. 14.
- 23 *Ibid.*, 24 January 1997, p. 19.
- 24 *Ibid.*, 1 Nov. 1996, p. 10; 25 April 1997, pp. 9-10; and 2 May 1997, p. 7.
- 25 J. Wheatley, "Brazil lifts hedge restrictions", *Financial Times*, 26 May 1997, and "Deregulation delights BM&F", *ibid.*, 4 June 1997.
- 26 *Latin American Economy and Business*, April 1997, p. 2.
- 27 See *TDR 1996*, Part One, chap. II, sect. B.2.
- 28 J.P. Morgan, *Emerging Markets Data Watch*, 30 May 1997, p. 33.
- 29 For example, the raising of the ceiling on foreign equity investment in the shares of individual firms to 23 per cent (part of the planned liberalization of the country's capital account associated with its OECD accession) was implemented as of 1 May 1997 and is to be followed by an additional accelerated raising of the ceiling to 25 per cent in the second half of the year. The increase of 1 May was accompanied by an opening to foreign investors of the market for non-guaranteed convertible bonds and a relaxation of the limits on borrowing abroad for state banks.
- 30 China's central bank, too, engages in a policy of the partial sterilization of the expansion of the money supply due to its purchases of the foreign exchange associated with capital inflows through reductions in its loans to commercial banks.
- 31 Finance companies are the most important non-bank financial institutions in Thailand, accounting for rather less than 20 per cent of the total assets of such institutions in the early 1990s. See United States Department of the Treasury, *National Treatment Study 1994* (Washington, D.C., 1994), p. 488.
- 32 Concerning the high exposure of Thai finance companies to the property sector see T. Bardacke, "Thai property crisis leaves banks exposed", *Financial Times*, 7 Feb. 1997; and concerning the capital of such companies see J.P. Morgan, *Emerging Markets Data Watch*, 7 March 1997, p. 1.
- 33 For example, at the end of 1996 non-performing loans as a proportion of total loans amounted to between 4.3 and 8 per cent for five of Thailand's largest banks and to 7.7 per cent for all banks (*ibid.*, 28 Feb. 1997, p. 24).
- 34 By the beginning of 1997, according to the Bank of Thailand, the country's short-term external debt was falling and amounted to only 44 per cent of total external debt, in comparison to 50 per cent at the beginning of the previous year (*ibid.*, 31 Jan. 1997, p. 22). On estimates indicating a narrowing of the trade deficit in the first quarter of 1997 see the same source, 23 May 1997, p.26.
- 35 Much of this external financing was in the form of interbank borrowing from Thailand's offshore banking sector (the Bangkok International Banking Facility).
- 36 Liabilities to non-residents as a proportion of total domestic credit of the Thai banking system are estimated at more than 45 per cent in early 1997 (*ibid.*, 25 April 1995, p. 1).
- 37 Concerning the longer-term origins of the property boom in selected East and South-East countries, which is associated with major cities' mutually competitive objectives to become commercial or financial centres and involve luxury and middle-class housing as well as offices, see E. Paisley, "Asia's property perils", *Institutional Investor*, Jan. 1996.
- 38 Concerning support for the baht by central banks of other East and South-East Asian countries see T. Bardacke, "Singapore joins Thailand in the defence of the baht", *Financial Times*, 15 May 1997, and P. Montagnon and J. Ridding, "Asian central banks may bolster links", *ibid.*, 26 May 1997.
- 39 The export credits in table 12 include not only the private lending that carries insurance or guarantees from an export credit agency (ECA.), which is discussed in the present section, but also direct lending by OECD Governments, the determinants of which are not discussed here. It is customary to define credits carrying "official" insurance or guarantees as "private export credits". "Official" insurance in this context is in some cases provided by privately owned institutions with officially recognized mandates.
- 40 The difference which official insurance cover can make to the interest costs of international loans can be exemplified by the Birecik hydroelectric dam project in Turkey initiated in 1995. Of two loans used to finance the project, the one for DM 400 million without official guarantees carried a rate of interest of 230 basis points over LIBOR, while the second, for DM 1.4 billion, which was supported by guarantees from the Austrian, Belgian, French and German ECAs, carried a rate of interest of only 100 basis points over LIBOR. See World Bank, *Global Development Finance 1997*, Vol. 1 (Washington, D.C.: The World Bank, 1997), p. 24. (In comparison of the net cost to the borrower of the two loans account would need to be taken not only of the rates of interest but also of the charges associated with the guarantees.)
- 41 The ECAs upon which the figures in table 20 are based are the Compagnie Française d'Assurance pour le Commerce Extérieur (COFACE) of France, Hermes of Germany, the Export Development Corporation (EDC) of Canada, the Compañía Española de Seguros de Crédito a la Exportación (CESCE) of Spain, ECGD, the Sezione Speciale per l'Assicurazione del Credito all'Esportazione (SACE) of Italy, the Office National du Dueroire

- (OND) of Belgium, EXIM, the Export-Import Insurance Division of the Ministry of International Trade and Industry of Japan, and Exportkreditnämnden (EKN) of Sweden. Figures are not available for the premiums charged by each of these ECAs to all the countries in the table. See R. Kelsey, "Getting better terms from EKN", *Project and Trade Finance*, Oct. 1996.
- 42 The concept, "instance", is explained in note c to table 18.
- 43 The same sources used for tables 18 and 19 indicate no change in such terms during the year.
- 44 The country coverage for the four regions for which preferred payments terms are given in *International Trade Finance* is smaller than that in the Payments and Credit Surveys in *Project and Trade Finance* on which tables 18 and 19 are based.
- 45 The 21 countries are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Portugal, Spain, Sweden, Switzerland, United Kingdom, United States.
- 46 The various stages involved in the negotiation of an agreement to reduce debt and debt-service obligations to commercial banks are described in *TDR 1995*, Part One, ch. II, note 46.
- 47 The London Club is the forum in which commercial banks renegotiate external debt with debtor countries.
- 48 Under the IDA Debt Reduction Facility (established in 1989) money is made available to low-income countries for reduction of their external debt in the form of obligations to commercial banks and suppliers through buybacks at large discounts on face value. The financing is contingent on programmes acceptable to IDA for medium-term adjustment and the management of external debt. Other donors may provide cofinancing in the form of grants in support of individual debt-reduction operations under the Facility.
- 49 See World Bank: *Global Development Finance 1997*, Vol. 1, Appendix 2 "External debt trends in 1995".
- 50 The UNCTAD secretariat has repeatedly highlighted the heavy burden represented by the multilateral debt and debt owed to non-OECD creditors of the low-income countries, notably in *TDR 1993*, *TDR 1995* and *TDR 1996*.
- 51 At an exchange rate of \$1.44 per SDR at the end of 1996, this amounted to \$258 million.
- 52 The stock of debt of Bolivia, Burkina Faso, Côte d'Ivoire and Uganda at the end of 1995 amounted respectively to \$5.3 billion, \$1.3 billion, \$19 billion and \$3.6 billion (see World Bank, *Global Development Finance 1997*), Vol. 1.
- 53 See, *TDR 1995*, p.45 and *TDR 1996*, p.54 on the proposal to sell a portion of IMF gold reserves.

Sources for table 14

Current account balance and GDP: 1994-1995 were taken from IMF, *International Financial Statistics* and 1996-1997 were taken from J.P. Morgan, *Emerging Markets: Economic Indicators*, except for Malaysia in 1995, where the item was taken from the latter source. **Net direct investment:** 1994-1995 were taken from IMF, *International Financial Statistics* and 1996 was taken from World Bank, *Global Development Finance, 1997*, except for Hungary in 1995 and Mexico in 1996, where the item was taken from World Bank, *Global Development Finance, 1997*, for Republic of Korea and Czech Republic in 1996, and Mexico in 1997, where the item was taken from J.P. Morgan, *Emerging Markets Data Watch*, and for Colombia, Peru and Venezuela in 1996, where the item was taken from ECLAC, *Preliminary Overview of the Latin American and Caribbean Economy 1996*. **Portfolio investment:** 1994-1995 were taken from IMF, *International Financial Statistics*; Argentina, Brazil, Czech Republic and Mexico in 1996 and Mexico in 1997 were estimated from J.P. Morgan, *Emerging Markets Data Watch* and BIS, *International Banking and Financial Market Developments*, and Chile and Peru in 1996 were estimated from ECLAC, *Preliminary Overview of the Latin American and Caribbean Economy* and BIS, *International Banking and Financial Market Developments*; **Short-term debt:** all data were from Union Bank of Switzerland (UBS). **Import cover:** imports for 1994-1995 were taken from IMF, *International Financial Statistics*, for 1996 were made available by UBS, and for 1997 were taken from J.P. Morgan, *Emerging Markets Data Watch*, except for Malaysia in 1995, for which the item was made available by UBS, and for Poland and Argentina in 1996, where it was taken from IMF, *International Financial Statistics*; reserves for 1994-1996 were taken from IMF, *International Financial Statistics* and for 1997 were taken from J.P. Morgan, *Emerging Markets: Economic Indicators*, except for China, Malaysia and Poland in 1996, where the item was also taken from the latter source. **Short-term debt plus current-account balance as per cent of reserves:** based on the data in sources cited above. **Interbank debt as per cent of total bank debt:** both interbank debt and total bank debt for 1994-1996 were taken from BIS, *International Banking and Financial Market Developments*.

Annex to Part One

ISSUES INVOLVED IN TRADE DISPUTES THAT HAVE ARISEN CONCERNING THE NATIONAL TREATMENT PROVISION OF THE WTO AGREEMENT

Globalization and liberalization are modifying the relative impact of trade measures. With the entry into force on 1 January 1995 of the Marrakesh Agreement Establishing the World Trade Organization (WTO), some are losing their importance as trade barriers and as instruments of trade policy. The Agreement on Agriculture and the Agreement on Safeguards, for example, make it virtually impossible to resort to quantitative restrictions and voluntary export restraints, in both agriculture and industry. On the other hand, the Agreement on Agriculture gives prominence to the tariff quota¹ as a liberalizing measure, but this, as discussed below, has given rise to a number of disputes concerning implementation. The liberalization of border measures and increased penetration of markets by investors have also served to focus attention on internal measures designed to protect domestic production, explaining to some extent the preoccupation of the WTO dispute settlement mechanism with issues relating to the national treatment principle.²

The strengthening of the GATT dispute settlement mechanism is one of the major achievements of the Uruguay Round.³ Since the WTO Multilateral Trade Agreements (MTAs) entered into force on 1 January 1995, the number of disputes referred to the new dispute settlement mechanism has increased dramatically compared to the situation under the former GATT. As of 2 July 1997, the WTO Dispute Settlement Body had received 88 requests for consultations, involving 63 separate matters. Seven of the panels constituted have completed their work, and in five cases both the Panel Report and the report of the Appellate Body have been adopted. In almost half

of these disputes, the question of conformity with the national treatment provisions of GATT article III has been at issue.

Article III aims at ensuring that the benefits of tariff concessions are not frustrated by measures of internal taxation and regulation which could be applied in a discriminatory fashion against imported products. Its disciplines include the following broad elements: (i) the imported product must not be subject to internal taxes or other internal charges in excess of those applied to “like domestic products”; (ii) the imported product must be accorded treatment no less favourable than that accorded to like domestic products in respect of rules and requirements affecting the sale, purchase, transportation, distribution or use of the product; (iii) regulations relating to the mixture, processing or use of products may not specify that a certain amount or proportion must come from domestic sources; and (iv) internal taxes or other internal charges or internal quantitative regulations may not be applied in a manner so as to afford protection to domestic production. While elements (i), (ii) and (iii) relate to the rate of taxes, regulations and the compulsory utilization of domestic products, respectively, element (iv) is about “the manner of application” of taxes, regulations, etc. Its purport is that even if the taxes or charges are applied at the same rate on the imported and like domestic products, the manner of application should not be such as to afford protection to domestic production. Thus, both *de jure*, and *de facto* discrimination is prohibited. Similarly, internal quantitative regulations, even other than those mentioned above, cannot be applied in a manner which affords protection to domestic production either of a particular

product or of directly competitive or substitutable products.

The observation that as tariff barriers to trade are reduced or eliminated, non-tariff measures become of greater importance has been repeated so often it has almost become a cliché. However, it is evident that globalization of production and trade liberalization have led to greater attention being paid to the effects of internal measures that discriminate against imports. Thus, it is no accident

that the large number of complaints brought before the WTO Dispute Settlement Body have included allegations of contravention of the national treatment provision of GATT article III mainly through: (a) discriminatory internal taxes; (b) local content requirements; (c) allocation of tariff quotas among supplying countries; (d) measures relating to technical standards and the environment; (e) measures aiming at the preservation of cultural identity; (f) the limitation of access to distribution channels.

A. Discriminatory internal taxes

Some disputes have involved complaints over certain traditional forms of discrimination. For example, in many countries domestic production of alcoholic beverages has benefited from a variety of protective measures, including fiscal privileges (such as taxes) and state trading. In the so-called “beer war” between the United States and Canada during 1990-1991, each country had filed a case against the other with respect to domestic (or internal) measures affecting the sales of certain imported alcoholic beverages in the other’s market. The United States challenged Canada’s monopoly of import and distribution by provincial liquor boards and restrictions on the size of the package in which imported beers could be sold. In the retaliatory complaint filed by Canada, the United States measures (both state and federal) on taxation and sale of alcoholic beverages were claimed to discriminate against imports.⁴

The Uruguay Round succeeded in achieving considerable trade liberalization in this sector, and exposed internal barriers that permitted the continuation of protection. For example, Japanese taxes on alcoholic beverages were recently challenged by the European Communities (EC), Canada and the United States on the alleged grounds that they discriminated against imports of vodka, whisky, cognac and white spirits by imposing substantially lower taxes on the domestic product *shochu*. They argued that *shochu* and the imported products were “like products”.

The definition of the term “like product” has been the subject of dispute on many occasions. The

general practice has been to interpret it on a case-by-case basis. But certain essential features have often been recognized as relevant in this context, e.g. the end-use of the product in a given market, the tastes and habits of consumers, and the properties, nature and quality of the product. Both the WTO Panel, in July 1996, and the Appellate Body, in October 1996, concluded that *shochu* and vodka were like products and that Japan, by taxing imported products in excess of like domestic products, was in violation of GATT article III:2, first sentence.

As noted above, the requirement of “no less favourable treatment” applies not only to the rate of a tax but also to the manner in which it is applied; and “domestic production” refers not only to like products but also to directly competitive or substitutable ones. What is a directly competitive or substitutable product has been the subject of intense consideration. Here again the practice has been to proceed case by case. For example, in the dispute on alcoholic beverages, it was concluded that *shochu* and other distilled spirits and liqueurs listed in HS tariff heading 2208, except for vodka, were “directly competitive or substitutable products”, and that Japan, in the application of the Liquor Tax Law, did not tax imported and directly competitive or substitutable domestic products in the same way and afforded protection to domestic production in violation of article III:2, second sentence. It was the view of both the Panel and the Appellate Body that the term “directly competitive or substitutable product”, in accordance with its ordinary meaning, should be interpreted more broadly than the term “like product”.⁵ The Euro-

pean Communities and the United States are similarly contesting taxes on alcoholic beverages by

the Republic of Korea, and a similar case is being brought by several countries against Chile.

B. Local content requirements

The Agreement on Trade-Related Investment Measures (TRIMs), drawing upon earlier GATT panel decisions, prohibits investment measures which contravene GATT article III, notably local content requirements. It in effect codifies the finding in the complaint brought by the United States in 1984 against Canada's administration of the local content provisions of the Foreign Investment Review Act (FIRA).⁶ The TRIMs Agreement has encouraged WTO members to challenge measures such as local content requirements which are prevalent in certain sectors, notably the automotive sector.

For example, complaints have recently been made by Japan, EC and the United States against Indonesia concerning its "National Car Programme". Under that programme, the Government designated "PT Timor Putra National" as the only "national car" manufacturing company eligible for exemption from customs duties and luxury taxes on condition that it achieved specified minimum local content ratios (20 per cent by the end of the

first year of production, 40 per cent by the end of the second year and 60 per cent by the end of third year). Furthermore, the Government permits complete vehicles produced abroad by the Korean Kia Motors Corporation to be imported tariff-free as "national" cars so long as Indonesian workers participate in the foreign production of the vehicle and Korean Kia Motors Corporation counter-purchases from Indonesia parts worth 25 per cent of the value of the vehicles to be imported thereunder.

Complaints have also been filed by Japan, EC and the United States against Brazil concerning certain measures affecting trade and investment in the automotive sector. These measures require that companies must maintain a government-established ratio of net exports (by value) of certain goods, such as complete vehicles, to imported auto parts receiving duty preferences. They consider that the local content requirements in Brazil's automobile investment incentive measures constitute a prohibited TRIM, inconsistent with GATT article III:4.

C. Allocation of tariff quotas

Another area where it is perceived that breaches of the national treatment principle are being used to frustrate the liberalization achieved in the Uruguay Round is in the administration of the tariff quota system under the Agreement on Agriculture. For example, in the complaint filed by the United States against the Philippines concerning the latter's tariff quotas for pork and poultry, the United States considered that the implementation of these tariff quotas, in particular the delays in permitting access to these quantities

and the licensing system used, appeared to be inconsistent with the relevant WTO provisions, including those under GATT article III. In the case of complaints by Ecuador, Guatemala, Honduras, Mexico and the United States against the European Communities in relation to the importation, sale and distribution of bananas, the WTO Panel found that the allocation to Category B⁷ operators of 30 per cent of the licences allowing the importation of third-country and non-traditional ACP bananas at in-quota tariff rates was inconsistent

with the requirements of GATT article III:4. The ruling was based on the conclusion that the design, architecture and structure of the EC measure indicated that this measure was applied so as to afford protection to EC producers.⁸ Despite the fact that its exports are negligible, the United States took a leading role to protect the interests of United States banana corporations operating in Central America. The Panel felt that under the Understanding on Rules and Procedures Governing the Settlement of Disputes, the United States

had a right to advance the claims it had raised, even if it did not have actual trade or a potential export interest, since its internal market for bananas could be affected by the EC regime and by that regime's effect on world supplies and prices. The case also set a precedent for interpreting the legal meaning of the provisions in the General Agreement on Trade in Services (GATS) and its Schedule of Commitments, in particular with respect to those related to national treatment as provided for in article XVII of that Agreement.⁹

D. Technical standards

Many of the measures for which conformity with GATT article III is being challenged relate to those imposed for social and other non-economic reasons. The Agreement on Technical Barriers to Trade (TBT) was originally negotiated during the Uruguay Round with a view to ensuring that standards and technical regulations did not contravene the national treatment principle. It was recognized that the application of such standards and technical regulations required that foreign products meet domestic standards and be subject to conformity assessment procedures (e.g. testing) but that neither the technical regulations nor the related procedures should be applied so as to result in unnecessary restriction of trade. The Agreement on the Application of Sanitary and Phytosanitary Measures (SPS) applies the national treatment principle to the extent possible in the application of measures intended to protect human, animal and plant life and health.

The increased scope and application of measures aimed at environmental protection has also increased the possibilities of circumventing the national treatment principle by imposing more stringent conditions for foreign products. The first case resolved in the WTO dealt with a challenge by Venezuela and Brazil to environmental protection regulations in the United States relating to standards for gasoline, which they claimed allowed greater flexibility to domestic than to foreign refiners in conforming to special regulations for reformulated gasoline in major urban centres. The complaining countries were successful in demon-

strating that the United States "Gasoline Rule" imposed more stringent criteria for foreign refiners. They argued that, by imposing less favourable standards for imported gasoline from certain countries than those applied to domestic products, the United States violated several provisions of the MTAs, including GATT article III.¹⁰ They also claimed that the Gasoline Rule had nullified and impaired benefits under the non-violation provision of GATT article XXIII:1(b). The European Communities and Norway made submissions to the Panel as interested third parties, expressing concern that the gasoline rule could justify the fears of many countries about the use of purported environmental measures as disguised restrictions on international trade. Venezuela stressed that it was not seeking to avoid legitimate regulations for environmental protection, but merely wanted its gasoline to be subject to the same rules as gasoline produced in the United States.

Under GATT article III:4, the Panel found that imported and domestic gasoline were like products and that under the regulation imported gasoline was effectively prevented from benefiting from sales conditions as favourable as those afforded to domestic gasoline. It rejected the United States argument that the requirements of article III:4 were met because imported gasoline was treated similarly to gasoline from similarly situated domestic parties. Such an interpretation, it said, would be contrary to the ordinary meaning of article III:4, and would mean that imported and domestic goods could no longer be treated on the objective basis of

their likeness as products, but rather on the basis of a “highly subjective and variable treatment” according to extraneous factors. It would create great instability and uncertainty in the conditions of competition as between domestic and imported goods in a manner fundamentally inconsistent with the object and purposes of GATT article III. In its concluding remarks the Panel noted that it was not its task to examine generally the desirability or necessity of the environmental objectives of the United States’ Clean Air Act or the Gasoline Rule; WTO members were free to set their own environmental objectives, but were bound to implement those objectives through measures consistent with the provisions of GATT 1994, notably on the relative treatment of domestic and imported products.

One of the notable characteristics of such disputes is the high degree of technical competence required to prepare evidence in support of a complaint. The cases under the Agreement on the

Application of Sanitary and Phytosanitary Measures mentioned above have to be based on “scientific evidence” (e.g. that beef from hormone-fed cattle endangers human health); under the Agreement on Technical Barriers to Trade there is provision to call upon technical expert groups to assist panels in disputes. However, the need for such technical expertise is not confined to interpretations of these Agreements. For example, in order to successfully challenge the decision of the French Government to restrict the use of the term “coquille Saint-Jacques”, Canada, Peru and Chile were required to demonstrate that molluscs harvested in the Pacific Ocean were in fact “like products”. The complainants claimed that the French decision would reduce competitiveness of their exports of scallops in the French market as they would no longer be able to be sold as “coquilles Saint-Jacques” although there was no difference between their scallops and French scallops in terms of colour, size, texture, appearance and use.

E. Preservation of cultural identity

Other measures imposed for health, environmental, cultural and social reasons are currently being challenged. A dispute brought by the United States against Canada involves measures by the latter, motivated by considerations of cultural identity, imposing an 80 per cent tax on revenue from advertisements placed in the Canadian editions of

periodicals sold both in Canada and abroad (the so-called “split-run” periodicals). The United States also complained about Canada’s disallowing an income tax deduction to Canadian firms which advertise in “split-run” periodicals and applying favourable postage rates to its own periodicals

F. Distribution channels and related provisions of the General Agreement on Trade in Services

In the “Kodak/Fuji” case currently before the Dispute Settlement Body, the United States is challenging a series of Japanese laws, regulations, requirements and measures which it considers effectively exclude the firm Eastman Kodak from the Japanese market for consumer photographic film and photographic paper. According to the United

States, these Japanese measures are “liberalization countermeasures”; they include measures to restructure the distribution system for photographic products, as well as the Premiums Law and the Large Stores Law and related measures aimed at preventing Kodak and other foreign firms from obtaining adequate access to the Japanese film dis-

tribution network and retail outlets.¹¹ The United States considers that these measures by Japan, including the measure to provide protection to the domestic production of consumer photographic film and paper, nullify or impair its benefits and violate GATT provisions within the meaning of GATT article III:1. It claims that they also conflict with GATT article III:4 since they affect the conditions of competition for the distribution, offering for sale and internal sale of consumer photographic film and paper in a manner which accords less favourable treatment to imported film and paper than to comparable products of national origin. The United States has also alleged that these measures nullify or impair its benefits (a “non-violation” claim) in as much as the Japanese Government’s ineffective enforcement of its competition law was not foreseen when the concessions were negotiated on this product.

The United States has also filed a separate case under the GATS concerning Japan’s measures affecting distribution services (not limited to the photographic film and paper sector referred to above) through the operation of the Large Stores Law, which regulates the floor space, business hours and holidays of supermarkets and department stores. In its view, the Large Stores Law has the effect of limiting the establishment, expansion and business operations of large stores in Japan by foreign investors and exporters. It further argues that by impeding the business operations of large stores, the Law reduces productivity in merchandise retailing, raises costs, discourages new domestic capital investment and ultimately limits the selection and quality of goods and services.

One of the driving forces of globalization has been the recognition by enterprises of the importance of obtaining access to domestic distribution systems, or of setting up their own distribution systems in the importing country. The major developed countries pressed for commitments in GATS for market access and national treatment in this sector. During the Uruguay Round, 35 countries made commitments related to distribution services, in particular with respect to wholesale and retail trade. It should be noted that while GATT article III deals only with goods, GATS article XVII contains a national treatment provision for service suppliers. National treatment, however, is not an obligation, as it is for trade in goods, but a concession that can be extended on a sectoral or subsectoral basis. In the Uruguay Round, countries were not prepared to accept that any enterprise or natural person which gained access to the domestic market would have the automatic right to engage in all activities on the same basis as domestic suppliers. The GATS differs from the GATT in the sense that market access and national treatment are both seen as negotiable. Accordingly, market access for services does not automatically imply national treatment, which is also subject to negotiation. Some countries considered that the two concepts should be merged into a single discipline. Such an approach was subsequently adopted for the basic NAFTA obligation on investment, in which the national treatment provision is broadened to subsume the market access concept, i.e. including the right of establishment. The national treatment provision in the draft OECD Multilateral Agreement on Investment virtually reproduces the equivalent NAFTA text.

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With the significant reduction of tariffs and liberalization of non-tariff measures at the border, the discriminatory application of domestic taxes and regulations to protect national production, often reflecting protectionist pressures from domestic producers, has become more prominent as a barrier to trade. National treatment, as defined by GATT article III, alongside MFN treatment, is one of the central principles of the multilateral trading system. The main purpose of the national treatment rule is to eliminate or reduce “hidden”

domestic barriers to trade and to increase transparency and predictability. In other words, GATT article III is designed to impede the adoption of policies and measures that have domestic protection as their purpose. As a result of the Uruguay Round, the idea of national treatment has been extended from trade in goods to trade in other areas, such as services, though in a limited manner. In this context, the intention to multilateralize the rules and disciplines relating to government procurement practices can be viewed as another step

towards strengthening the application of the national treatment rule. However, with increasing interactions between trade, investment and competition policies, an analysis is often drawn between the elimination and/or reduction of “hidden” domestic barriers to trade and the peeling away of the layers of an onion. As formal import restric-

tions have been removed, “embedded” barriers have come to light, such as domestic regulatory measures and inter-firm trading relationships. Thus, as the process of trade liberalization gathers momentum, the application and enforcement of competition policy at the national level assumes greater importance. ■

Notes

- 1 Under a tariff quota a fixed quantity of a given product may be imported at a special tariff rate; for quantities in excess of the quota the general, higher, tariff rate is applied.
- 2 Under this principle, WTO members are required to accord treatment to imported products no less favourable than that accorded to like domestic products (article III of GATT 1994).
- 3 See UNCTAD, *The Outcome of the Uruguay Round: An Initial Assessment. Supporting Papers to the Trade and Development Report, 1994* (United Nations publication, Sales No. E.94.II.D.28), chap. IX.
- 4 See GATT documents DS17/R and DS23/R reproduced in GATT, *Basic Instruments and Selected Documents, Supplement No. 39* (Geneva, Dec. 1993).
- 5 See the reports of the Panel and the Appellate Body in WTO document series WT/DS8, WT/DS10 and WT/DS11.
- 6 Under the Canadian FIRA, foreign investors are required to give preference to purchase of Canadian goods over imported goods and to meet certain export performance requirements. The GATT panel found that Canadian requirements were inconsistent with GATT article III:4, which stipulates that imported products shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of requirements affecting their internal sale, purchase, transportation, distribution or use.
- 7 Under the EC’s operator category rules set out in article 19 of Council Regulation (EEC) 404/93 (as amended), import licences are distributed among three categories of operators, based on quantities marketed during the latest three-year period for which data are available. Category A refers to operators that have marketed third-country and/or non-traditional ACP bananas, who are given a 66.5 per cent allocation of import licences allowing imports at in-quota rates. Category B refers to operators that have marketed EC and/or traditional ACP bananas, given a 30 per cent quota allocation. Category C refers to operators who started marketing bananas other than EC and/or traditional ACP bananas in 1992 or thereafter (“newcomer category”), given a 3.5 per cent allocation.
- 8 See also the Report of the Appellate Body (WTO document WT/DS8/AB/R), p. 29.
- 9 See WTO documents in the series WT/DS27/R/... of 22 May 1997.
- 10 See the reports of the Panel and the Appellate Body in WTO document WT/DS2/9, 20 May 1996. Venezuela did not make any claim based on article 12 of the TBT Agreement (Special and Differential Treatment of Developing Country Members), rejecting the notion that it was seeking privileges for its own gasoline. Brazil stated that it, too, was not asking for a ruling under article 12, but wished to point out that the discriminatory treatment affecting its gasoline was particularly objectionable in the light of the provisions of that article.
- 11 See United States Trade Representative (USTR), *1997 National Trade Estimate Report on Foreign Trade Barriers* (Washington, D.C.), pp. 225-227.

