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PROCEEDINGS OF THE INTER-REGIONAL DEBT MANAGEMENT CONFERENCE

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NOTE

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Executive Summary

This document is a compilation of presentations made by debt management experts and professionals during the inter-regional debt management conference held in Geneva in December 1997. The presentations cover topics related to debt management and, in particular, new trends in institutional practices and information technology which affect the ways in which governments and international institutions such as UNCTAD approach effective debt management.

Experience has shown that effective institutions matter as much as appropriate public and private policies to maintain a prosperous economy. Events such as the liberalisation of developing country economies and those of countries with economies in transition have forced governments to respond to new economic challenges and conditions. The presentations made during the seminar aimed at addressing the effects of these developments on public debt, the way it has been managed and the institutions which played the primary roles in the management of national debt obligations.

Another important factor involves the rapid developments in computer technology. Sophisticated integrated computer systems continue to offer new possibilities and challenges that affect the institutions in which they are employed. A number of the presentations addressed such important related issues under four principal themes: the institutional environment for effective debt management, integrated financial management systems, best practices in debt management and capacity building and regional cooperation.

The analyses provided in the ensemble of the presentations will serve to analyse debt management situations faced by a number of countries in several regions; bring new issues into perspective; and enrich the thinking and practice on effective debt management systems for the future by drawing on lessons learnt from the past.

UNCTAD wishes to thank UNDP for its financial support in compiling this publication.

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ABBREVIATIONS

ADAPS	Automated Debt Auction Processing System
ADB	Asian Development Bank
ACBF	African Capacity Building Fundation
ALM	Asset/Liability Management
AMS	Aid Management System
BIS	Bank for International Settlements
CBDMS	Computer-based Debt Management System
CIDA	Comité Interamericano de Desarrollo Agrícola
CIS	Commonwealth of Independent States
CTP	Customised Training Programme
CUT	Single Treasury Account (Argentina)
DMFAS	Debt Management and Financial Analysis System
DAD	Donor Assistance Database
DO	Debt Office
DvP	Delivery-versus-Payment
ECA	Economic Commission for Africa
ECOWAS	Economic Community of West African States
EMU	European Monetary Union
ERM	External Ressources Mobilization/Management
ESAF	Enhanced Structural Adjustment Facility (FMI)
ESAIDARM	Eastern and Southern African Initiative in Debt and Reserves Management
GDP	Gross Domestic Product
GNP	Gross National Product
HIPC	Heavily Indebted Poor Countries
HQ	Headquaters
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFI	International Financial Institution
IFMS	Integrated Financial Management System
IMF	International Monetary Fund
ISIN	International Securities Identification Number
IT	Information Technology
JUPE	Retirement and Pensions System (Paraguay)
MEFMI	Macroeconomic and Financial Management Institute of Eastern and Southern Africa
MoF	Ministry of Finance
NPV	Net Present Value
NTMA	National Treasury Management Agency of Ireland

OAU	Organisation of African Unity
ODBC	Open Database Connectivity
OECD	Organisation for Economic Cooperation and Development
PIDM	Performance Indicators in Debt Management
RAMS	Risk Analysis and Management System
RoSS	Registry of Scripless Securities
SABYS	Goods and Services Administration System (Paraguay)
SAF	Administrative Financial Service (Argentina)
SHD	Sustainable Human Development
SIAF	Integrated Financial Administration System (Paraguay)
SIARE	Integrated State Resource Administration System (Paraguay)
SICO	Integrated Book-keeping System (Paraguay)
SIDIF	Integrated Financial Information System (Argentina)
SIME	Entry Table System (Paraguay)
SINARH	National Human Resources System (Paraguay)
SIPP	Integrated Budget Programming System (Paraguay)
SITE	Integrated Treasury-Management System (Paraguay)
SNDO	Swedish National Debt Office
TCDC	Technical Cooperation among Developing Countries
TCP/IP	Transmission Control Protocol/Internet Protocol
TGN	General Treasury of the Nation (Argentina)
TOPNET	The Treasury of the Philippines Network
UBS	Union Bank of Switzerland
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNITAR	United Nations Institute for Training and Research
USAID	United States Agency for International Development
WAIFEN	West African Institute for Financial and Economic Management
WB	World Bank

OPENING STATEMENT

Rubens Ricupero

Distinguished Participants, Ladies and Gentleman,

It is a great pleasure to welcome you to this conference. As a former Minister of Finance of my country, Brazil, I fully realise the crucial role of effective debt management and, more generally, good public financial management. The presence of so many debt managers and experts at this event is evidence that you agree with this assertion and believe that UNCTAD can play a useful role in this regard. With around 150 government officials from more than 50 countries from all regions of the world, this is probably one of the largest gatherings of its kind over the last few years.

Fifteen years have passed since August 1982 when Mexico's inability to service its debts triggered a rapid succession of similar moratoria by other debtor countries and led to what has come to be known as the "debt crisis". This crisis brought into stark relief the importance of effective debt management for many developing countries. This was a relatively new field of development administration but it soon became a central feature of governmental efforts to restore stability and creditor confidence in their economies. Recovery from debt service difficulties has been uneven among countries and regions, but the need to effectively manage the external debt of a country remains a constant endeavour for all. The establishment and continuous improvement of sound debt management systems, policies and practices is required, both by countries facing debt-servicing difficulties and by those in a more comfortable situation.

Clearly, at the end of the nineties, debt management has considerably changed and also differs significantly among various groups of countries. Highly indebted poor countries, whose debt is almost entirely owed to official creditors, bilateral and multilateral, may in the future benefit from the so-called HIPC Initiative. The objective of this Initiative, which was endorsed by the Interim and Development Committees of the IMF and the World Bank in September 1996, is to help these countries achieve overall debt sustainability, on a case-by-case basis, thus providing an exit from the rescheduling process. Therefore, during 1996 debt managers from, for example, Bolivia, Burkina Faso and Uganda, have been heavily involved in preparations and negotiations with the World Bank, the IMF and the Paris Club within the framework of this initiative.

In contrast, since mid-1996 a number of developing countries and countries in transition, such as Jordan, Kazakhstan, Lithuania and Panama, have issued international bonds for the first time or returned to the market for such bonds after long absences. Debt managers of these countries are discussing these bond issues with investment banks and lead managers. They are also concerned by the first-time assignment of credit ratings to the foreign currency debt of their country by the major credit rating agencies.

In an environment of increasingly mobile and volatile capital flows and integrated international capital markets, debt managers in a small number of emerging markets, taking the example of several OECD countries, have started to look at the external risk exposure of their country's sovereign liabilities and are acquiring knowledge and experience in modern risk management techniques, such as futures, options and swaps.

Thus, debt managers face different challenges and approach their tasks from different situations, experiences and perspectives. For some, debt sustainability is at the forefront; for others, market access or risk management techniques are the major issue of the day.

Whatever these differences, it is critical for all countries to have a professional debt management function. Some experts believe that investment in a professional debt management office is one of the most important investments a country can make. After all, the senior debt management officials are the defenders of the Government's reputation in the international financial community and in the market place. Attracting and retaining qualified staff, establishing a debt management office with sufficient autonomy to do its job effectively and ensuring that it has the information systems, authorities and accountabilities in place to implement strategies successfully are key issues that need to be addressed.

While many experts will present their views on various issues in the evolving field of debt management, this meeting is also an occasion for debt managers to meet with colleagues from other countries and exchange experiences. It will hopefully give you a feeling of being part of a distinguished group of professionals who share a common endeavour: to manage your country's debt in the most effective way. At the end of the conference we hope to have a better understanding of the new challenges and tasks ahead. UNCTAD will also be in a better position to provide you with further assistance.

Last year, UNCTAD IX underlined the importance of UNCTAD's technical co-operation and explained that it should focus its work on activities that provide practical assistance to developing countries and economies in transition. It also mandated the UNCTAD Secretariat to provide continued support for debt management. As an important element of UNCTAD's technical co-operation activities, the Debt Management and Financial Analysis System (DMFAS) Programme is an excellent example of how the organisation is assisting member countries, involving practical work at the country level, on an issue directly relevant to the integration of developing countries and countries in transition into the international economy.

The DMFAS Programme originated some fifteen years ago at the outset of the so-called "debt crisis". It resulted from UNCTAD's participation in the Paris Club, as well as its accumulated experience in dealing with the debt problems of developing countries. UNCTAD's economists recognised the strengths and weaknesses of debt management systems in a large number of countries. We therefore thought that enhancing the capacity of developing countries to manage their foreign debt would make a significant contribution to disentangling some aspects of the debt problem. UNCTAD started by building a computer-based debt management information system called the Debt Management and Financial Analysis System (DMFAS), which is the major component of our technical co-operation in this area. Since then, the DMFAS has been regularly upgraded in order to adapt to the evolution of international finance as well as the rapid changes in information technology.

The DMFAS Programme is now one of the major providers of technical co-operation services in the area of debt management. Its software is the most widely used standard system for debt management in the world. Today, the DMFAS client base consists of more than forty developing countries and economies in transition. The number of user countries is growing rapidly and is expected to be close to sixty by the year 2000. Taken together, the long and medium-term public and publicly-guaranteed debt, currently being managed or about to be taken under management by the DMFAS, represents around 35% of the total outstanding of this category of debt of developing and transition countries. It amounts to close to $ 600 billion - a highly impressive figure, and an indication of the trust placed in our organisation.

Finally, let me thank all of you for participating in this event. Our special thanks are due to the UNDP, which is co-sponsoring this meeting, as well as to all the other donors which have provided financial support to the DMFAS Programme over many years. I wish you a successful meeting and profitable deliberations.

Part 1

The institutional environment for effective debt management

THE CHANGING MACRO-ECONOMIC FRAMEWORK AND CRITICAL ISSUES IN SOVEREIGN DEBT MANAGEMENT

Dr Pervez Tahir

I have been asked to focus on recent significant developments in the macroeconomic framework and the emerging issues for sovereign debt management consideration. An interesting fact to note is that policy makers are reminded of debt management policy under the rubric of macroeconomic policies only when a crisis is already there. When the going is good - more or less free flowing capital, increasing growth and expanding employment - the expansionary stance merrily moves forward until the economy receives the next shock or hits a bubble. I think it was Rosenstein-Rodan, the pioneer of a big push in capital investment, who underscored the point that what was important was the uninterrupted flow of interest payments, not repayment of principal.

It is the prospect of non-payment of interest that leads to panic recalls. This happened in the nineteenth century and again in this century. Creditors have always acted pro-cyclically. Foreclosures are not relevant in the case of sovereign borrowers. To them access to future credit is important. In case an unsustainable debt burden accumulates, continued lending to ensure debt servicing at real interest rates equal to or lower than the long-term growth of the economy is likely to dissuade sovereign borrowers from default. This is after the event. Before the event, macro-economic projections place growth rate above interest rate in an accounting sense, with no cushion generally for failure of assumptions to hold or unexpected changes in objective data.

Our understanding of the subject will be facilitated if I am permitted to view the "rediscovery" of debt management policy in its proper historical perspective. For over a century and a half, beginning with Adam Smith's canons of taxation of 1776 until the publication of Keynes' *General Theory* in 1936, the housewife's view of debt held supreme for the nation as well: the coat must be cut according to the cloth. The macroeconomic framework proposed for the liberal western state was to practice fiscal prudence, view money as a veil, and enjoy the wealth accumulating effects of free trade and capital movements. Debt was a burden, an evil to be avoided.

No sovereign ever acted as a consistent housewife though, not at least during wars and periods of economic distress. The progress from the stage of a net foreign borrower to net lender has been seen by some as a sign of maturity. Keynes, let us not forget, had argued that foreign investment diverted resources away from critical investments at home.

The Keynesian revolution provided analytical support to expansionary fiscal policy for employment and growth. The debt associated with it was no more considered a burden if it led to the creation of capital assets. It would, in time, be repaid out of the growth of output. External debt did involve a current burden, as output must flow out in discharge of service obligations. Internal debt, even when incurred for consumption, led to undesirable transfer effects within a nation, but was not seen as a burden. On the whole, while fiscal policy, in co-ordination with monetary policy, became the main instrument for growth and stability in the post-war period, debt management policy turned out to be "the big engine that couldn't". There was neither agreement nor clarity vis-à-vis its compositional, stabilisation or interest-minimisation objectives.

Developing countries shared with developed countries the remarkable post-war prosperity, especially in the sixties. During the fifties and the sixties they were able to maintain current account deficits through long term concessional bilateral and multilateral assistance. It was towards the end of the sixties that the composition of international indebtedness began to shift towards private banking. When commodity price shocks of the seventies and the developed countries' demand-reducing responses disrupted the expansion of the world economy, developing countries in general experienced sagging exports and significant terms of trade losses. In addition, the oil importing developing countries faced skyrocketing oil import bills. Private lenders stepped in to meet these sharply increased borrowing requirements by recycling petrodollars. Debt enabled many of them to maintain growth. The external debt of developing countries rose massively and the costs of servicing it enormously when tight monetary policies of the developed world led to very high interest rates. As private lending was far less co-ordinated than official development assistance, the overall exposure of private banks to sovereign borrowers was not immediately apparent. The first signs of economic deterioration at the start of the eighties sent shock waves around and the banks turned off the tap faster than they had turned it on. As noted earlier, creditors act procyclically; private creditors more so. The reason is that normal bankruptcy laws do not apply to sovereign borrowers. For them the incentive to default increases, especially when the exposure is largely to private lenders. They are restrained by the threat of denial of future access to loans. However, the market process whereby the riskier borrower is charged a higher interest rate may lead to adverse selection as higher interest rate scare away good borrowers. As a climate of panic also provides maximum incentive to capital flights, a debt crisis followed in all its dimensions. It also changed the nature of debt assets. Ever since, contracts have been indexed not merely to LIBOR, but a lot more.

The proposals for adjustment to the Latin American debt crisis of the eighties contained what continues to this day as the most significant change in the macroeconomic framework and major issues for sovereign debt management consideration. The world learned to deal with imperfect information and foresight through co-ordinated action by creditor nations, multilateral institutions and private banks. In essence, the macroeconomic proposals were programmes for downward adjustment of domestic demand. The outcome in many cases was stagflation and reduced ability to repay, at least in the early phase of a stabilisation programme. With financial sector reform, sovereigns had to borrow more at the market rates than from the central banks. Domestic debt began to hurt and eventually became a burden.

In the early nineties, the reform programme in Mexico stabilised the economy in terms of conventional indicators. As might be expected, it attracted large capital flows. These flows contributed to currency appreciation rather than growth of output and investment. What was billed as a successful reform effort quickly degenerated into a debt crisis, with economy failing to meet its external liabilities. The rescue effort required the announcement of a $50 billion package by the IMF and the United States. The issue for debt management consideration was that the sovereign's macro-economy risks a liquidity crisis even when the borrower perceives that it is lowering borrowing costs through short-term borrowing abroad. What may be considered a safe debt/GDP ratio for the budget can be problematic if the maturity structure and the currency composition of are not right. A relatively higher proportion of short-term debt and portfolio equity has the potential to cause a serious liquidity crisis.

In my own country, the share of the volatile component of the external debt has doubled in seven years and its share in debt servicing exceeds the share of long term debt (see Annex). The economy is borrowing short even to repay the highly concessional long-term debt. The state of the current account balance shows where the problem lies, but only partly. Large fiscal deficits, a heavy and costlier domestic debt and high inflation have also persisted to complete the folklore of structural adjustment. An Enhanced Structural Adjustment Facility (ESAF) arrangement is now in place.

In 1996, private capital flows to developing countries rose by as high as 32 per cent, with half of the increase contributed by portfolio bond and equity flows. This was attributed to the confidence built up by the adjustment to the Mexican crisis and improved East Asian credit ratings.

In 1997, the macroeconomic story began to take a very different turn when the largest ever rescue package of US$ 55 billion was announced early this month by the IMF for an economy like South Korea, which has sustained spectacularly high growth since the sixties. (Rescue packages for other growth leaders, Indonesia and Thailand, were announced in July.) The macroeconomic issues involved here are not low saving, high fiscal deficit and high inflation. Even the reserves had not been falling before the crisis. Such economic fundamentals led a World Bank report to rule out "a full-blown Mexican style crisis". Not only that there is a crisis, these countries are also being prescribed the old wine in the old bottle, i.e. a tight fiscal and monetary policy. The debt is private, but the sovereign must deal with the macroeconomic consequences. True, there is a repeat of lenders refusing to rollover just when the need is utmost. Again, imperfect information and foresight must be dealt with in a co-ordinated manner. But the question is: do we have enough experience to conclude that the deflationary medicine will do the needful?

Short-term foreign private debt utilised by conglomerates for overextending themselves, in real estate and other non-tradables, encouraged speculative attacks on Asian currencies. Real exchange rate appreciated, putting serious pressure on the current account and thus the ability to meet external liabilities.

Foreign exchange transactions are several times the global trade in goods and services; they overwhelm the capital account. Perfect capital mobility implies that reserve deficiency could be overcome by attracting capital by offering higher interest rates. Short of perfect capital mobility, the possibilities to borrow abroad have risen tremendously after the breakdown of the fixed exchange rate regime in the early seventies. The floating regimes since have not exactly lived up to the promise of relieving sovereigns of the balance of payments constraint. Access to world capital market reduces the importance of reserves as an indicator of the soundness of international accounts. Sovereigns can borrow as much as they can, subject to intertemporal budget constraint. But sovereign borrowers also face a binding credit constraint; there is the risk of non-repayment. Sovereign borrowing cannot be analysed in terms of normal bankruptcy laws, so that the access to funds is not as much as should be possible at a certain interest rate. Lenders lend less to cover for default risk. Credit is thus rationed. In theory, it pays to default whenever present discounted benefits are more than discounted costs. In practice, there is a willingness to repay, as participation in world trade and payments system is beneficial. Trade liberalisation improves access to credit and trade restrictions to improve current account balance take many points off credit worthiness.

The 1992 bursting of European ERM, the Mexican peso crisis of 1994 and the East Asian crisis of 1997 have exposed the vulnerability of diverse economic structures to the unrestrained powers of the open foreign exchange markets. Not infrequently, short term speculative motives rather than economic fundamentals reign supreme. Nor does capital necessarily flow to the most productive areas. The unpractical nature of the Tobin tax on foreign exchange transactions and the lack of support at the Vancouver Summit for Mahathir Mohammad's proposal to limit currency traders' exposure to twice the capital invested, does not mean that the issue for sovereign debt management consideration has gone away. The impact of the IMF medicine on the East Asian economies will be keenly watched by policy makers elsewhere.

To sum up. The rapid pace of financial globalisation necessitates the formulation of a debt management policy as effectively as the fiscal, monetary and exchange rate policies. While co-ordination is desirable, the independence of debt office is as important as that of the central bank.

Annex

Pakistan: External debt, its servicing and current account balance

	Total External Debt Outstanding (US $ Billion)	Share of Short and Medium Term Debt (%)	Total Debt Servicing (US$ Billion)	Share of Short and Medium Term Debt-Servicing	Current Account Deficit (% of GDP)
1990-91	17.3	10.5	2.4	43.5	3.0
1991-92	19.6	11.6	2.8	46.1	1.9
1992-93	19.0	13.6	2.9	43.4	6.4
1993-94	20.3	17.0	3.6	50.4	3.8
1994-95	22.1	18.3	4.3	51.6	4.1
1995-96	23.1	19.8	4.4	50.1	7.1
1996-97	23.6	20.3	5.0	55.0	6.5

Source: State Bank of Pakistan

PRIVATE EXTERNAL DEBT AND OTHER PRIVATE FLOWS

Enrique Cosío Pascal

1. Nature of foreign capital flows

Importing or exporting capital flows imply two kind of risks: first, the commercial risk that is embodied in the entrepreneurial activity and, second the exchange rate risk associated with the currency exchange operation necessary to invest, to lend to or to borrow from a foreign agent.

The commercial risk is an inherent condition of the schumpeterian entrepreneurial activity, and as such is borne by the entrepreneur. The exchange risk is a different matter: if the Central Government imposes an exchange control[1], this means that the entrepreneur has to request an authorisation in order to invest, to borrow or to lend abroad. In this case the Central Government authorisation makes that the later has to bear the exchange rate risk. If there is not an exchange control and the entrepreneur is free to buy and sell foreign currency, the exchange risk is also his responsibility in addition to the commercial risk. This is summarised in Box 1.

<u>Box 1</u>

Private External Debt and Other Private Flows

Foreign Capital Flows:

Commercial Risk
Foreign Exchange Risk

Commercial Risk ⇒

To be assumed by the entrepreneur

Foreign Exchange Risk ⇒

To be assumed by the Government if there is an exchange control

If there is no exchange control, to be assumed by the entrepreneur

[1] Or the local currency has a fixed parity. This is also an implication foreign exchange risk guarantee.

Capital flows are of a different nature, and it is of paramount importance to have a clear classification of them in order to assess their volatility. The flows of private direct investment (FPDI) are linked to medium- and long-term development projects and are not, by nature, volatile. The medium- and long-term loans, including bond issues and shares, to be channelled to domestic productive domestic activities are also not volatile. The short- and medium-term export loans, linked to the foreign trade activity are not volatile *per-se*. The untied short-term loans to domestic commercial banks are high volatile flows that can be channelled to consumption, purchase of real estate and other non-tradable activities. The short-term capital flows to the domestic stock exchange are high volatile flows that are created by expectations of high short-term profits. These flows are diverted to speculative investment from the productive one and originate a "wealthy effect" that deprives the national savings and lead to an exchange rate overvalued. This is summarised in Box 2.

Box 2

Private External Debt and Other Private Flows

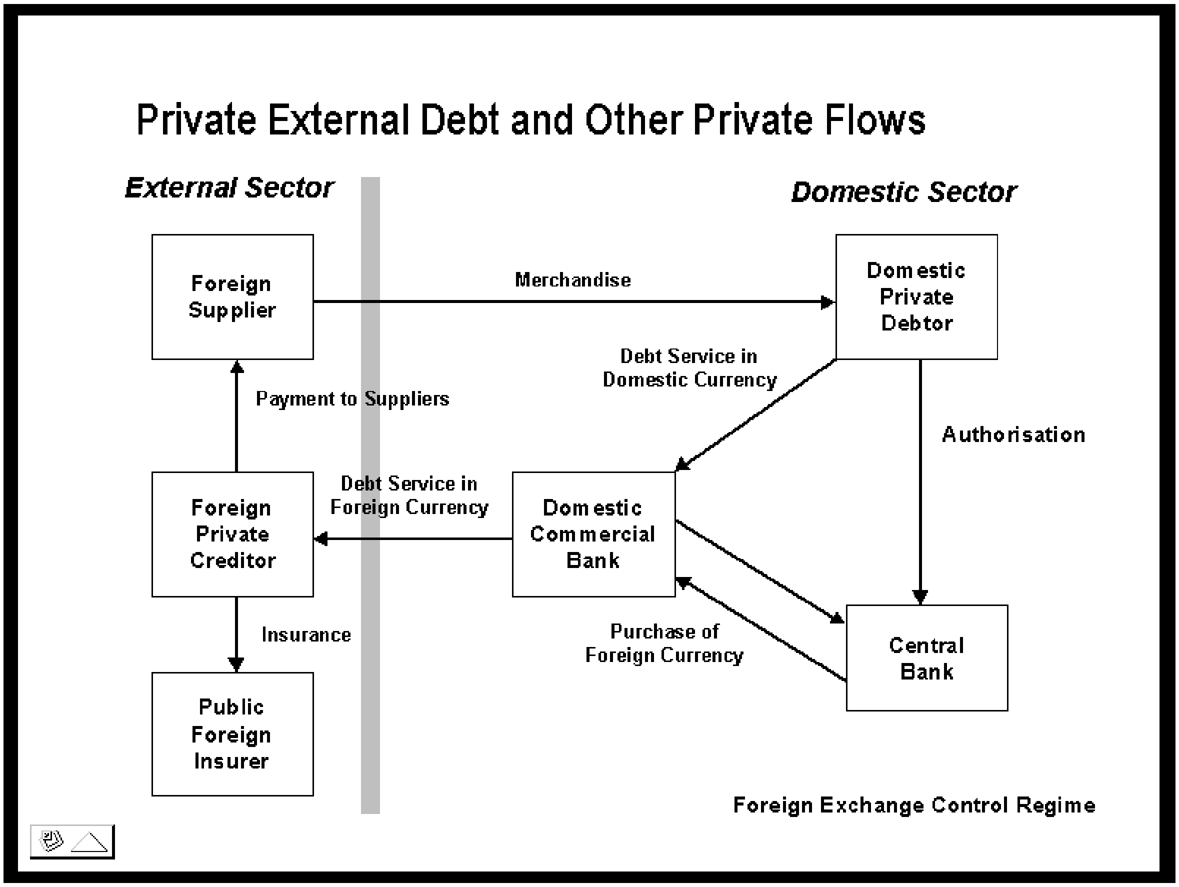
Capital Classification	Characteristics
Foreign Direct Investment	Linked to concrete medium- and long term development projects. Non - volatile and productive.
Medium and Long-term Loans	Including bonds issues and shares to be channelled to productive domestic activities: Non volatile and productive.
Short and medium-term export loans	Activities linked to the exporting sector: Non volatile and productive.
Untied short-term loans to domestic banks	Highly volatile flows that can be channelled to the financing of consumption, real estate and other non-tradable goods.
Short-term capital to domestic stock exchange	Highly volatile flows that are created by expectatives of high short-term profits. These flows create a "wealthy effect" that deprive the national savings and lead to an exchange rate overvalued.

2. The external indebtedness crisis scheme in the 1980's

Chart 1 describes the external indebtedness mechanism characteristic during the 1980s. The main characteristic of this mechanism is that there is an exchange rate control[2] and that the flows are linked to imports of merchandise. In the external sector there is the exporter, the exporter's financial agent and the insurance Export Company of the exporter country. The agents in the national sector are the importer, the importer's financial agent and the Central Bank of the debtor country.

[2] Or a fixed parity.

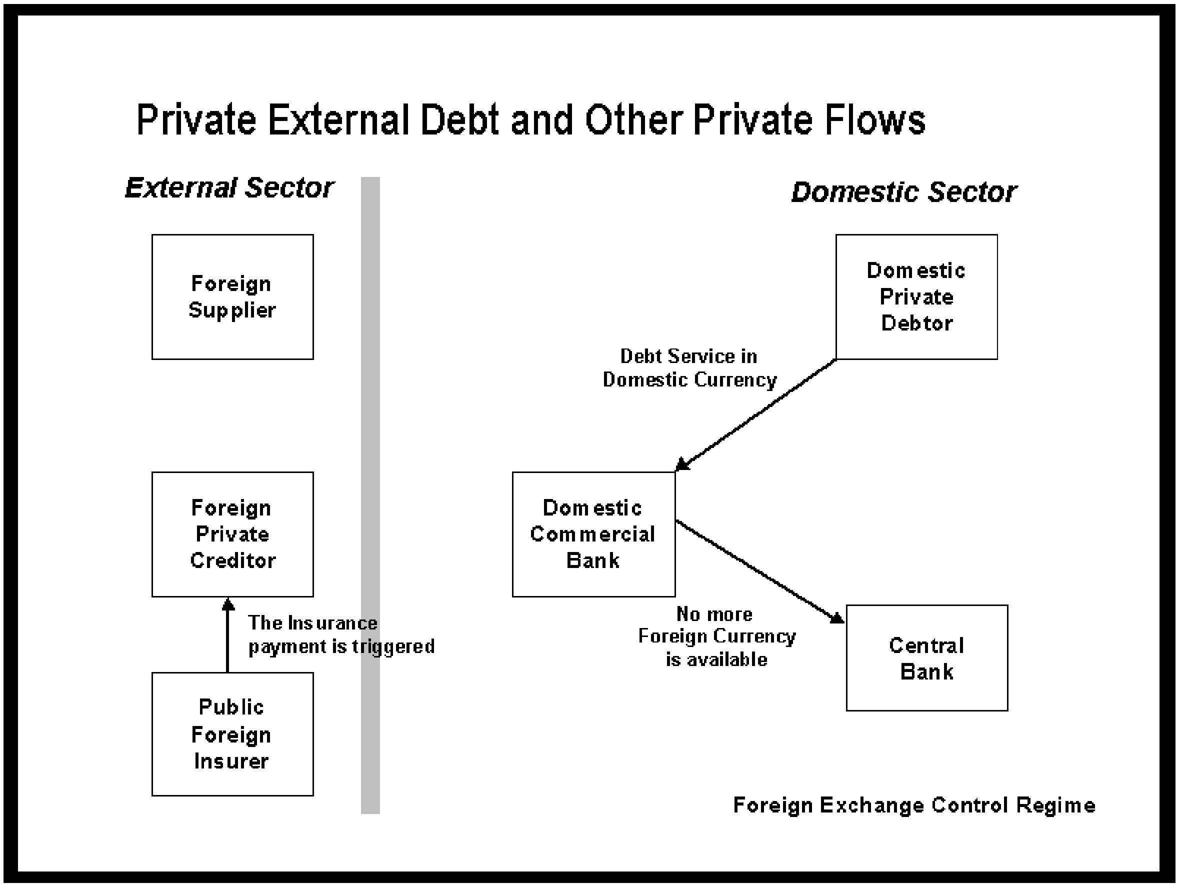
Chart 1



The process starts with the authorisation from the Central Bank to the local importer in order to contract a loan in foreign currency. The exporter's financial agent takes an export insurance with the National Insurance Export Company. Then it pays the exporter, who in its turn sends the merchandise to the domestic importer. The importer pays in domestic currency to his financial agent, who in its turn buys foreign currency from the Central Bank and sends the foreign currency abroad in order to pay the foreign debt.

The Central Bank foreign reserves are the currency buffer for all external operations. If a problem of shortage in foreign currency arose, then, in spite of the local debtor continuing to service its debt in domestic currency, the domestic financial agent would not be able to purchase the foreign currency from the Central Bank, and thus would stop to service the external debt. This makes the exporting insurance to be triggered and the foreign supplier stops its exports to the domestic importer. The description of this mechanism is shown in Chart 2.

Chart 2

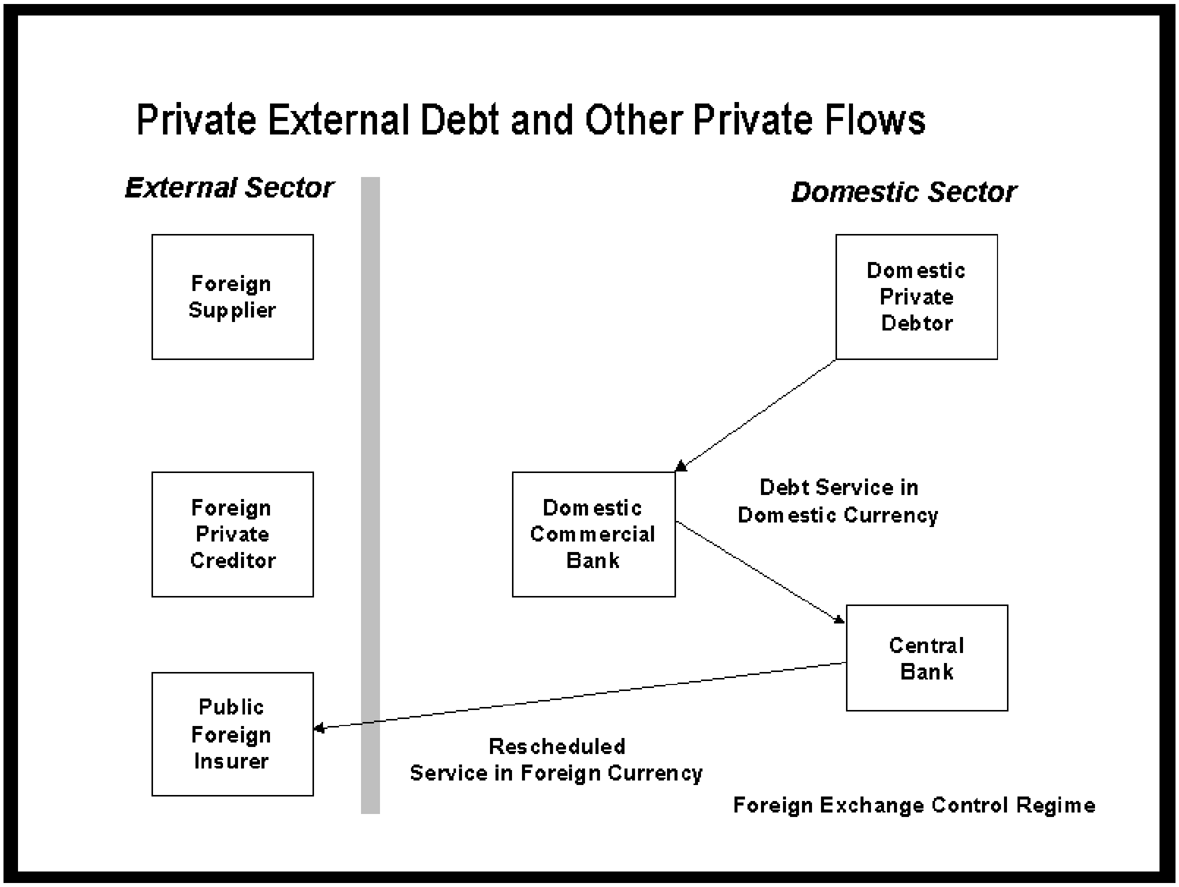


Very often these loans were private loans, i.e. without the guaranty of the debtor's Central Government. In the middle income-countries, very often too, these exports were intermediate goods for the industrial sector and thus major inputs for the local industry. The abrupt stopping of these kind of imported goods created huge disruptions in the local production and as a consequence in the local consumption market. The economic effects were so dramatic that the debtor's country Central Government country had to take the initiative to negotiate the private guaranteed and non-guaranteed debt at the Paris Club[3].

The rescheduling of the private external obligations of the private sector was channelled through the Paris Club agreements. In general, the domestic debtor continued to service the debt in domestic currency as originally scheduled and the Central Bank (or other domestic financial institution) would create a trust fund to repay the rescheduled debt in foreign currency. This mechanism is described in Chart 3.

[3] For instance, in Mexico in 1982, immediately after the debt crisis exploded, it was impossible to find toothpaste in the shops, not because there was not toothpaste in the country, but because the toothpaste tubes were imported from abroad. The 1983 Paris Club for Mexico addressed only the private non-guaranteed external debt arrears, in order to allow the domestic economy to restart activity. The price to pay for this was that the Mexican Government assumed the exchange rate risk and the commercial risk: the private sector non-guaranteed external debt arrears became public responsibility.

Chart 3



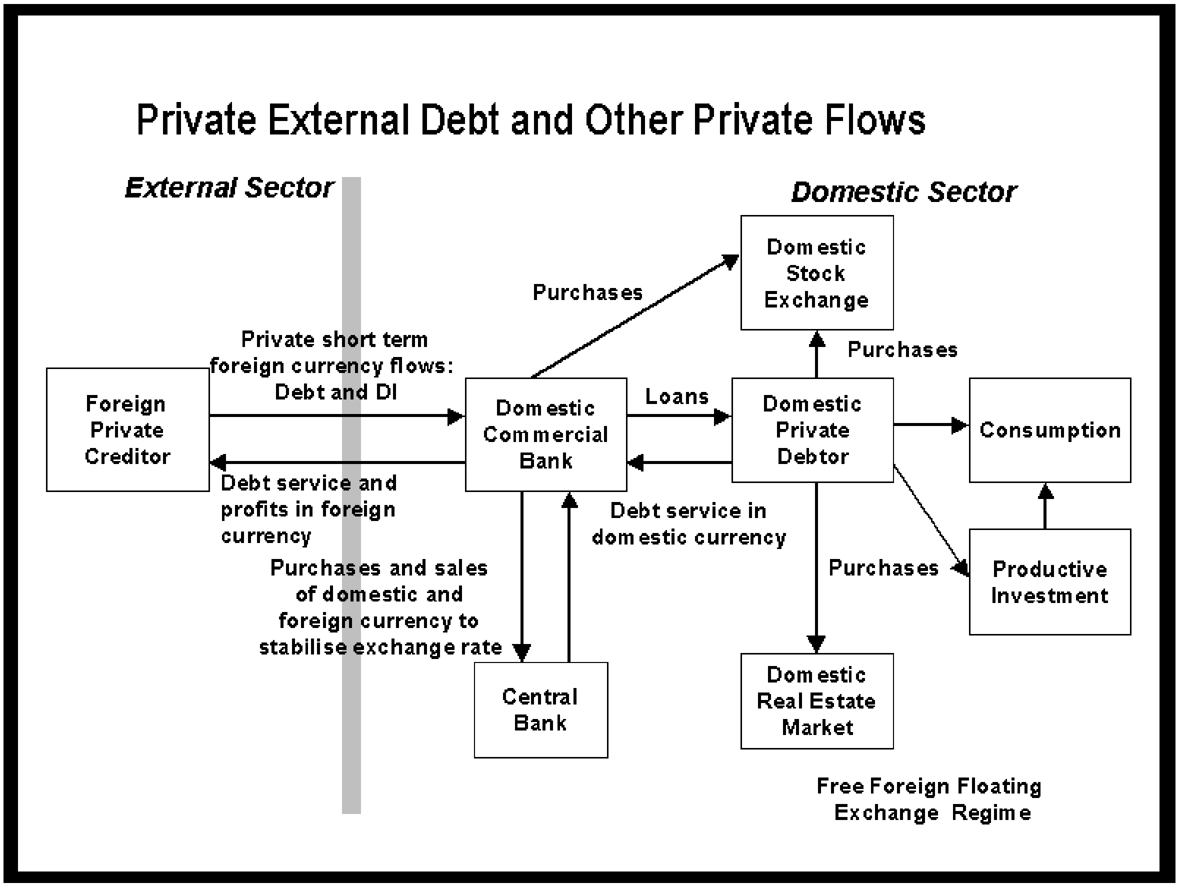
3. The external indebtedness crisis scheme in the 1990's

The indebtedness process in the 1990's is quite different from that in the previous decade and is very much the result of the financial deregulation. The financial deregulation lead, among other things, to the elimination of the exchange controls and to establish a floating exchange rate regime. This situation has created the opportunity for investment and debt flows, very speculative in nature, not necessarily linked to productive activities.

A single actor represents the external sector, normally private banks, which would invest in shares, through the domestic commercial banks, or to lend money to them. The domestic commercial banks would purchase shares in the stock market on behalf of their foreign customers or to lend to the domestic agents the excess liquidity coming from abroad in domestic currency.

The domestic borrowers would use the loan's proceeds to buy shares in the stock market, for consumption, for productive investment and to purchase real estate locally. The debt service and profits would be channelled abroad through the domestic commercial banks network. In this case, the Central Bank would limit its responsibilities to sell and purchase foreign and domestic currency in order to stabilise the exchange rate. This process is described in Chart 4.

Chart 4

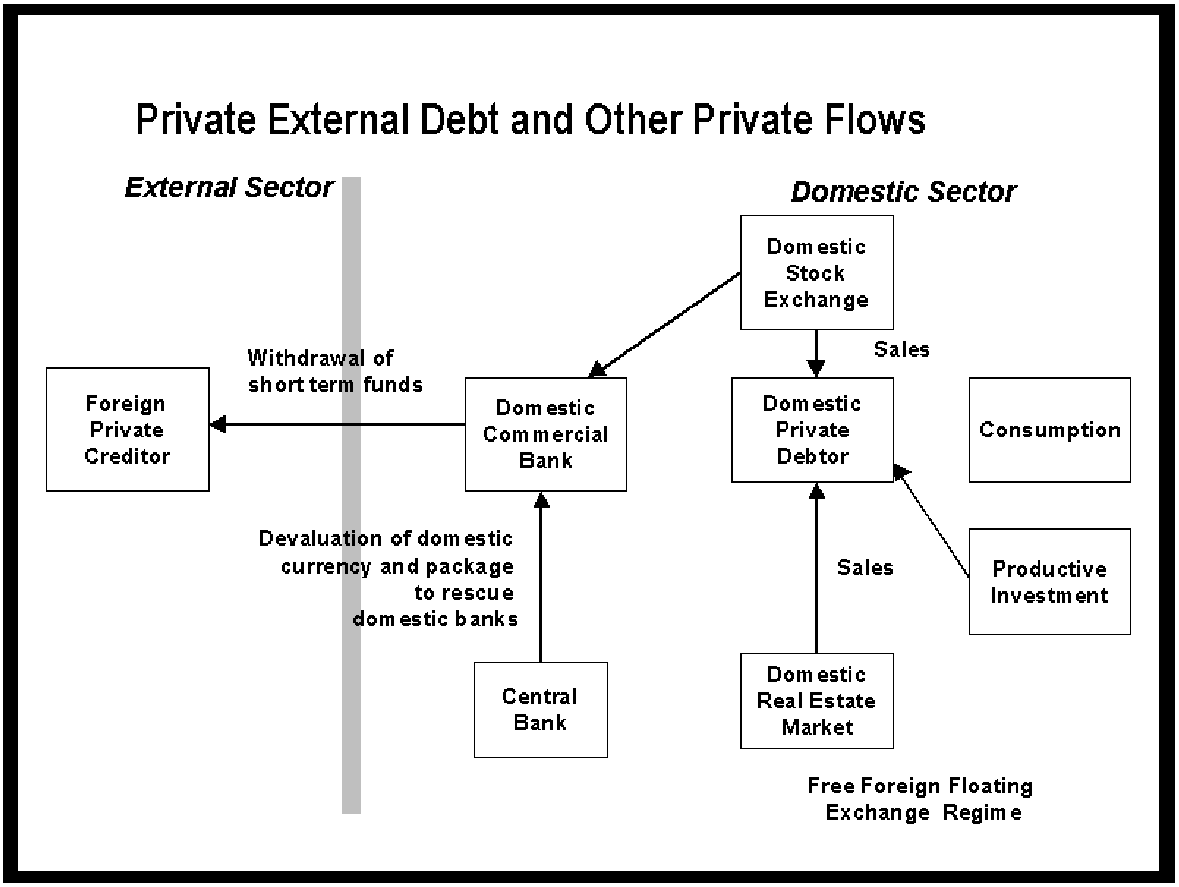


If the external lender foresees a risk in the investment and loans made in and to a specific debtor country, it will withdraw abruptly its capital from that country. If the domestic commercial banks were not following a conservative borrowing and lending policy (maturity structure of liabilities consistent with the assets maturity structure) they will be constrained to sell quickly their shares in the local stock exchange market and to stop lending to the domestic customers. The lack of credit to the domestic customers would force them to sell their shares in their turn, in the domestic stock exchange market too, to stop or to slow down consumption and also to sell their real estate properties. The result of this would be first, a dramatic decline in the domestic stock exchange prices as well as in the real estate market, and second a decrease in the local goods demand for consumption[4]. The lack of demand for domestic consumption will also deprive the productive activities.

The result of this crisis was quite different from that in the 1980's. The most affected sector was the commercial banking sector rather than the productive sector, and thus all the households that deposited their savings with the banks. This transformed the economic problem into a social one and the Central Government was constrained to intervene. The Central Government had to bail out the banks with a lump sum rescue package that implied exceptional finance from the IMF. The adjustment measures included also a devaluation of the domestic currency. This situation is shown in Chart 5.

[4] In some countries the consumption of goods was based on imports rather than domestic output like in Latin America but this was not always the case in Asian countries.

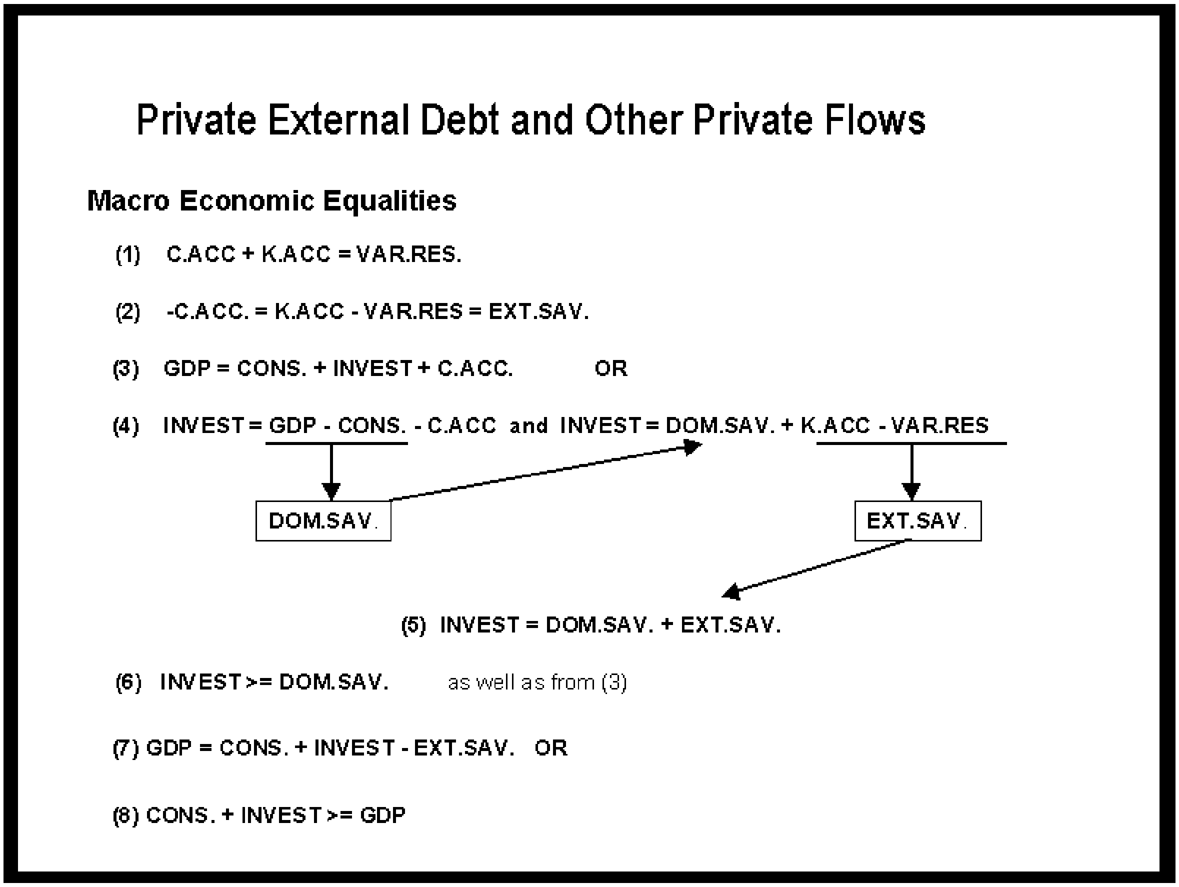
Chart 5



4. The macroeconomic equalities

The macroeconomic equalities are represented in Box 3. Equality 1 represents the balance of payments: C.ACC stands for the current account balance, K.ACC for the capital account and VAR.RES for the foreign reserves variation. Equality 2 shows that the external savings are the current account with minus sign or the capital account (the net flow) minus the variation of reserves. Equality 3 represents the Gross Domestic Product components: consumption plus investment plus the current account.

Box 3



From 2 and 3, equalities 4 and 5 are derived. In particular, equality 5 shows that domestic investment is achieved through the addition of domestic and foreign savings. Equality 6 shows that in the case in which the debtor country is running a current account deficit, with the absence of foreign savings, the investment needs are larger than the domestic available savings.

From equalities 2 and 3 equality 7 is derived, which shows that the GDP is equal to consumption plus investment minus external savings. In the case in which the external savings are positive (current account deficit), the GDP is not large enough to satisfy the domestic needs for consumption and investment.

Equalities in Box 3 show very clearly that, in the case of a deficit in current account, the external savings can be used to finance the current account deficit or to increase reserves. Also, in the same case, it can be seen that, through external savings, either consumption or investment is financed.

5. Macroeconomic variables in selected Latin-American countries

Table 1 shows averages data for macroeconomic variables from 1979 to 1995 for Mexico, Paraguay and Argentina for selected periods: 1979-82, 1983-89, 1990-91, 1992-94 and 1995. The rational for choosing the periods is the following: 1979-82 is the pre-debt crisis period for the 1980s, 1983-89 is the debt crisis period, 1990-91 is the overhang after the crisis, 1992-94 is the pre-debt period crisis for the 1990’s with its culmination in 1994 and 1995 is the debt overhang for the 1990’s crisis.

Table 1								Average values in % of GDP
COUNTRY	Periods	Consum.	Invest.	Dom. Sav.	Ext. Sav.	Net Flow	Res. Var.	C/Acc. Bal.
Mexico	1979-82	74.4	26.4	21.6	4.8	5.5	0.7	-4.8
	1983-89	74.9	20.3	20.9	-0.7	-0.8	-0.1	0.7
	1990-91	79.0	23.1	19.1	4.1	6.0	2.0	-4.1
	1992-94	82.3	22.4	15.7	6.7	6.7	0.0	-6.7
	1995	77.3	19.7	19.5	0.2	-4.1	-4.3	-0.2
Paraguay	1979-82	78.6	28.2	21.8	6.3	8.5	2.2	-6.3
	1983-89	80.8	23.5	19.2	4.4	1.0	-3.4	-4.4
	1990-91	83.3	23.8	19.6	4.2	1.0	-3.2	-4.2
	1992-94	90.3	23.1	12.7	10.3	4.5	-5.8	-10.3
	1995	N/A.	N/A.	N/A.	N/A.	N/A.	N/A.	N/A.
Argentina	1979-82	76.8	23.1	21.0	2.1	0.9	-0.1	-2.1
	1983-89	78.1	18.5	2.7	15.8	0.6	-1.4	-1.9
	1990-91	82.0	14.3	15.7	-1.4	-1.6	0.2	1.4
	1992-94	83.7	18.4	15.4	2.9	3.4	0.0	-2.9
	1995	82.0	18.0	18.0	0.0	0.1	0.0	-0.9

5.1. Mexico

The macroeconomic values show that consumption increased dramatically, with a drop in investment and domestic savings. For Mexico the consumption increases from 74.4 to 82.3 percent of GDP[5] from 1979-82 to 1992-94; a drop is registered in 1995, 77.3 percent, due to the crisis that exploded that year.

Regarding investment and domestic savings a drop, respectively of 26.6 to 22.4 and of 21.6 to 15.7, is shown from 1979-82 to 1992-94. The adjustment policies in 1995 originated a slight increase in domestic savings to 19.5 percent, as long as consumption was compressed, but the investment continued to drop to 19.7 percent.

The net flow (the capital account) increases from 5.5 percent in 1979-82 to 6.7 percent in 1992-1994; with a negative average during the debt crisis period, 1983-89, of -0.8 percent. The net flow has a dramatic drop in 1995 to -4.1 percent.

The variation of reserves show an increase in 1979-82 and 1990-91 of 0.7 and 2.0 percent due to a the strategy that was foreseeing the forthcoming debt crisis, but, besides this period, the variation of reserves is quite low and constant, it even shows a negative percentage in the 1980's, during the debt crisis and in 1995.

The current account balance is always negative with the exception of the adjustment period for the 1980's crisis period. The deficit increases from -4.8 percent in 1979-82 to -6.7 in 1992-94. The 1990's crisis originates an improvement to -0.2 percent in 1995.

[5] All the percentages are in relation to GDP of the year. The averages are the arithmetic mean of the yearly percentages. All the figures were calculated from data of the IMF, *IFS Yearbook 1997*, Washington 1997.

What can be seen from these figures is that the external savings, through the net flow, as well as variation in reserves are relatively small and have been financing the current account deficit. The increase in domestic consumption and the drop in investment and domestic savings also show that import items have probably been in majority consumption goods.

5.2. Paraguay

The macroeconomic values show that consumption increased dramatically in this case too, with a drop in investment and domestic savings. For Paraguay the consumption increases from 78.6 to 90.3 percent of GDP from 1979-82 to 1992-94; a smaller increase is registered in 1992-94 rather than in the other periods.

Regarding investment and domestic savings a drop, respectively of 28.2 to 23.1 and of 21.8 to 12.2, is shown from 1979-82 to 1992-94. Domestic savings showed a dramatic drop all along the period observed, the lowest values observed among all the countries of the sample. The investment share also drops following the domestic savings trend.

The net flow (the capital account) decreases from 8.5 percent in 1979-82 to 4.5 percent in 1992-1994, with a low average during the debt crisis period, 1983-89 and the debt overhang period, 1990-91, of 1.0 percent. Unfortunately, no data are available for the balance of payments in 1995.

The external savings are high in the period 1979-82, 6.3 percent, with a drop to 4.4 percent in the period 1983-89, due to the debt crisis, decreasing subsequently to 4.2 percent in 1990-91 and increasing dramatically to 10.3 in 1992-94. Paraguay, with the exception of the period before the first debt crisis, also increases slightly the external savings during the whole period in opposition of the decrease of domestic savings.

The variation of reserves shows a negative average in all the periods. 1983-89 was the debt crisis, which did not affect Paraguay very strongly.

The current account balance is always largely negative with the larger deficit in 1992-94 of -10.3 percent. What can be seen from these figures is that the net flow and variation in reserves have been financing the current account deficit. The increase in domestic consumption and the drop in investment and domestic savings also show that import items have probably been in majority consumption goods.

5.3. Argentina

The macroeconomic values show that consumption increased dramatically in this case too, with a drop in investment and domestic savings. For Argentina the consumption increases from 78.6 to 83.7 percent of GDP from 1979-82 to 1992-94. In 1995 drops to 82.0 percent, this is, probably, in relation to the crisis that exploded that year in Mexico.

Regarding investment and domestic savings a drop, respectively of 23.1 to 18.4 and of 21.0 to 15.4, is shown from 1979-82 to 1992-94. The adjustment policies in 1995 originated a slight increase in domestic savings to 18.0 percent, as long as consumption was compressed, but the investment continued to drop to 18.0 percent.

The net flow (the capital account) decreases from 0.9 percent in 1979-82 to -1.6 percent in 1990-1991. It increases dramatically to 3.4 percent in 1992-94, the Cavallo period, and drops to 0.1 percent in 1995 due to the effect of the Mexican crisis.

The variation of reserves varies in function of the financing needs to close the current account balance, which is always negative with the exception of the debt overhang period for the 1990-91.

What can be seen from these figures is that the net flows have been financing the current account deficit. The increase in domestic consumption and the drop in investment and domestic savings also show that import items have probably been in majority consumption goods for Argentina too.

6. Macroeconomic variables in selected Asian countries

Table 2 shows averages data for macroeconomic variables from 1979 to 1995 for Thailand, Indonesia, Philippines and Korea. For selected periods: 1979-82, 1983-89, 1990-91, 1992-94 and 1995. The rational for choosing the periods is in order to have comparability to the Latin American countries analysed in the previous section.

Table 2 Average values in % of GDP

COUNTRY	Periods	Consum.	Invest.	Dom. Sav.	Ext. Sav.	Net Flow	Res. Var.	C/Acc. Bal.
Thailand	1979-82	77.4	28.1	22.1	6.0	6.0	0.0	-6.0
	1983-89	72.6	29.9	26.7	3.2	4.6	1.4	-3.2
	1990-91	64.7	41.6	33.6	8.1	11.3	3.2	-9.1
	1992-94	64.1	40.8	35.4	5.5	8.5	3.0	-5.5
	1995	64.1	43.6	35.3	8.2	13.3	5.1	-8.2
Indonesia	1981-82	69.5	28.8	25.7	3.1	4.0	0.9	0.0
	1983-89	68.6	29.9	26.7	3.2	4.1	0.9	-3.7
	1990-91	63.7	35.8	32.6	3.2	4.6	1.3	-1.4
	1992-94	65.1	32.3	30.6	1.7	3.5	1.8	-2.9
	1995	66.4	32.4	28.9	3.5	5.2	1.7	-1.3
Philippines	1979-82	74.3	28.9	22.5	6.4	6.7	0.3	-6.4
	1983-89	78.4	19.6	17.4	2.2	1.2	-1.0	-2.2
	1990-91	82.3	22.2	18.0	4.2	5.5	1.4	-4.2
	1992-94	85.5	23.1	19.1	4.0	6.7	2.7	-4.0
	1995	85.4	22.2	19.6	2.7	7.2	4.5	-2.7
Korea	1979-82	74.7	31.4	25.3	6.2	7.5	1.3	-6.2
	1983-89	65.8	30.3	34.2	-2.6	-0.8	1.8	2.6
	1990-91	63.7	37.9	36.3	1.8	1.7	0.0	-1.8
	1992-94	64.6	35.9	35.4	0.7	2.0	1.3	-0.7
	1995	63.3	37.1	36.7	1.8	3.8	2.0	-1.8

6.1. Thailand

The macroeconomic values show that consumption decreased with a dramatic increase in investment, in domestic savings and in external savings. For Thailand the consumption decreases from 77.4 to 64.1 percent of GDP from 1979-82 to 1992-94 and 1995.

Regarding investment, domestic savings and external savings an increase, respectively of 28.1 to 40.8, of 22.1 to 35.4 and of 6.0 to 5.5, is shown from 1979-82 to 1992-94. In 1995, the consumption percentage stays at the same level as the average of the previous period, as well as domestic savings, whereas an increase in investment is observed from 40.8 to 43.6 percent. This increase in investment is financed, jointly through domestic and external savings, where the later increase from 5.5 percent to 8.2.

The net flow (the capital account) increases from 6.0 percent in 1979-82 to 11.3 percent in 1990-1991. It decreases to 8.5 percent in 1992-94 and then increases dramatically to 13.3. This increase in 1995 is signal of the massif flows that reached Thailand and that was part of the elements that originated the crisis to come in 1997.

It has to be noticed that the current account deficit percentage is very large, actually the largest observed for the countries of the sample. This is important for the analysis to be carried out below.

The positive sign of the variation of reserves shows that they finance the net flow financed the increase in reserves, as well as the current account balance, which is always negative. The composition of exports was, certainly in majority, investment and intermediate goods at least at the beginning of the periods observed. Nevertheless, towards the end of the periods, with a peak of 1.3 percent in 1995. This might translate that, towards the end of the period, the share of consumption goods that were imported to Thailand increased.

6.2. Indonesia

Indonesia shows the smallest percentage in consumption of the sample: 69.5, whereas all the other countries show a minimum of 74. The macroeconomic values show that consumption decreased with an increase in investment and in domestic savings. For Indonesia, the consumption decreases from 69.5 to 65.1 percent of GDP from 1981-82 to 1992-94, with an increase to 66.4 in 1995.

Regarding investment and domestic savings an increase, respectively of 28.8 to 32.3 and of 25.7 to 30.6, is shown from 1981-82 to 1992-94. In 1995, the consumption percentage increases to 66.4 percent; domestic savings decrease to 28.9, whereas a small increase in investment is observed to 32.4 percent. This increase in investment is financed through external savings. The external savings decrease from 3.1 percent to 1.7 from 1981-82 to 1992-94, and increase to 3.5 percent in 1995. It seems that domestic savings substitute external ones all along the periods, only for 1995 the opposite occurred.

The net flow (the capital account) increases from 4.0 percent in 1981-82 to 4.6 percent in 1990-1991. It decreases to 3.5 percent in 1992-94 and then increases dramatically to 5.2. This increase in 1995 is signal of the massif flows that reached Indonesia and that was part of the elements that originated the crisis to come in 1997.

The positive sign and the small variation of reserves show that the source of finance of the current account balance, which is always negative, with the exception of 1981-82, is the net flow. The composition of imports was, certainly in majority, investment and intermediate goods. This might translate that, all along the period, the share of consumption goods that were imported to Indonesia was not important.

6.3. The Philippines

The macroeconomic values show that consumption increased dramatically in this case with a drop in investment and domestic savings. The Philippines has a typical Latin-American behaviour. The consumption increases from 74.3 to 85.5 percent of GDP from 1979-82 to 1992-94; a small decrease is registered between 1992-94 and 1995, this is also probably due to the crisis that exploded that year in Mexico.

Regarding investment and domestic savings a drop, respectively of 28.9 to 23.1 and of 22.5 to 19.1, is shown from 1979-82 to 1992-94. Domestic savings that showed a drop all along the period observed improvement to 19.1 in 1995. The investment percentage further decreases to 22.2 percent in 1995, the lowest value observed among the Asian countries of the sample.

The net flow (the capital account) decreases from 6.7 percent in 1979-82 to 1.2 percent in average during the debt crisis period, 1983-89, increasing steadily in the following periods, reaching a peak in 1995 with 7.2 percent.

The variation of reserves shows small positive average values in all the periods, with the exception of the debt crisis period, 1983-89, that shows a small negative average of –1.0 percent. The current account balance is always largely negative. What can be seen from these figures is that the net flow and variation in reserves have been financing the current account deficit. The increase in domestic consumption and the drop in investment and domestic savings also show that import items have probably been in majority consumption goods.

6.4. South Korea

For Korea, the macroeconomic values show that consumption decreased with an increase in investment and in domestic savings. The consumption decreases from 74.4 to 64.6 percent of GDP from 1979-82 to 1992-94, with a further decrease to 63.3 in 1995.

Regarding investment and domestic savings an increase, respectively of 31.4 to 35.9 and of 25.3 to 35.4, is shown from 1979-82 to 1992-94. In 1995, domestic savings increase to 36.7, whereas a substantial increase in investment is observed to 37.1 percent. This increase in investment is financed through domestic savings. The external savings remain quite modest through the whole period, with the exception of 1979-82. It seems, however, that domestic savings are complementary to external ones with the exception of 1983-89.

The net flow (the capital account) decreases from 7.5 percent in 1979-82 to -0.8 percent in 1983-1989. After the debt crisis, the net flow becomes positive and increases slowly from 1.7 to 2.0 to reach 3.8 percent in 1995. The net flow is an important source to finance the current account deficit.

The variation of reserves stays quite small during the whole period, nevertheless positive. The current account deficit is relatively small, with the exception of 1979-82, and it seems to be financed through the net flow.

7. Elasticity of substitution between external and domestic savings

Table 3 summarises the values of the elasticity of substitution between external savings and domestic savings, for the Latin American and Asian countries examined in the previous section, for three selected periods: 1979-89, 1985-95 and 1989-95. The rational of choosing these periods is that 1979-89 covers the first debt crises, whereas the period 1985-95 is a transition period from one crisis to the other and 1989-95 is the preparation to the second crisis. These elasticity values lead us to confirm the conclusions that were elucidated in the previous section.

Table 3		Elasticity of substitution Ext.Sav% = f(Dom.Sav.%)	
	1979-89	1985-95	1989-95
Mexico	-0.42	-1.17	-0.29
Paraguay (*)	-1.52	-0.09	-3.29
Argentina	-0.01	-0.12	1.17
Philippines	-0.68	1.78	0.46
Thailand	0.18	2.31	1.15
Indonesia (**)	-0.07	-0.24	0.22
S. Korea	-3.66	1.27	0.71

(*) 1985-94 and 1989-94.
(**) 1981-95 and 1981-89.

Six countries, namely Argentina, Indonesia, Korea, Mexico, Paraguay and the Philippines show a negative elasticity during the first period. Argentina, Mexico and Paraguay show this negative elasticity because, during this period, the domestic savings decreased as the external ones increased. This trend could be called the "Latino Behaviour"; i.e. the external savings substituting the domestic ones as domestic consumption increased, in part, fostered through imported goods that were financed by the net transfer of the capital account.

Indonesia, Korea and the Philippines show negative values for the elasticity values in this first period for a different reason. This is because these three countries substituted foreign savings with domestic ones in the period 1979-89. This is a unique behaviour for the countries in the sample and could be called the "Asian Behaviour": import of capital goods financed by the net flow of the capital account, increase in investment and domestic savings, decrease in foreign savings and domestic consumption.

Indonesia, the Philippines and Thailand show a positive elasticity for most of the periods. Actually, Thailand and Indonesia increase domestic savings as well as foreign ones: they are complementary rather than a substitute of each other. This could be called the second type of "Asian Behaviour ": increase, in a complementary way, of foreign and domestic savings, decrease in consumption, increase in investment and finance of imports of capital goods financed through the net flow of the capital account. Whereas, for the Philippines, the value of the elasticity of substitution is negative because both, external and domestic savings, decrease. This could be called an acute "Latino Behaviour": i.e. external and domestic savings decrease, so that they appear to be complementary, domestic consumption increases, in part, fostered through imported goods that were financed by the net transfer of the capital account with a high current account deficit.

8. Credit to the private sector through commercial banks

In the previous section, it has been shown that important capital inflows have taken place during the periods considered for the countries of the sample. These flows, nevertheless, had to be channelled through financial institutions, in particular the domestic banking sector. Table 4 shows the credit to the private sector, through domestic commercial banks, in percentage of GDP.

Table 4
Credit to the private sector through domestic commercial banks in percentage of GDP

COUNTRY	1989	1990	1991	1992	1993	1994	1995
Mexico	15.90	20.40	26.10	32.70	36.70	46.30	35.00
Paraguay	10.80	12.00	14.90	17.70	19.40	21.20	21.60
Argentina	N/A.	15.50	12.50	16.10	16.50	N/A.	N/A.
Thailand	71.94	83.08	88.64	98.39	110.82	128.14	142.04
Indonesia	34.93	49.69	50.32	49.45	48.90	51.88	53.73
Philippines	20.41	22.24	21.44	24.97	31.96	35.91	45.05
Korea	49.97	52.63	52.99	53.68	54.60	57.20	57.51

The figures in Table 4 suggest that the credit to the private sector increased dramatically in the period considered. For Mexico, the credit to the private sector in percentage of GDP increased from 15.90 percent in 1998 to 46.30 percent in 1994, one year before the crisis. The credit to the private sector in percentage of GDP more than doubled in six years. After the crisis, the severe contraction of credit driven by the stringent policies and the crisis itself brought down the percentage to 35.00 percent, below the 1993 level.

For all the countries in the sample, with the exception of Argentina and South Korea, the banking credit to the private sector, in percentage of GDP, more than doubled, or almost doubled, form 1989 to 1995.

The most impressive figure is that of Thailand: in 1995: the private sector owed to the commercial banks 142 percent of the country's GDP. Anyone looking at that figure might have been able to forecast a future problem. How can the private sector pay back to the banks 40 percent more than what the country produces? This was a clear sing of an emerging crisis!

The bailout operations that debtor's governments had undertaken are creating moral hazard for the creditor banks, foreign and domestic, who were protected from bearing the full cost of poor lending decisions. For instance, it is thought that solely regulation measures will not solve the problem[6], the creditor banks have to be more circumspect and they do not have to

[6] Mr. Andrew Crockett, General Manager of the BIS, declarations at the Davos Forum, Switzerland and published in 'Excelsior' 2 February 1998, Mexico D.F.

behave as if there were no risks involved, as they seem to assume that they will be rescued. Another problem in emerging market's countries is that the domestic credit is made very often on confidential basis, where the banks also belong to influent politicians. Each time that a loan is made not on economic and financial basis, but on personal interest or political influence is highly probable that the loan is not well fundament. To this it has to be added that very often too the high exposure and the poor accounting system of the banks, in the domestic debtor countries, are undermining the whole domestic banking system.

The key task for the regulatory organisations (like the BIS) will be to strengthen the banking systems through supplying the needed incentives and the required information for the banking institutions in creditor countries in order for them to take better decisions. In this respect, the 25 basic principles in banking matters established by the Bale Committee will be tested in the times to come[7].

Nevertheless, if the lessons about excess credit, poor banking supervision, lack of transparency, political cronyism and hubris have been heavily pointed out in debtor countries, the role of international banks has to be pinned down too. The nature of the crisis seems to suggest that, in the future, some mechanism has to be implemented for discouraging short-term flows lending by the international banks. The banking supervisory authorities, in the international banks' home countries, should take more notice of their operations overseas too. These short-term flows need as careful monitoring as lending by the debtor countries' domestic banks to the nationals. There must be, and there will be, a shift to longer-term lending, preferably through securities or channelled through the strongest local institutions or the government.

Another important factor is that open market and technological change have reduced to almost zero the cost of shifting between currencies. This necessarily encourages trading and thus volatility. A tax on foreign exchange transactions to limit volatility could be figured out, even if in the past this has been seen as impractical, this issue deserves examination[8].

9. Conclusions

In this section general conclusions will be presented. The first section will deal with the matter of understanding the differences between the two debt crisis periods, namely the 1980s and the 1990s. The second section will deal with the differences between Latin America and Asia in the 1990s crisis.

9.1. Differences between the 1980s and the 1990s crisis

The 1980s crisis affected all developing countries, to a more or less important degree, but all of them were affected through the "drop in creditworthiness" effect, which implied the shrinking of international credit for this category of countries. Whereas the 1990s crisis seems to touch only countries which had attracted large private capital flows[9].

[7] The Bale Committee on banking supervision is composed by supervisory banking authorities and established by the governors of central banks of the Group of 10. The Committee was established in 1975.
[8] See Andrew Cornford, "The Tobin Tax: Silver Bullet for Financial Volatility. Global Cash Cow or Both?", in *UNCTAD Review 1996*, pp.105-119, Geneva 1996.
[9] This statement does not mean that we are ignoring the side-effect or secondary-wave-effect to third countries, like Vietnam for instance. This secondary wave effect has been extremely important and deserves study too.

The 1980s crisis was resolved, in general, through a rescheduling of foreign liabilities stretching over the period for repayments. This rescheduling taking place at more or less structured fora like the Paris Club and/or an *ad hoc* Private Banks Steering Committee (the wrongly called London Club).

The 1990s crisis ended in a lump sum payment from the debtor Government in order to bail out domestic banks, implying the necessity of exceptional financing from abroad[10]. This exceptional financing was obtained through IMF's stabilisation agreements, which implied conditionality for the debtor country also.

The origins of the 1980s crisis were to be found in drop of terms of trade for debtor countries, increase of interest rates in international markets and a sudden shorten of credit supply by creditors. All this in a situation in which debt management was inefficient, or ignored, on the side of the debtors, and, on the side of the creditors the country-risk creditworthiness responded to unsound analysis.

The origin of the 1990s crisis seems to be due to a rapid financial deregulation. The same phenomenon has been observed in the aftermath of financial deregulation in the U.K. and some Scandinavian countries: a fall in savings, plus a deterioration in current account and an increase of private consumption, stock exchange shares and real estate shares through capital inflows[11].

The domestic commercial banks were the agents channelling these resources from abroad. The strategic location for collecting information and monitoring these flows is then the supervisory authority of the commercial banking system. In order to achieve an efficient monitoring and collection of data, it is necessary to reinforce the rules and regulations allowing monitoring the nature and amount of foreign capital inflows channelled through the commercial banking system.

The rules and regulations should be applied by the institution monitoring the banking sector in order to keep under control, within established agreed limits, a set of selected indicators. Among those indicators, one of maturity structure between assets and liabilities of domestic banks is of vital importance[12].

9.2. Differences between the Latin American and the Asian countries

Although the troubles in both Latin America and Asia were triggered by large current account deficits and difficulties in rolling over short-term debts denominated in foreign currency, the underlying causes were different. In Latin America, capital inflows were used to finance a consumer-spending spree; in Asia they went into overinvestment, especially in property. Latin America did not have a real estate property bubble, so its debt problems were not exacerbated by the asset-price deflation that Asia is now facing.

Another difference is that the Asian countries have, proportionally, more domestic private debt than Latin America as can be seen from table 4. In Mexico, bank's non-performing

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[10] Around 6 and 4 percent of GDP in Mexico and Paraguay respectively.

[11] See Jan Joost Teunissen, editor, *Can Currency Crises be Prevented or Better Managed?*, FONDAD, The Hague, 1995, p.35.

[12] The rules and regulations to be applied as well as the set of indicators to be selected are beyond the scope of this paper.

loans were around 30 percent of total loans, i.e. around 15 percent of GDP in 1994. If non-performing loans reach the same level in Thailand they will be around 45 percent of GDP[13].

Latin America was, in some way, fortunate with the timing of its crisis because 1995 was a bumper year for world trade and the NAFTA gave Mexico freer access to the U.S.A. market. After devaluation Mexican exports increased by 40 percent in dollar terms, of which 90 percent went to the U.S.A. The Asian economies do not have a "locomotive", like the U.S.A., in their region and 60 percent of their exports go to other Asian economies, including Japan, so any growth is likely to be less rapid than post-crisis Latin America's. Devaluation is a double-edge sword for Asian exporters because most of their components are imported, besides they have the same customers to export, so that, a devaluation in one country could trigger a series of competitive devaluation in the other countries that could be very damageable for the region.

Last, but not least, Latin America's economy recovered because implemented tough measures and restructured its financial sector, very often under the pressure of the U.S.A. Treasury; whereas the Asian governments' dithering, including Japan's, will likely prolong the down turn.

Nevertheless, in both cases, the nature of the crisis seems to suggest that, in the future, some mechanism has to be implemented for discouraging short-term flows lending by the international banks.

[13] See *The Economist*, 7th –13th March 1998, "Survey of East Asian Economies".

UGANDA'S DEBT STRATEGY: AN EXAMPLE OF THE NEED FOR FLEXIBLE, CO-ORDINATED INSTITUTIONS IN A CHANGING MACROECONOMIC ENVIRONMENT

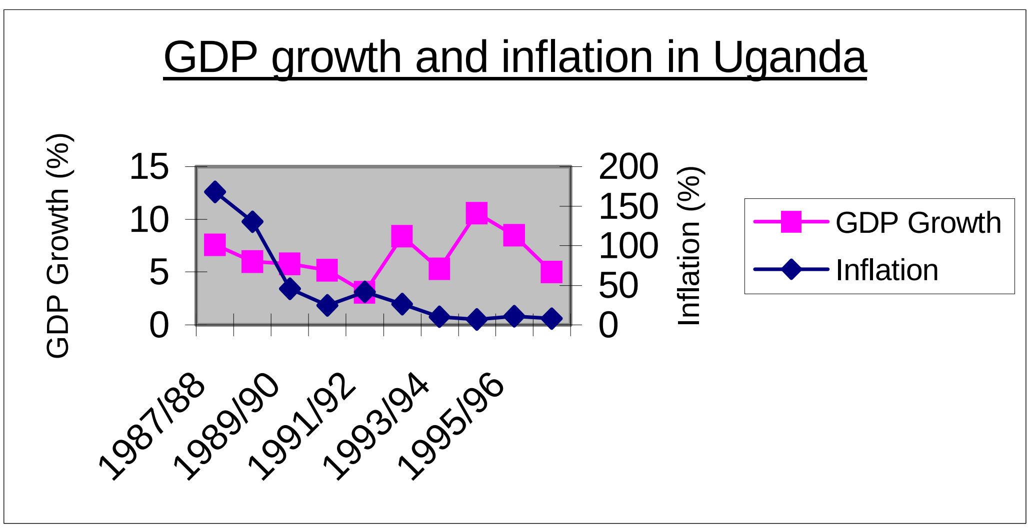
Damoni Kitabire

1. Opening remarks

The case of Uganda demonstrates the need for a cohesive and effective institutional structure which is capable of adapting to new conditions and, in some circumstances, providing the momentum for change. It is my intention here to review the debt strategy Uganda has implemented, as this will allow the role key financial institutions have played in reducing debt to be highlighted. I hope this emphasis will be of interest and practical use to those delegates representing countries who find themselves in a similar situation to that faced by Uganda in recent years.

2. Overview of the Ugandan economy

As many of you will be aware, Uganda has experienced remarkable success with its programme of economic reform.



3. The economy

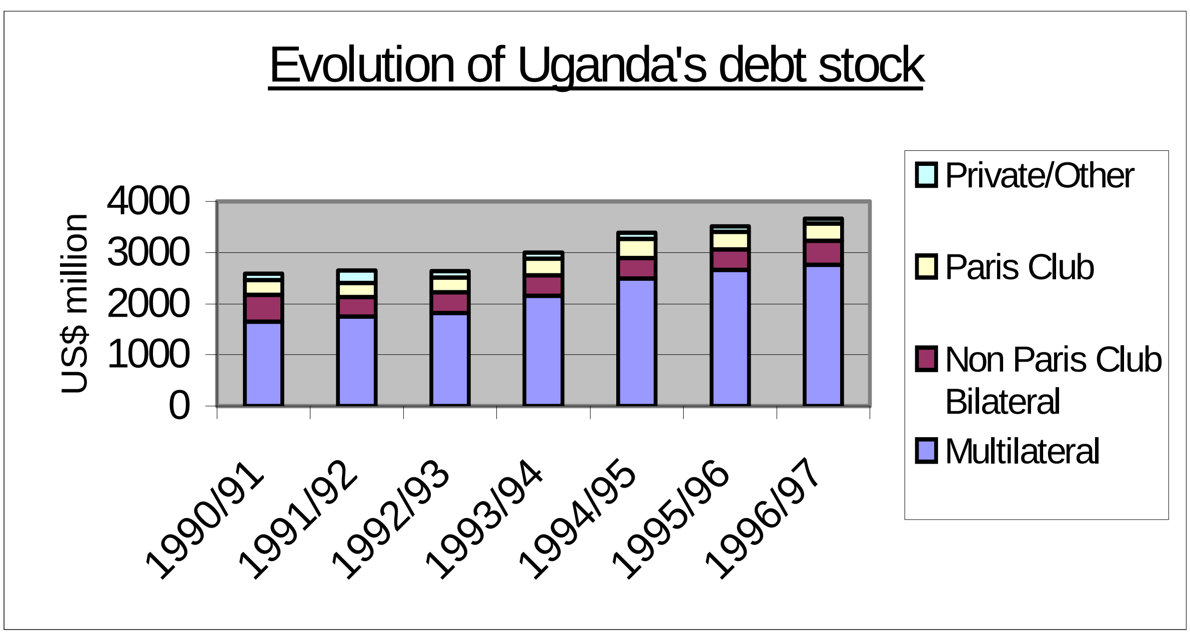
The economy has been liberalised and opened to international trade, foreign exchange controls have been lifted and the capital account has recently been completely liberalised. This has contributed to the establishment of a stable macroeconomic environment which has seen Uganda grow at an average rate of 7% over the last five years while inflation has been reduced to 6%. This progress has been due in no small part to the establishment of financial and administrative institutions which have designed and implemented the policies which have proved to be such a success.

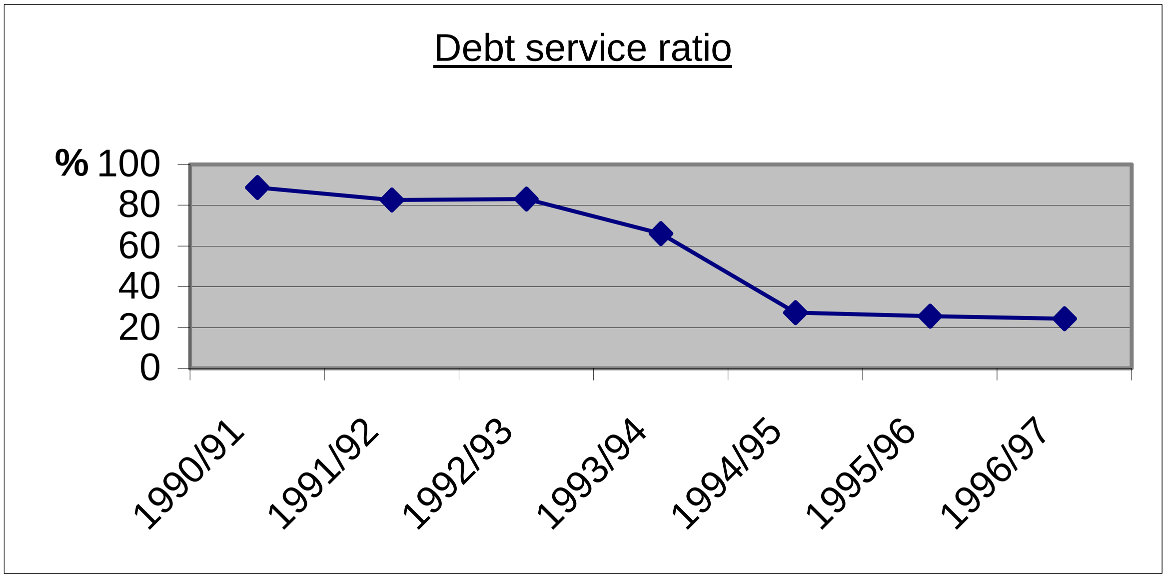
4. The debt strategy

Within this framework a debt strategy has also been implemented and it too has had great effect, largely because the institutional capacity has been in place to oversee it. This is why I would like the main focus of my address this morning to rest on the creation and implementation of the debt strategy. The ability of the institutions whose task it is to deal with debt issues to adapt and evolve in the face of changing circumstances can be seen by recounting the events which led to Uganda becoming the first country to benefit from debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative.

5. The debt burden

Uganda's debt burden had grown to $2.6 billion by 1991 and the level of debt service, at over 80% of export revenues, was such that attempts to fund priority sectors, such as health and education, were stifled.





It was at this stage that the necessity for designing a coherent debt strategy to deal with external debt became clear.

Besides the need to make available resources for domestic use, this first move towards setting out a clear path to attaining a sustainable stock of debt was desirable for other reasons.

- First, it must be understood that Uganda's whole development strategy is based on the creation of an environment in which private sector investment and economic activity can thrive. The problem of debt overhang, however, was threatening to dissipate investor confidence. The stock of debt/exports ratio was approaching 1,500% and although this clearly could not be addressed overnight it was necessary to take swift action to reassure the private sector that the debt problem was being taken seriously and would be dealt with competently. A forward looking and pragmatic programme for dealing with debt therefore provided the signal investors were looking for and ensured the debt burden did not seriously inhibit prospects for growth.

- Second, the composition of a debt strategy allowed a process of serious self-examination to be undertaken. Policy weaknesses, operational shortcomings and gaps in local technical capacity could therefore be systematically identified and addressed but, moreover, all parts of Government involved in debt issues could be co-ordinated. Defined and agreed processes for acquiring new debt, for example, were established and this contributed to the creation of a uniform and transparent policy. This not only allowed government and central bank institutions to work more effectively, it also had the desirable effect of reassuring donors and investors. This issue of transparency has proved critical when considering how institutions may adapt and evolve in a changing environment and is a theme I will return to.

6. Uganda's 1991 debt strategy

This first debt strategy placed strict new limits on borrowing: loans were only to be contracted for priority projects contained in the national Public Investment Plan. Furthermore, funding for these projects was to be on concessional terms. Line ministries were required to work through the External Aid Coordination Department in the Ministry of Finance to ensure funds were obtained on the best possible terms, consistent with the debt strategy. This division of responsibilities allowed each institution to focus on its own speciality; line ministries were tasked with identifying priority projects while the Ministry of Finance oversaw the process of ensuring the resources were in place.

There were three key committees charged with overseeing and monitoring debt issues.

- The Balance of Payments Committee brought together officers from the Bank of Uganda and the Ministry of Finance who specialised in debt and trade issues to discuss strategy, consider current trends and analyse the sustainability of the debt burden.

- The Cashflow Committee provided the forum for discussing debt issues in the context of the whole macroeconomic framework. This enabled Bank and Finance officers to consider the revenue constraints debt service may have in the short term and their repercussions on other sectors of the economy.

- The Development Committee, which consisted of senior members of Finance and Planning and representatives of the line ministries, provided an executive forum for high-level co-ordination and an exchange of views, thus enabling policy decisions to be made with valued input from all institutions. This committee thus provided the overall co-ordination necessary for identifying priority projects and their source of financing, recommending new loans only when necessary.

Other aspects of the strategy defined new roles for the Ministry of Finance and the Central Bank. An external consultant was charged with designing a programme for buying back commercial debt while the External Debt Management Office (EDMO) at the Bank worked closely to provide the data necessary to enable the buyback to be completed successfully. The result was the virtual elimination of commercial debt.

7. Paris Club

Perhaps the key aspect of the 1991 Debt Strategy, however, was the beginning of negotiations with the Paris Club. This was to lead to rescheduling on Toronto, London and then, in 1995, Naples Terms. This reduced our debt to these creditors by 67% and could be seen as a first step to attaining HIPC debt relief.

Having completed the Naples Terms negotiations in February 1995, debt management officers considered the structure of the new debt profile and identified multilateral debt, which accounted for 75% of debt service, as the main component of debt for which Uganda should seek relief or rescheduling.

8. Enhanced debt strategy

Subsequently, in July 1995, the Enhanced Debt Strategy was launched. This highlighted actions which could be taken to minimise the further impact of multilateral debt and suggested means by which debt service could be reduced. A Multilateral Debt Fund was launched which pooled donor contributions which were then used to service debt to IDA, the IMF, the African Development Bank and the African Development Fund. This Fund has proved remarkably successful in mobilising grants which reduced multilateral debt service by up to $40 million in each of the last two fiscal years.

The institutional structure which allowed the Multilateral Debt Fund to function is worth recounting as it highlights the need for accountable institutions which are capable of responding to prevailing conditions. Donors were understandably concerned to ensure their funds were being used in the desired way and also to see that Government policy shared their overall aims of reducing debt and taking on new loans only for priority projects and then only on concessional terms.

9. Relationship with donors

To address these concerns the Ministry of Finance created a Donor Committee, which provided feedback on Development Committee meetings, providing contributors to the Multilateral Debt Fund and other donors with an opportunity to discuss policy and to observe the decision making process. In this way a good working relationship with donors has been established; this is something of great value which, in the post-HIPC era, will be employed to implement targeted policies aimed at raising standards in the social sectors.

10. Capacity building

The capacity created in the ten years the government has pursued an active debt strategy has been a valuable by-product of the work done in reducing and managing debt. Skill shortages have been identified as the strategy has progressed but the Government of Uganda has been fortunate to have donor support which recognised the need to build local capacity. This has enabled officers to attend long and short-term training courses, enabling them to acquire the skills necessary to perform their tasks effectively. Once back in station they have then been able to share these skills with others, reinforcing the benefits accruing to the individual.

This donor funded training has enhanced the overall level of technical capacity and has enabled officers to monitor current trends, devise new strategy and negotiate confidently with creditors. As a result buybacks and rescheduling arrangements have been pursued with non-OECD non-Paris Club creditors while a portfolio review of existing debt has also been undertaken.

11. The HIPC debt relief initiative

In senior level debt negotiations, continued sound economic management and the pursuit of all available debt relief options, combined with some effective third party lobbying for which we are grateful, was sufficient to persuade the IMF and the World Bank that, despite the progress Uganda was making, the debt burden was unsustainable and that multilateral debt relief was necessary. Earlier this year Uganda was therefore deemed eligible for HIPC relief, an initiative which will reduce our debt by approximately 20% in NPV terms at the completion point. The negotiations which led up to the HIPC agreement consisted of a thorough process of reconciling and consolidating debt and the experience acquired over the past six years was tested to the full.

12. Post HIPC debt strategy

Although the relief granted under the HIPC Initiative was less then some had hoped for, it is a welcome development and is seen as an endorsement of the progress Uganda has made over the last ten years.

It is now time to look forward and embark on the next stage of the development process, however, and this we can do with confidence, knowing the institutional structure necessary to formulate and execute policy is in place.

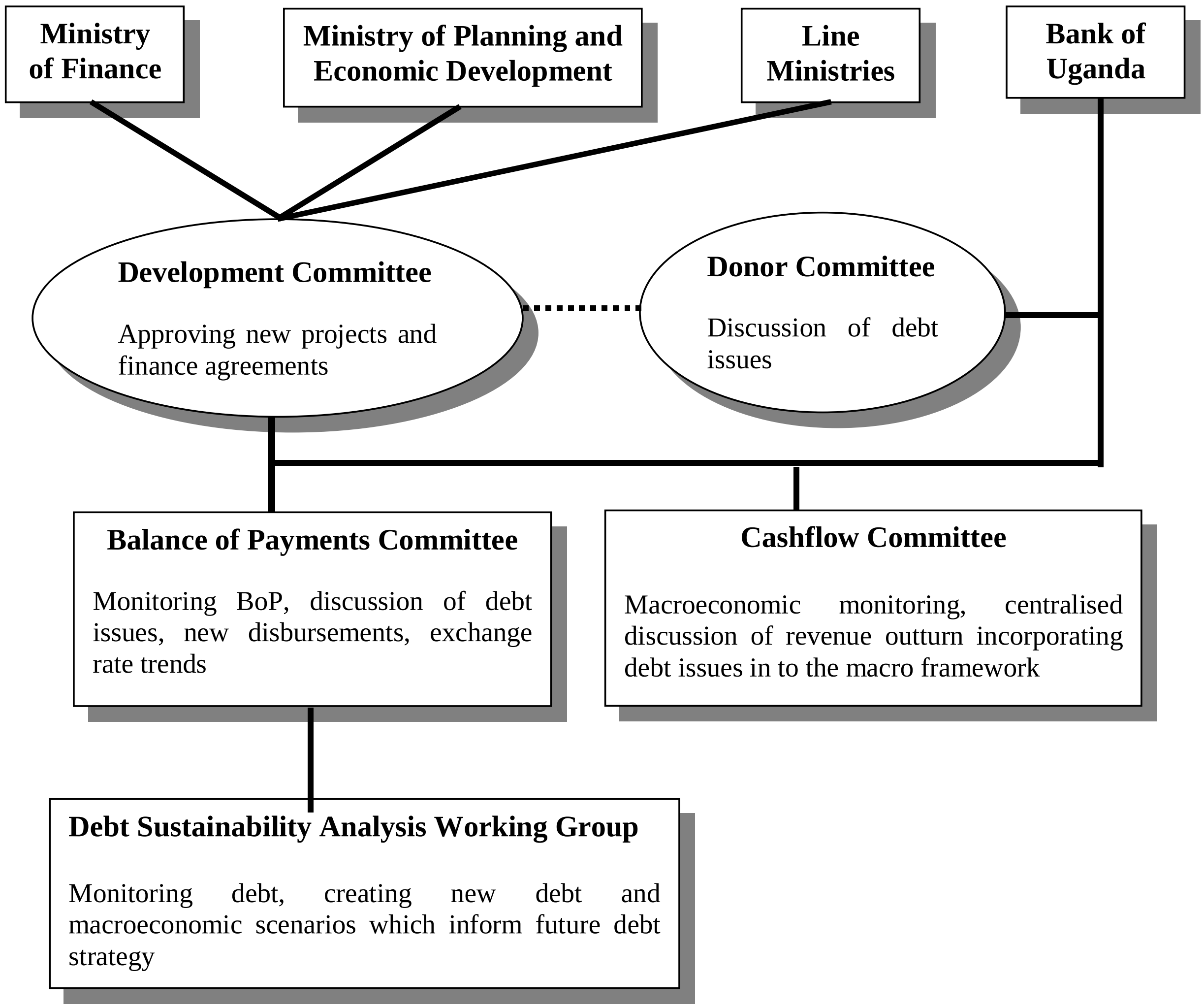
Specifically, the Ministry of Finance and Planning has been divided into two separate ministries to enable long-term strategy to be devised in key sectors of the economy, leaving Finance to manage shorter term macroeconomic issues.

Regarding debt issues, for example, the Ministry of Finance, along with debt officers from the Central Bank, has recently formed a dedicated debt management committee to consider the way forward after Uganda is granted HIPC relief. This will include the regular updating of the Debt Sustainability Analysis, using debt software such as DMFAS, which will consider scenarios, such as an exogenous shock, which may render Uganda's debt unsustainable once more. This will then allow the debt strategy to be updated in line with the team's findings and give policy makers prior warning of potential developments which may exacerbate the debt situation. It will also allow Government to negotiate with the IMF on a more equal footing as we can present our own informed analysis when considering appropriate policy and targets with the Fund.

Overseeing this whole process, the Development Committee has remained a central feature, providing an opportunity for discussion on future strategy and policy. This is an especially critical institution now that Finance and Planning are independent ministries. This ensures all future borrowing will be on terms consistent with our current debt strategy and will be employed in priority areas which address poverty eradication.

The key institutions I have discussed and their relationship with one another can be seen in this chart.

DEBT MANAGEMENT: INSTITUTIONAL STRUCTURE



I would like to emphasise that, although each of these sections, departments and committees serves a specialised function, there is a good deal of interdependence between them, as the chart demonstrates. The success of the debt strategy has largely been due to the close co-operation fostered by this institutional structure, in particular between the Ministry of Finance and the Bank of Uganda.

At a technical level officers from these institutions work closely on an everyday basis to exchange new information and consider macroeconomic developments. Over the years an excellent working relationship has been forged which is based on close co-operation and the shared goal of achieving significant reductions in Uganda's debt stock and servicing obligations.

There is of course always a need to reflect and consider how the links between these institutions can be made more robust and cohesive. Our updated debt strategy, which will be prepared in the new year, will consider, therefore, how this structure can be improved still further.

13. Summary and conclusion

To summarise: the most important characteristic of the institutions charged with managing Uganda's external debt is one of openness and co-operation between institutions. Another glance at the graph showing the evolution of Uganda's debt service ratio shows the significant impact a coherent debt strategy, supported by an effective institutional structure, has had.

Debt management brings together a range of officers and policy makers and its effectiveness requires sound management and good co-ordination. The pooling of information and experience combined with the ability to consider problems from different institutional perspectives, therefore, has provided insight and a fertile ground for assessing and adapting policy at all levels.

This has embedded other qualities which enable technical officers to look forward and thereby respond quickly to prevailing conditions. In some cases, as we saw when discussing the implementation of the 1995 Enhanced Debt Strategy, it also provides the opportunity to seize the initiative and shape future events, as was the case with the creation of the Multilateral Debt Fund. This has not only provided valuable relief in the short term but has also built a lasting relationship between government and donors which bodes well for the future.

The key role for institutions, therefore, may be to provide continuity with change and this is, perhaps, best achieved by creating an integrated system capable of forward looking behaviour which allows policy makers to adapt quickly to change and influence events where necessary. Recognising the need for these qualities is the first requirement of building institutions capable of operating effectively in a changing macroeconomic environment.

Once an environment of co-operation and co-ordination is established, the necessary technical capacity to deal with economic conditions can be created, expanded and reinforced. In this way the whole process becomes self-sustaining.

LINKAGES BETWEEN DEBT OFFICES AND OTHER GOVERNMENT ENTITIES. NEW DEVELOPMENTS IN THE NORDIC DEBT OFFICES

Lars Kalderen

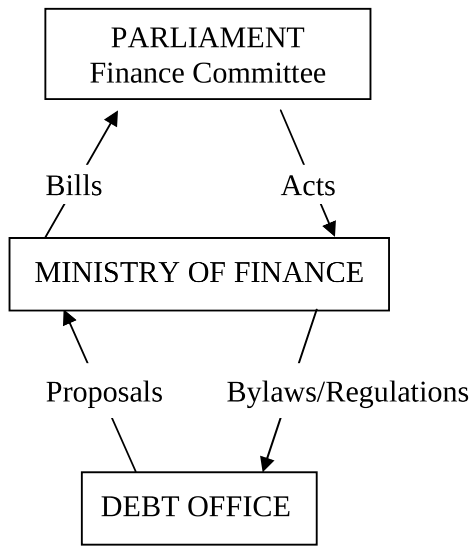
Because of my background in the Swedish National Debt Office in the l980s and continued close relations with that office and with colleagues from other Nordic countries, my presentation will be coloured by experiences in that part of the world. But I have also worked in many developing countries and found that institutional problems in debt management are often quite similar, although of course in certain respects each country is different. In fact, as you will find, even among the five Nordic countries which may seem indistinguishable from each other (all the governments borrow exclusively from the financial markets and have high credit ratings) there are significant differences, as a result of administrative traditions, size and kind of loan portfolio, etc.

But before getting into country specifics, let us look at a few simple pictures which illustrate some basic relationships. These are clearest if we assume that there is a separate Debt Office (DO) reporting to the Ministry of Finance (MoF) but with some degree of independence (there are now a number of countries which follow this model, Sweden among them but also Austria, Hungary, Ireland and New Zealand. In other countries the DO is usually a clearly identifiable department of the Ministry of Finance or - less frequently - of the central bank).

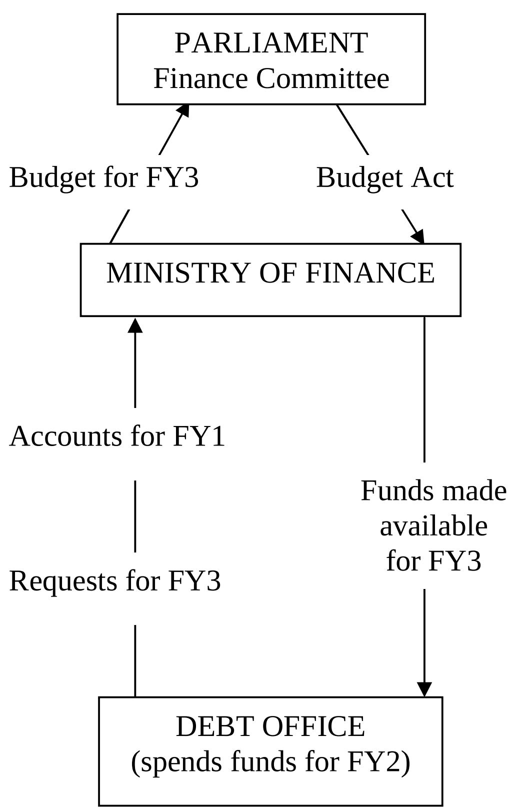
Let us start with the **formal relations** between the DO and its superiors, which normally fall within a **vertical, hierarchical** system. Major decisions, including the delegation of powers to the DO to decide on certain matters within set limits, are usually delivered from the highest authority in the land (such as Parliament or President) by the MoF to the DO. In the opposite direction, the DO sends requests for changes in the relationship to higher authority (Parliament through the MoF). We can distinguish between two cases:

- **Infrequent** communications, such as the handing down of a new law on government debt or on the organisation of the DO; after adoption by Parliament, the law is normally sent to the DO through the MoF. The preparation of the law may have involved other ministries as well (such as Justice) or agencies (such as the central bank). In passing on the legislation or ad hoc decision to the DO, the ministerial level - and especially the MoF - may add on its own bylaws/regulations. The DO, in turn, may request changes in the laws or the bylaws from time to time by approaching the MoF.
- **Regular** communications, the most important one being the **annual request** from the DO for an operating budget for the next fiscal year. This process will often follow a standard pattern - the MoF issues forms to be filled in and instructions on how the need for funds should be calculated. The timetable is normally set by the MoF and is identical for all or most government agencies. The MoF will pass on the DO´s request to Parliament with its own suggestions for modifications - most likely cuts rather than additions - and once it has received the parliamentary decision, the MoF will communicate it with the DO, again perhaps adding its own regulations or even restrictions for the DO to observe. - At the end of the fiscal year, the DO will report on how funds were spent and whether there are any left to carry over into the next year.

Formal relationship
(infrequent communications)



Formal relationship
(annual budget cycle)



The legal framework for the operations of the DO may be more or less complex. In some countries there are a series of separate acts, such as:

- Foreign loans act;
- Domestic loans act;
- Parastatal loans act;
- Loan guarantees act.

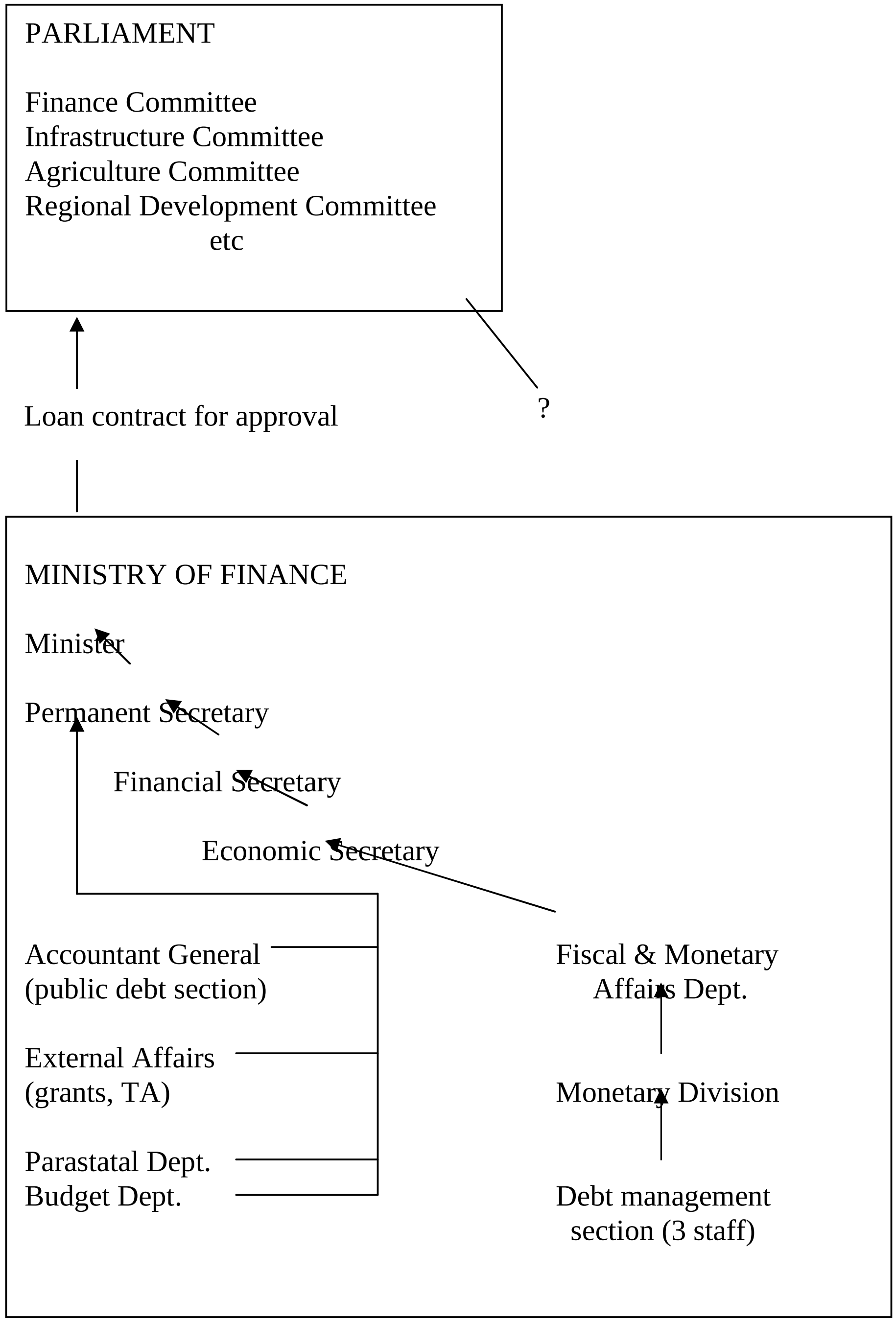
Regardless of the number of acts and by-laws, together they must create a clear, uncontroversial framework for the DO to operate within. There should be no gaps and no overlaps, the language must be unequivocal, the terminology identical between the laws. The legal framework must create a firm division of labour and authority between the layers of government so that the responsibilities of the DO match its competence - avoiding both risk exposure beyond its control and undue restraint on its freedom of action in the best interests of the state.

Similarly, the annual budget cycle should be as smooth as possible, making resources available to the DO in a flexible way so as to match the tasks given to it by the government (which may vary in the course of the budget year) or which it may be called upon to perform because of developments in the financial markets, rescheduling operations, etc.

These two aspects of the relationship of the DO to its superiors - the legal and the financial - point to the need for the Office to be equipped with staff who can identify, articulate and represent its interests vis-à-vis lawyers and budget officers in the MoF as well as the politicians in Parliament. The leadership of the DO is critical - it has to have both the clout and the confidence of higher authority necessary to make its weight felt in the machinery of government and politics. And the quality of its staff must be such that it can effectively give support in the negotiations not only with lenders, investors and donors but also with the civil servants of their own country.

The demands on the DO to push its interests become particularly acute in countries where the situation is as multi-layered as is shown in what I have called "the Worst Case".

"Worst case"


PARLIAMENT
Finance Committee
Infrastructure Committee
Agriculture Committee
Regional Development Committee
etc
Loan contract for approval
?
MINISTRY OF FINANCE
Minister
Permanent Secretary
Financial Secretary
Economic Secretary
Accountant General
(public debt section)
External Affairs
(grants, TA)
Parastatal Dept.
Budget Dept.
Fiscal & Monetary
Affairs Dept.
Monetary Division
Debt management
section (3 staff)

Luckily, the chart combines the atomised structure of the MoF of one particular country where the DO spent about half its time and effort on fighting other units of the Ministry and reporting to several members of the top brass (who were not agreed on how to share the turf among themselves); and the highly confused parliamentary situation of another country where all loan agreements had to be vetted and accepted by the legislature, a process which entailed endless wrangling in a series of committees whose members were often wholly ignorant of international finance. Fortunately, both cases were observed a long time ago and should have been corrected by now - if not, I imagine that all debt raising has now come to a standstill in these two countries.

The laws on state borrowing as well as the regulations by the MoF may contain references to the relations between the DO and other government agencies such as the ministries of planning, foreign affairs, justice, trade and industry, or state enterprises; the central bank; the general accounting office; the attorney general's office; the tax authority, etc. In such case, the purpose is to make the DO behave in a certain way towards these agencies. On the other hand, in order to bind **them** to a certain behaviour towards the DO, separate legislation/regulations may have to be issued through the channels normally used for communications between the agencies and the highest authority. We may think of these relations as **formal and horizontal**; and all who are engaged in gathering data for processing by a DO know that these relations are no less important for the success of the Office than the vertical ones. Again, the DO is well served by having competence to interface with these other government agencies - it needs to understand their roles in the administration and to be able to work constructively with them in solving common problems. In the early stages of DO operations a good deal of time and effort must be spent on explaining to such agencies what debt management is all about - why it is important to the country and to state finances, and that it needs the support of the rest of the government rather than turf fighting.

Parliament

<u>Ministry of:</u> Finance | Planning | Foreign Affairs | Justice (Attorney General) | Infrastructure///Parastatals Agriculture etc.

- Financial Supervisory Authority
- General Accounting Office
- Tax Authority
- Capital Market Authority

<u>Central Bank</u>
Monetary management
Foreign exchange policy
Paying agent for MoF/DO

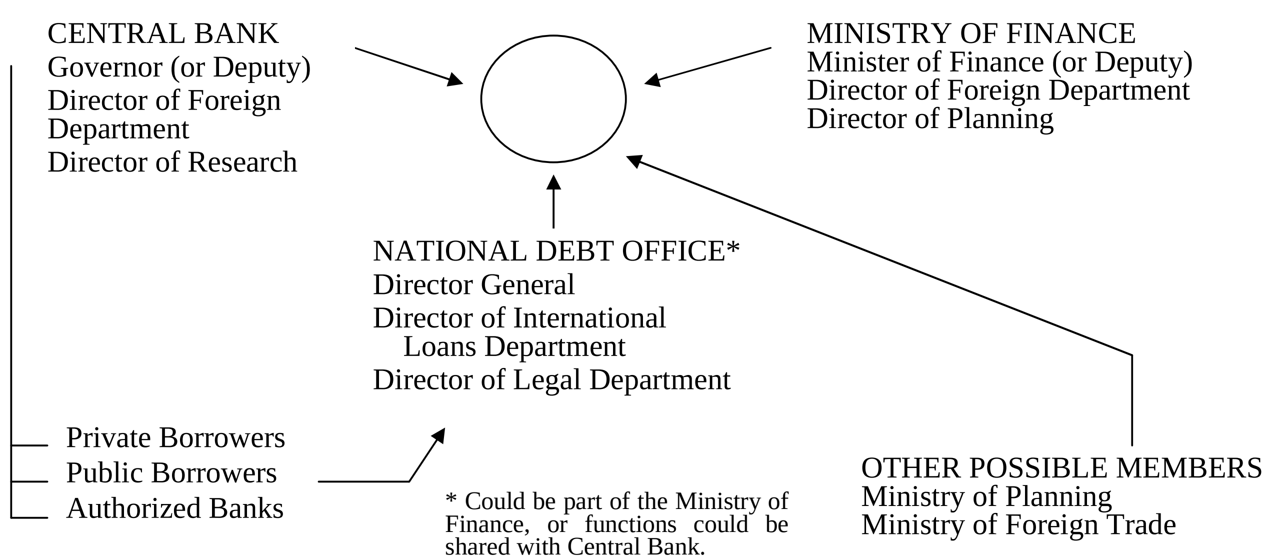
In this context, some agencies are more important than others are. First and foremost, the MoF has other units than the one directly responsible for relations with the DO, and some of these units may find it difficult to accept a DO which claims the right to do things that they were formerly entrusted with (but perhaps had little capacity for actually undertaking). The Accounts Department may be a case in point, particularly if it is less computerised and has fewer "whiz kids" to project future debt service payments than the DO which has the benefit of, e.g., UNCTAD support. Close and friendly co-operation with Accounts is crucial, i.e. if the DO is responsible for raising short-term finance in the market to cover seasonal deficits in the government's cash position. Another area of friction may be the separation of the administration of loans and grants: thus, the department in charge of relations with donors may see little reason for such a separation and will only grudgingly hand over responsibility for the former to a new unit like the DO.

Outside the MoF, the Ministry of Planning and the Ministry of Justice (or the Attoney General's Office) are essential partners for the DO. Planning has to be relied upon to provide inputs to debt strategy formulation, and the legal authorities to help in loan negotiations and reschedulings. In many countries, however, the **central bank** is the most important partner of the DO, in both the domestic and the external debt field. Volumes have been written about that relationship, particularly with regard to monetary policy, and I will not try to summarise the state of theory nor that of practice, which varies a good deal from country to country. But a general tendency seems to be for central banks to become more independent of the MoF in order to be able to conduct monetary policy unfettered of other considerations, including getting facilities to issue short-term notes alongside the Treasury Bills which are increasingly becoming the responsibility of the DO. Thus, the areas of friction and/or co-operation tend to be reduced as a result of global institutional developments as well as the maturing of country-specific debt management.

A few words should be said about the need for the DO to help build up the capacity of the **government auditors** to understand and assist in debt management. This must take place in parallel with the growing sophistication of the DO so that the auditors on the one hand can catch any wrongdoings but on the other hand will not constrain the debt managers in the development of new techniques, or slow down their operations so as to cause unnecessary costs or deny the state the savings that can be achieved from speed and decisiveness.

It is for these horizontal relations that a **debt policy committee** can be most useful. Such committees have been set up in many borrowing countries during the past two decades, under various names (a random search has yielded names such as "high-level co-ordinating committee", "foreign finance committee" and - in Sweden - "joint advisory group").

Composition of Foreign Finance Committee



shows a possible composition of a committee for this purpose; it has been taken out of the report from a UNDP workshop held in l985 and was already then based on the solid experience of a number of countries. Debt policy committees tend to be most useful in the early stages of setting up and running a debt management machinery, when they will help establish the roles of the various agencies and the sequencing of activities. Even when they do not take formal decisions their influence can be great in the co-ordination of action by the agencies concerned, because they provide a platform for the sharing of information and building a consensus within the government.

The **informal** relations between government agencies are equally important. They consist of routine sharing of information - reports generated by the DO are distributed "in exchange for" what is being produced by ministries other than the MoF (with which the DO has a symbiotic relationship, including the sharing of data bases), the central bank, etc. - but also of almost daily contacts, by phone and meetings, between DO staff and their counterparts in other agencies. An excellent opportunity to create a team spirit in favour of the debt management effort among staff members of different agencies is usually presented when foreign loans are to be negotiated, or annual reports on debt management composed. Again, for data gathering but also for the smooth workings of formal and business relations (see below) informal relations must be good. If the DO can play the role of an information center (e.g. by having a home page with vital and current economic and financial data) this will enhance its general standing in the government.

Many DOs have **commercial relations** with other government entities - in Sweden the SNDO takes deposits and extends credit to some 60 agencies and state companies who participate in this scheme on a completely voluntary basis (and there is no subsidy in the services extended by the DO). Its guarantee schemes - for specific sectors such as shipyards, oil exploration and certain infrastructural projects - are available for public as well as private borrowers. Relations between a DO and the central bank may have a considerable commercial content, in addition to their joint efforts to cope with the problems of inflation and disequilibra in the balance of payments. Although perhaps in a monopoly position as buyer of the proceeds of foreign currency loans as well as supplier of currencies to the DO´s debt service payments, the bank nevertheless cannot deviate too far from good business behaviour in serving the needs of the DO - who would then have good reason to complain to the MoF and ask for permission to turn to the commercial banks instead.

So clearly the DO has many linkages with other government entities - formal, informal and commercial. This is in keeping with its role as a "spider in the web", a communication center for essential financial information and a major player in the economic life of the country. If it is part of the government treasury it may have important banking functions vis-à-vis its public sector clients. Because of the long-term nature of its commitments - it serves debt contracted decades ago and has to plan ahead 10-20 years for the service of loans contracted today - it provides vital inputs to the government’s economic forecasting and planning work.

1. New developments in the Nordic debt offices

Looking back over the past ten years or so one finds significant changes in the five Nordic countries with regard to the location of debt management functions and the role of various agencies. In Denmark a large chunk of the DO which had always been located in the MoF was moved to the Central Bank in 1991 and emphasis was put on the co-ordinated management of the State’s external assets and liabilities (through the concept of a net portfolio).

In Finland which expects to join the EMU in the first wave and will therefore gradually reduce its foreign currency debt in favour of the Euro, the MoF is in the process of divesting itself of duties in the field of external debt by transferring responsibility to the State Treasury Office, which reports to the Ministry and has capacity to handle all debt in domestic currency. A few years ago Iceland set up a DO separate from the MoF (but with management from the Ministry) and located it in the Central Bank building. In Norway, like in Denmark, the Central Bank does most of the heavy work (including managing a net portfolio) while the MoF takes the decisions and relates with Parliament. And in Sweden, the DO which for more than two-hundred years had been run by a Board of parliamentarians and reporting directly to Parliament was put under the MoF in l989 and is now involved in a discussion with other entities of the government about its authority and responsibilities. These changes have different causes, some of them based in developments in the size and characteristics of debt portfolios and/or the progress in financial techniques, others more related to administrative reform in the government or shifts between the political and the administrative domain.

1.1. Denmark

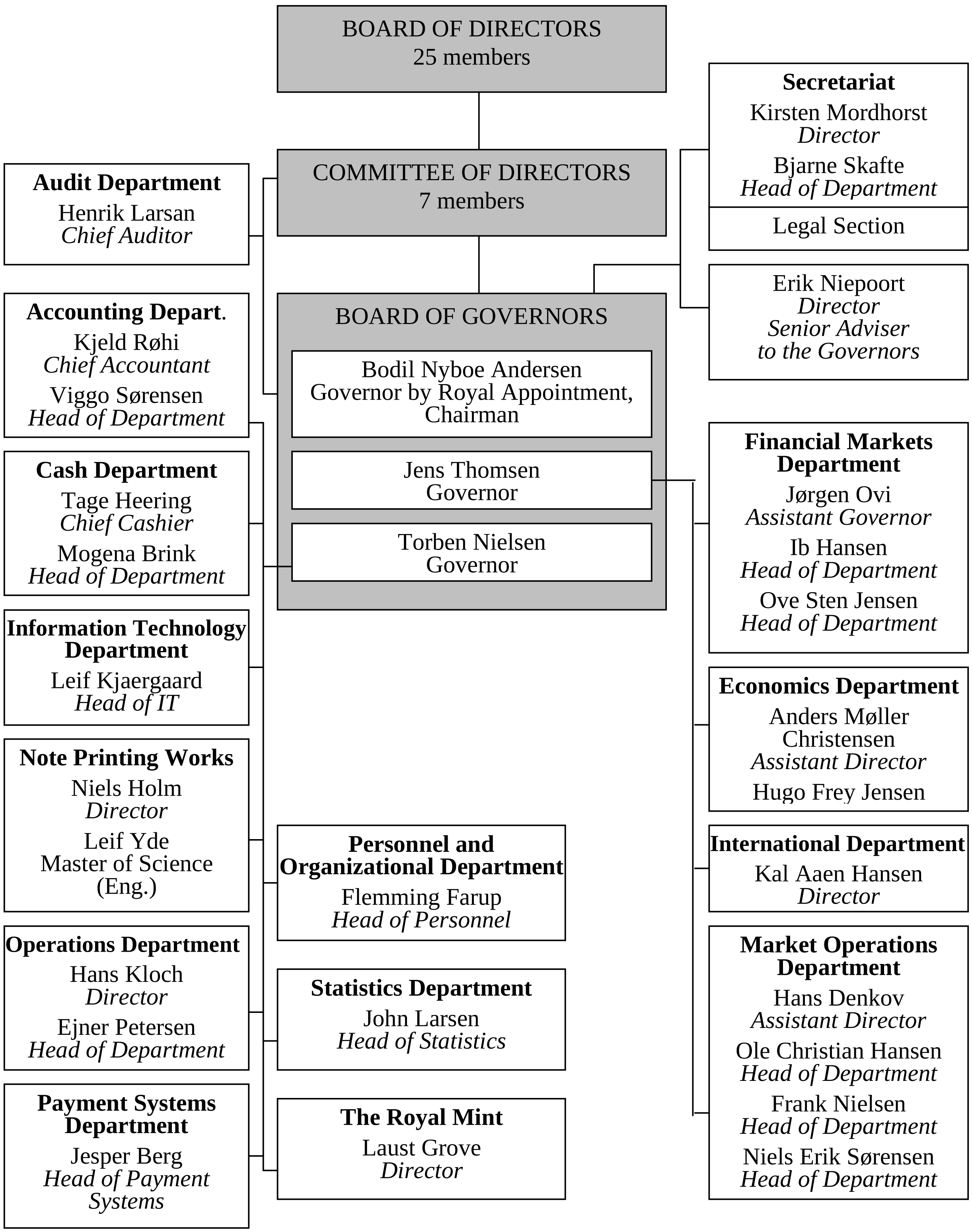
In 1991 it was decided to move foreign exchange borrowings and the management of the external debt from the MoF to the Danish National Bank (Danmarks Nationalbank, DB) which had for a long time taken care of the sale of domestic bonds for the government. A certain co-ordination between the two agencies ensured that when the foreign assets of the Bank and the liabilities of the State ("the Kingdom") were regarded as a whole, the net foreign exchange risk was not excessive; but it was felt that such consideration could be made more effective if the work was concentrated in one agency.

At present foreign exchange borrowing in a year equals the amount of foreign debt falling due in that year so that the foreign debt of the Kingdom (not to be confounded with the net foreign debt of Denmark, which also includes debt of other public entities and the private sector) remains practically constant at approximately the size of the exchange reserves. Thus all of the government cash deficit is covered by domestic borrowing. DB also serves as the government's bank, buying the foreign currency raised through borrowing on behalf of the Kingdom and selling the foreign currency needed to service of debt.

A Borrowing Act, adopted by Parliament, sets a ceiling on total government debt (at present DKK 950 billion, equivalent to about US$ 125 billion, of which some 80% has been utilised – but only 10% for foreign current debt). The distribution between foreign and domestic borrowing is governed by the so-called "Central Government Borrowing Norm" agreed between the Minister for Finance and DB.

While the overall responsibility for managing the government's debt still rests with the MoF, DB is authorised – within guidelines that are drafted by the Bank and reviewed quarterly with the Ministry – to conduct the necessary debt transactions on behalf of the government. Within the Bank both domestic and foreign debt are dealt with in two departments. One (called "Financial Markets Department") takes care of, i.e., the formulation of central government debt policy and borrowing strategy, risk management and performance measurement, rating issues, and publications on borrowing and debt; the other (called "Market Operations Department") deals with, i.e., the monitoring of markets, the administration of DB's domestic bond portfolio, the purchase and sale of securities, the administration and investment of DB's international reserves, the execution of the government's borrowing and swap program, and state guarantees and legal questions concerning borrowing.

Organisation chart – March 1997



Benny Andersen, Head of Department, is acting board member of the International Monetary Fund until 1 January 1998.

These two departments meet every three weeks or so, to co-ordinate their thinking and activities. There is also an Accounting Department which handles payments and the Book-keeping for the government debt. DB drafts monthly reports on the borrowings and other financial transactions for the MoF to send to the Finance Committee of the Parliament, for information. Annual Reports on the government debt are produced by DB and published after approval by the MoF.

1.2. Finland

In Finland, the state's debt has always been firmly in the hands of the MoF, with the central bank playing a minor role. Thus, in contrast to Denmark, the Finnish government is in the process of moving the administration of the state's foreign currency debt from the MoF – which will maintain responsibility for policy and reporting to Parliament – to an agency under the ministry called "Statskontoret" (the State Treasury Office) which already handles domestic debt, state pension matters and a range of other financial duties. About half the MoF staff working on external debt has moved over to the Office, to join a new unit headed by a former commercial banker. While the MoF will continue to set policy guidelines and report to Parliament, new procedures for giving instructions to the Office and receiving feed-back are being drawn up. The driving force behind this move is that the division of labour between foreign currency borrowing and local currency borrowing will no longer be reasonable after the start of the third state of the EMU.

1.3. Norway

Being an oil-rich country, Norway nowadays borrows internationally only to refinance some foreign debt and to raise currencies for on-lending or for making investments, i.e. in state banks. Norway lacks a law on state borrowing but the budget process forced the government to report its borrowing needs to Parliament twice annually, and to receive authorisation in the form of both a preliminary and a final budget (this process is now being simplified but the annual authorisation to borrow will remain). The authorisation sets ceilings for new foreign and domestic currency loans, respectively. For short-term and cash credits a ceiling is set for total amounts outstanding. Each loan in foreign currency requires a formal decision by the Minister for Finance, while domestic debt issues are handled by MoF officials and reported to the Minister twice annually. The aim of state debt management is to obtain the lowest possible cost, given the constraints of monetary policy and considering also the degree of risk.

The debt section (which is a small unit, with 5 staff members) was recently moved from the Financial Markets Department of the MoF to the Economic Department in order to obtain better co-ordination of debt matters with general economic policy. State guarantees are handled by the Ministry for Trade and Industry, while banking supervision is in a separate agency under the MoF.

The Bank of Norway is the paying agent for the government's debt and is also responsible for the co-ordination of the foreign currency debt with that part of the exchange reserves which corresponds to the state debt. It reports quarterly to the MoF on its activities. As it is in daily contact with the financial markets, the Bank serves as the adviser to the government on market development and arranges the auctions of domestic debt. No annual report on the national debt is issued beyond the background material submitted to Parliament as part of the annual request for borrowing authorisation (which arouses limited interest and causes no public debate).

1.4. Sweden

While Denmark and Iceland settled their organisation of debt management and the relations between various government entities one or two years ago, Sweden – like Finland and Norway – is in the midst of an overhaul of earlier patterns. Nobody disputes the usefulness of having a separate DO (Sweden has had one since the 18th century), but there has been argument about what should be the proper goals of debt management, how performance should be measured and the division of authority between the four layers of government: Parliament, the Ministry of Finance (together constituting "The Government"), the Board of Commissioners of the Swedish National Debt Office (SNDO) and the Director General of the SNDO. The relationship between the SNDO and the Riksbank (central bank) is also a subject for debate, with the bank reluctant to let go of the last vestiges of control of the DO's foreign currency operations. These issues were discussed in 1997 by a debt policy committee of inquiry, charged with the task of formulating proposals for a system that would match authority with competence – particularly as regards the setting of benchmark and measuring of performance. The inquiry was led by a university professor of economics who was advised by various experts including some from the SNDO. The report by the committee was published as SOU 1997:66 and received comments from government entities most directly concerned like the Riksbank and the SNDO.

The report suggests three goals for debt policy: (i) to avoid high future levels of taxation and market variations in tax rates over time, budget deficits should be kept down and real interest costs should have low variance; moreover, the debt structure should make interest payments low when GAP is unusually low and public expenditures unusually high; (ii) to reduce the proportion of debt issued in domestic nominal bonds, in order to enhance the credibility of the government's anti-inflationary policies (i.e., making it more difficult to "inflate out of debt"); and (iii) to contribute to market efficiency, including the development of new markets. Other possible goals, such as composing the debt portfolio with a view to stabilising domestic interest rates and exchange rates, or promote a certain distribution of income and wealth, are more arguable and should not influence the goal-setting.

In practical terms, the committee recommends that long-term indexed kronor bonds should constitute a major part of government debt, at the expense of nominal bonds and foreign currency debt. The general goals of debt policy should continue to be determined by Parliament, on the advice of the Cabinet (Ministry of Finance) which maintains a five-year strategy specifying – within wide margins – the debt portfolio shares of the three kinds of debt. The DO would then be delegated to implement the decisions as the government's portflio manager, including setting benchmarks and devising a system for performance evaluation. The report proposes that Parliament should arrange a yearly hearing on debt policy issues with the Director General of the SNDO and the Minister of Finance.

The report suggests that relations with the Riksbank could be improved by allowing the SNDO to exchange foreign currency proceeds in the market instead of having to go through the bank, and that it should be permitted to hold accounts in foreign currencies. On the other hand, the Riksbank should be consulted before decisions are made on the size of foreign currency borrowings. The Riksbank, in its comments, regards the proposals for greater freedom of the SNDO in the currency markets as premature, in the light of the uncertainties of the EMU process and the risk that the market might interpret transactions by the SNDO as based on insider information about the foreign exchange policy that the bank intends to conduct. In its comments of the report the bank also underlines the importance that it attaches to a continuation of the formalised consultations between the MoF, the bank and the SNDO in the so-called Advisory

Group on Foreign Loans (formerly "The Joint Advisory Group"), before the Government takes the annual decisions on the composition of the state debt portfolio.

Meanwhile, there has been a series of reforms, including development and refinement of benchmarks and other instruments of portfolio management, and several reorganisations of the SNDO to achieve synergies and savings. External and domestic debt are now administered in one department, supported by a substantive back office, and separate units have been created for risk control and information technology, respectively. The current status of the DO can be studied in the accompanying Charts. The information department of the SNDO can provide further details of how the office is organised and how it works – an annual report in English is published in the spring, and the Office also maintains a web site on the Internet which can be consulted by interest parties.

2. Up-date to October 1998 of the Swedish debt management system

The Cabinet (Ministry of Finance) proposed to Parliament in the spring of 1998 a new Act on State Borrowing and Debt Management which was adopted with only minor adjustments as Act 1998:1387. The proposal does not cover some of the recommendations of the committee which only concern the relations between the Cabinet and the DO. These may be referred to in future communications from the Ministry to the DO.

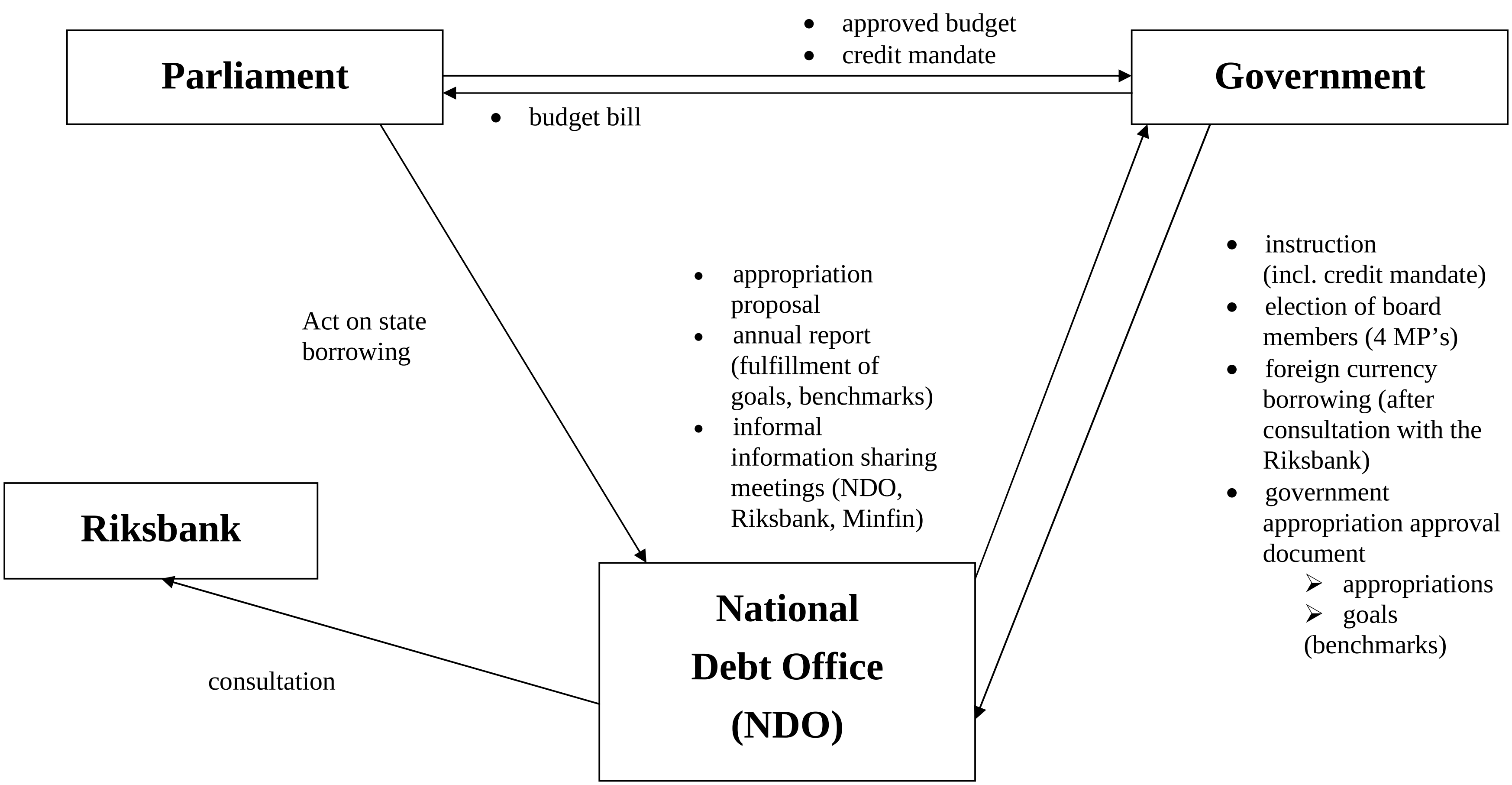
Only one goal of debt policy is specifically incorporated in the Act, viz.that of *minimisation over the longer term of the total cost of the entire debt portfolio, taking into account the overall risk*. However, large and unpredictable variations in debt servicing costs should be avoided, as these might raise interest levels and cause higher costs of debt management. Other possible goals of debt policy are considered to be covered by the cost minimisation target (tax smoothing, improving the financial markets) or better served by other instruments (credibility of economic policy). With regard to the Riksbank, the Act states that debt policy and management must be conducted so as not to obstruct or contravene monetary policy by the bank.

The Act further sets out the machinery for the annual cycle of decision-making involving Parliament, the Cabinet (Ministry of Finance) and the DO. Thus, by October 1 the DO is to submit a proposal on guidelines for the management of the State debt, and the Government, having requested and received comments from the Riksbank, is to take a decision – to approve or to revise the proposal – and to transmit it to the DO no later than November 15. These communications are public documents and will be available to the media and other interested parties. To enable the Government to evaluate the performance of the DO, the Office will supply the Ministry with material that will allow the Ministry to report to Parliament no later than April 15 on the result of debt management operations in the previous year. The report may also include performance evaluations by experts outside the DO. The parliamentary finance committee may then decide to arrange hearings with officials of the Ministry and/or the Director General of the DO, as suggested by the commission of inquiry. After such hearings and its own deliberations, the committee will report to the plenary and Parliament will then express its approval – or otherwise – of the conduct of debt management by the Cabinet and DO. This decision will be taken before the recess of Parliament in early June.

The first "Proposal for guidelines for the management of the central government debt" was sent by the Board of the DO to the Government on September 28, 1998 (text in English available from the information division of the DO. In the letter, the DO emphasises that the proposal represents the first stage in a process in which both the principles and techniques for guiding and evaluating the management of the central government debt will gradually be developed. On this, the first occasion, the proposals are largely based on qualitative reasoning and assessments, but the DO's ambition is also the create improved methods of quantitative analysis as a basis for the work on guidelines in the coming years. While it is judged to be too early to state in percentage terms how the debt should be distributed in the long term between nominal, inflation-linked and foreign currency borrowing, the DO's proposal nonetheless indicates the desired directions to take from the position today, i.e. an increase in inflation-linked borrowing and a continued amortisation of the foreign currency debt.

RIKSGÄLDS
KONTORET

THE SWEDISH
NATIONAL DEBT OFFICE



RIKSGÄLDS KONTORET

THE SWEDISH NATIONAL DEBT OFFICE

- Issues loans and manages the Central Government debt as cost-effectively as possible, in accordance with the Act on State Borrowing and the Instruction, by borrowing

in the money and bond market primarily in the form of

- Treasury Bonds
- Treasury Bills
- Short-term repurchase agreements (repos)
- Short-term deposits/loans

in the private market through

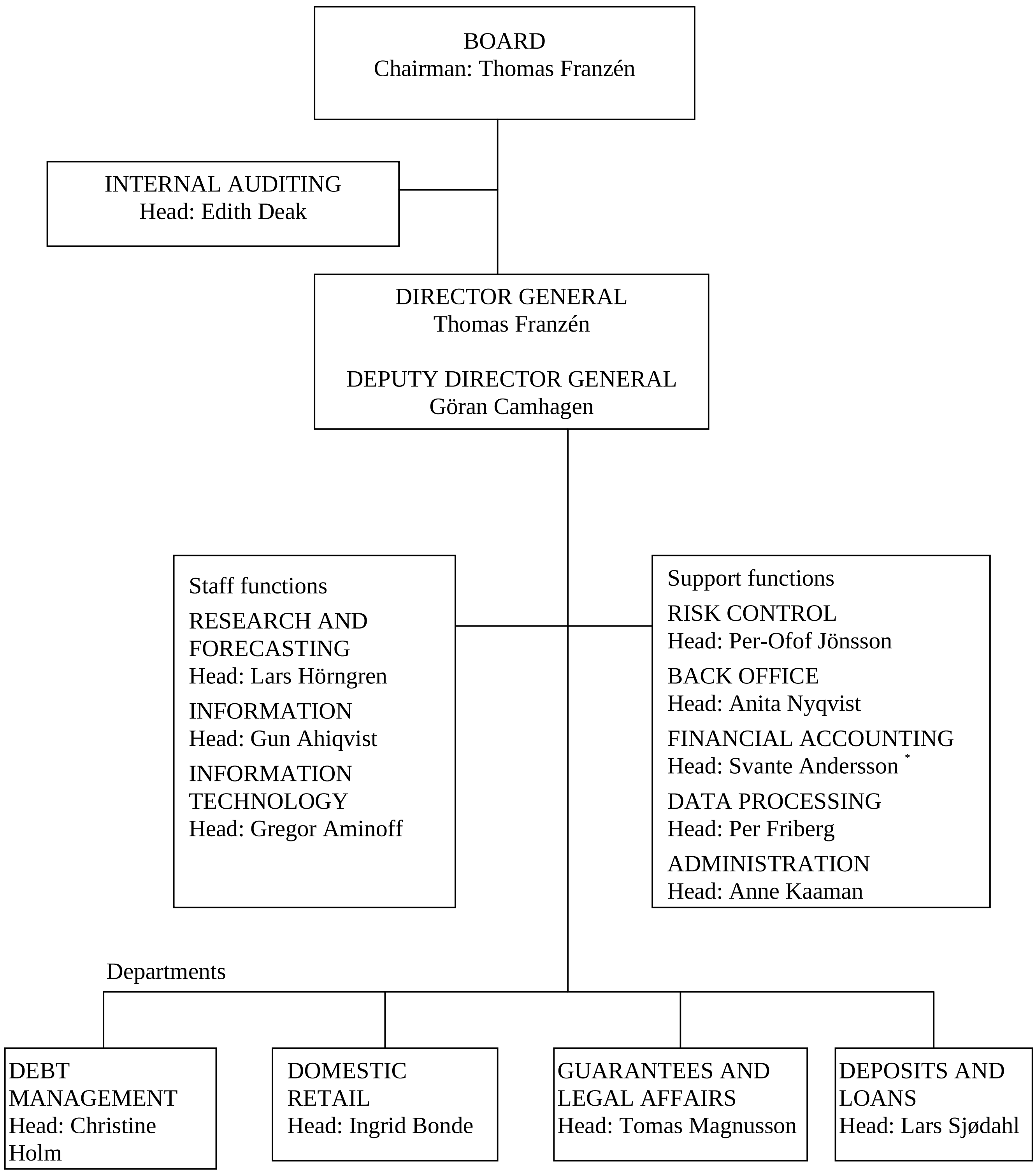
- Lottery Bonds
- the National Debt Account
- the National Savings Account

in the foreign currency markets through

- bonds issued in the Euromarket and in national markets
- Commercial Paper Programmes
- bank loans
- modern debt-management techniques (swap agreements, forward contracts, etc.)

- Acts as an internal bank on behalf of the State authorities
- Issues guarantees on behalf of the State
- Co-ordinates State guarantee operations and loans to industry and commerce, and monitors the related costs
- Issues forecasts covering State receipts and disbursements and ensures that these transactions are managed as cost-effectively as possible

Organisation of the Swedish national debt office and senior executives



* Holds this position as of March 1997

THE ROLE OF THE PHILIPPINE TREASURY IN TRANSFORMING THE DOMESTIC DEBT MARKET

Caridad Valdehuesa

1. Introduction

The Philippine Treasury is a member of the cluster of agencies within the Department of Finance. Its critical mandates are:

- To manage the cash resources of the National Government;
- To perform banking functions related to the receipt and disbursement of government funds;
- To manage, control and service all public debt from domestic as well as foreign creditors;
- To assist in policy formulation and execute policy in matters of financial management, public borrowing and capital market development;
- To maintain books of accounts of all financial transactions of the executive department of government;
- To assist other government agencies concerned in preparing projections of revenues, cash position and borrowing requirements of the republic.

In recent years theses mandates were expanded to include the origination of government securities, their servicing and redemption, the management of securities stabilisation funds, bond sinking funds and bond assurance funds, functions heretofore conducted by the Central Bank of the Philippines.

The idea was to separate fiscal responsibilities from monetary activities. It had been the impression of the legislators that the relationship between fiscal and monetary authorities was too close. Therefore they created an independent monetary authority in 1993 and mandated that the issue, service and redemption of domestic government debt revert to the Department of Finance. The Department in turn reverted the function into the National Treasury.

These three tasks are complementary to the Treasury's mandate of helping to develop and deepen the capital market and the mandate to control and service the public debt.

The Philippine Treasury initiated the re-engineering of its operations by installing computer systems and infrastructure, training of key people overseas and crafting of sensible debt policies in order to cope with the tremendous workload in a changing business environment, without the benefit of additional personnel.

Along with the internal organisational and personnel retooling, the Philippine Treasury introduced debt and capital market innovations amidst the resistance and noise of market players who had grown accustomed to the inefficiencies and retrogression of the market.

2. Market reforms and innovations

The Philippine Treasury introduced reforms and innovations one after the other to make the domestic debt market efficient, risk-free, and at par with global standards. The reforms were as follows:

First, because the Philippine Government borrows to refinance a portion of its debt by issuing government securities through auction method where any number of accredited dealers are invited to tender bids for amounts and yields of their choice, we prescribed uniform practices and standard forms when tendering bids for auction, advocated training of dealers and maintenance of a roster of qualified traders for the industry, then we recommended a self-regulation of the government securities industry consistent with the Philippine government liberalisation policies.

We also introduced state-of-the-arts auction with the development of the Automated Debt Auction Processing System (ADAPS). The electronic auction, the first of its kind in Southeast Asia, has enhanced the efficiency and transparency of the origination of government securities (it made the process real time from a 2 1/2 hours manualised auction to a 3 minute ADAPS).

We also shifted to Dutch auction for Treasury Bonds, a method of pegging a uniform coupon rate to a Treasury Bond at the stop-out level of arrayed amounts of bids and yields. The Dutch auction method eliminated the complicated process of computing the present value of the discounts for purposes of determining the tax. This has simplified and enhanced the trading of Treasury Bonds as well.

The Treasury adopted and implemented the policy of scripless government securities. All government securities floated starting November 1995 are not represented any more by certificates. This eliminated the cost of certificates printing and the burden and the accompanying risk of physical transport of certificated securities from one site to another.

We later on established the Registry of Scripless Securities or RoSS which is the official registry of ownership and other rights pertaining to scripless government securities. The Registry also functions as the clearing infrastructure for secondary market trades of scripless government securities. RoSS conforms to the G-30 Recommendations of Delivery-versus-Payment (DvP) through Netting but Same-Day Settlement.

Our ADAPS is now electronically interfaced with RoSS subscribers, principally the government securities dealers, insurance companies, regional unit banks, etc., via the Dow Jones Markets and Reuters Networks. Though this facility, RoSS subscribers electronically send their government securities trades in the secondary market without the need for paper documentation. With this infrastructure, the Philippine Treasury has completed the full automation of the government securities primary and secondary markets.

Concomitant to all this, we democratised and broadened the government securities dealership network by encouraging the entry of financial institutions with large funds and clientele to avoid the cartelisation among the past crop of government securities dealers. The expanded dealership network has spurred competition and has resulted in finer bid rates at the primary market. Government securities dealers now number 46 since the Philippine Treasury assumed the fiscal agency functions from the Central Bank of the Philippines which limited the network to 24.

Prior to 1994, the Philippine's domestic debt maturity profile has been limited to very short-term maturities, namely 91-day, 182-day and 364-day Treasury Bills.

We introduced longer-term government securities principally for better debt management and also to provide the domestic market with a menu of instruments that would meet different investors' preferences. The Philippine Treasury successfully introduced 2-year, 5-year, 7-year, 10-year and 20-year fixed rate treasury bonds. These innovations evidently lengthened the country's yield curve which is the longest in Asia. The market now functionally and extensively uses this yield curve to price their private financial instruments and products. The ratio of long-term Treasury Bonds with short-term Treasury Bills is currently at 50:50. However, whenever interest rates are high, the Philippine Treasury floats very short-term cash management bills of 35-day, 42-day and 63-day maturities. These floatations change the ratio in favour of short-term Treasury Bills, but only briefly.

On our own initiative, we successfully convinced the country's Internal Revenue Service to clarify the tax treatment of government securities. Treasury Bills and Bonds are subject to a 20% final income tax withheld at source but are now free of capital gains tax, transfer tax, documentary stamp tax in the secondary market.

We collaborated with the Securities and Exchange Commission in crafting rules to govern the Secondary Market Trade of Government Securities. These rules which are now in effect define the conventions to be observed by securities dealers when dealing with government securities, to ensure an orderly, efficient, transparent, professional and honest government securities market. It also provides for the administrative sanctions on government securities dealers for irregularities in their trading and disciplinary action for acts of misconduct due to breach of the said rules.

A periodic assessment of the market-making capabilities of these dealers as undertaken by the Philippine Treasury enhances their performance. The regular evaluation of dealer behaviour covers their active retail of government securities and intra-deals with each other. The Philippine Treasury annually gives awards to the best performing securities dealers as a way of recognising their significant contributions in the deepening of the domestic market for these securities.

3. Sustaining market development

While the Philippine Treasury is happy with the results of its innovations in the past years, more innovations are envisioned for 1998. Next year the Philippine Treasury will introduce 3 major market reforms, as follows, to deepen the debt market and render it more efficient.

We believe that the reopening method for selling government securities will enhance trading in Treasury Bonds. Reopening means auction of additional amounts of outstanding government securities under the same International Securities Identification Number (ISIN).

The reopening will reduce the number of outstanding ISINs, thereby making trades in government securities easy, allowing dealers to trade in larger blocks at a same time with less reference ISINs, enhancing the liquidity of government securities.

We are considering imposing a cap on Dealer's bids relative to the size of the offering so as to eliminate potential cornering of bids. The Federal Reserve Bank of New York caps dealer's tenders at 30% of the total offering, while the Bank of Canada pegs the limit at 25%. The Philippine Treasury is studying the appropriate bidding cap given the size of our government securities market and the financial capabilities of the securities dealers.

Finally, we will work towards the formulation of a simpler procedure to make operational the Philippine's tax treaties with other countries. The Philippine Treasury will continue its collaboration with the Internal Revenue Service of the country to arrive at a straightforward application of tax treaties. It is envisaged that the policy will clarify the ruling on double taxation and eliminate the cumbersome process of tax refunding to foreign investors. This reform when implemented is expected to pave the way for easy access and entry of foreign funds to our government securities market.

4. Conclusion

The need to deepen our domestic debt market is more pronounced now as it was 4 or 5 years back. With more and more countries competing for finite foreign funding, e.g., loans, grants, capital flows, a robust domestic debt market can allow any government to mobilise and raise significant amounts of funds from international savers for its requirements. In addition, the domestic debt market also induces savings mobilisation via the participation of individual savers and investors, including big corporations in debt securities.

Cognisant of the important role which our domestic debt market plays in the country's economic development, the Philippine Treasury will pursue more imaginative strategies to preserve the gains achieved for our domestic debt market and complete its graduation to a world class debt securities market.

INSTITUTIONAL TRANSFORMATIONS UNDERTAKEN BY THE PHILIPPINE TREASURY IN RELATION TO ITS ASSUMPTION OF THE DOMESTIC DEBT MANAGEMENT FROM THE CENTRAL BANK OF THE PHILIPPINES

Roberto Juanchito T. Dispo

1. Introduction

The New Central Bank of the Philippines Act which became effective on 3 July 1993 provides for the phase-out of domestic debt functions of the Central Bank within a period of three years but in no case longer than five years from the effectivity of the Central Bank of the Philippines Act and transfer the same to the Department of Finance.

The domestic debt functions involve the issuance, servicing and redemption of securities representing obligations of the Philippine Government. It also includes the administration and management of the Securities Stabilization Fund intended to be used in open market operations in order to increase liquidity and stabilize the value of government securities.

The rationale in the phase-out of the domestic debt functions of the Central Bank and its transfer to Department of Finance is to clearly delineate monetary functions from fiscal responsibilities. Abuses were not uncommon in the past wherein the Central Bank extensively used the domestic debt functions, i.e., borrowing through the issuance of government securities, for mopping-up operations, i.e., in order to siphon off excess liquidity in the system, which was a purely monetary responsibility. This occasioned massive yet sometimes unnecessary borrowings by the national government and a negative carry of huge cash balances lying idle and earning minimal interests with the Central Bank. The separation of the fiscal and monetary responsibilities is envisaged as preventing such abuses and establish the independence of these two sectors involved in the management of the country's economy.

Among the Bureaus and Commissions under the Department of Finance, the Philippine Treasury's primordial functions of managing the government's financial resources and public debt and formulation and execution of policies in capital market development are most akin to fiscal functions. Thus, in 1995 the Department of Finance designated the Philippine Treasury as the fiscal arm of the government to execute and conduct domestic borrowings through the issuance, servicing and redemption of government securities.

The Philippine Treasury was not intimidated by the tremendous added responsibilities when it assumed the domestic debt functions. The fact that these new responsibilities were turned over to the Philippine Treasury without provision for additional manpower complement, funding and logistics did not make the Philippine Treasury quiver and back out from the challenge. Instead, it quickly buckled down to work and crafted creative ways and means to efficiently and effectively discharge its new functions at the least cost to the government.

The Philippine Treasury was fortunate to receive grants and technical assistance from International Donor Agencies, e.g., United States Agency for International Development

(USAID), Comité Interamericano de Desarollo Agrícola (CIDA), United Nations Development Programme (UNDP), United Conference on Trade and Development (UNCTAD), to prepare itself for these daunting challenges. These grants and technical assistance were optimized and used by the Philippine Treasury in implementing the three important measures which it felt were necessary in order to transform the Philippine Treasury into a potent and state-of-the-arts fiscal arm of the government. The three measures are (1) the organizational re-shaping, (2) massive training of the human resources and (3) development and installation of robust Information Technology (IT) systems.

2. Organizational re-shaping

The organization of the Philippine Treasury was tailored to the requirements of internal control by separating operations of the front office and back office and manpower was redistributed to the domestic debt activities from the Central Bank and the decentralization of monitoring of revenue collections and budgetary expenditures. The organization was divided into three major sub-sectors namely, Operations, Policy and Planning and Auxiliary sub-sectors.

The operations sub-sector is comprised of the Asset Management and Liability Management and this sub-sector handles the heart and soul of treasury operations involving funds and debt management. The big portion of the domestic debt functions, i.e., issuance, servicing and redemption of government securities, was absorbed by the Liability Management while the administration and management of the Securities Stabilization Fund was taken over by the Asset Management. Manpower from collapsed divisions were redeployed to form the two new divisions for Securities Origination Division, which handles the flotation of government securities in the primary market through the electronic auction and the Registry of Scripless Securities Division which registers the ownership and transfers thereof of government securities both in the primary and secondary markets. The functions of the existing divisions, i.e., External Debt Division and Internal Debt Divisions, were expanded to encompass backroom operations for origination, servicing and redemption of government securities.

The former Operations Planning Service was upgraded to Policy and Planning sub-sector. The upgrading indicated the importance placed on this sub-sector. Given the critical roles of the Philippine Treasury in the area of debt management and capital market development, a strong and sharp think-tank is imperative to support the management in policy studies and formulations. Another group of redeployed personnel were banded together to form the Financial Market Analysis Division under the policy and planning subsector. This Division conducts in-depth analysis of the financial market and provides the management and the Auction Committee with forecasts of the direction of yield rates for government securities.

The Auxiliary sub-sector is self-explanatory. It provides logistics to both the operations and policy and planning sub-sectors. The IT Service is under the Auxiliary sub-sector but was overhauled and strengthened as existing divisions under it were given new functions and their manpower complement were increased from redeployed personnel from other divisions. The IT Service is at the forefront of the all computerization efforts of the organization.

Over-all treasury operations procedures were comprehensively reviewed and analyzed. Procedures found cumbersome or ineffective have all been streamlined, the number of way stations of assignments were reduced with introduction of routing slips and bureaucratic layers were dismantled by designating less number of signatories to the transactions. Manpower distribution was rationalized to balance workloads. Manual of operations devised and prescribed for all organizational units ensuring their adherence with internal control and prohibiting deviations from established operating standards, under pain of administrative sanctions.

The re-engineering of the Philippine Treasury Organization resulted in the complete transformation of the Philippine Treasury from a fat, multi-layered and slow-moving bureaucracy into a lean (personnel turnovers were not replenished), flatter and quick-responding institution ready and able to discharge the domestic debt management functions assumed from the Central Bank.

3. Manpower capacity building

The Philippine Treasury embarked on a massive training of its workforce to gear them for the assumption of the domestic debt functions. All middle management officers were subjected to intensive academic training in macro- and micro-economics at the University of the Philippines, including specialized training in domestic treasury operations in Ateneo University, and many seminars on active debt management, fund optimization and securities market and financial analyses.

Senior officers were sent to the Economic Institute, University of Colorado for courses on World Banking and International Finance. These were followed by several observation trips and internships by senior and middle managers in Federal Reserve Bank of New York, US State Treasuries of Texas, California and Oregon, Bank of Canada, Canadian Ministry of Finance, Korea Securities Depository, Shanghai Stock Exchange, US Treasury, leading international investment houses and securities dealers and Regulatory Bodies to study financial market conventions, debt management operations, securities clearing and settlement, market monitoring and treasury management.

IT people were sent to US, Canada and Japan for trainings in database administration, network management, systems development and systems and hardware maintenance.

In addition to these massive trainings, observation trips and internships, the Philippine Treasury was fortunate to have been provided by USAID, CIDA and UNCTAD, UNDP with consultants and experts in the field of economics, finance, debt management operations and management, information technology, capital market, legal conventions who complemented the learnings of our people with tutorials, lectures and advisories.

These officers and IT people who have been empowered and endowed with technical skills and knowledge are now manning the critical units in the organization, i.e., securities origination, backroom operations, debt servicing operations, securities registration, financial market analysis and IT operations thereby assuring the Philippine Treasury that the performance of its domestic debt functions are entrusted in capable and skillful hands.

4. Information technology revolution

The Philippine Treasury correctly assumed that best way to assimilate the domestic debt functions from Central Bank without the additional manpower complement is to go electronic. Therefore, with assistance of USAID, CIDA, UNCTAD and UNDP, the Philippine Treasury embarked on a virtual information technology revolution.

The Treasury of the Philippines Network or TOPNET which is envisaged to totally computerize the operations of the Philippine Treasury is now 80% completed. TOPNET is comprised of the five critical Information Systems, namely, the Treasury Operations IS, Field Operations IS, National Government Accounting IS, Policy Research IS and Auxiliary IS, covering the entire breadth and expanse of the Philippine Treasury operations.

Smaller and stand-alone applications systems, but which will be interfaced eventually with TOPNET, were developed and/or installed to equip the Philippine Treasury precisely in its domestic debt management functions. These are the Automated Debt Auction Processing System or ADAPS, the Registry of Scripless Securities or RoSS System and the Debt Management and Financial Analysis System or DMFAS.

The ADAPS is an electronic auction system, the first of its kind in Southeast Asia, which the Philippine Treasury uses to auction government securities to a network of securities dealers which are linked to the Philippine Treasury through Dow Jones Market Network (DJMN) every Monday for Treasury Bills and every second and fourth Tuesday for Treasury Bonds. Government securities dealers tender their bids (both competitive an non-competitive) by keying-in their bids competitive an using a Dow Jones terminal in the dealers office. Within seconds the bids are arrayed by the System in the terminal of the Philippine Treasury. After the cut-off time of 1:00 P.M. the array is viewed by Auction Committee which decides the award. The award is keyed-back to the respective terminal of winning government securities dealers, and downloaded to their securities account in RoSS.

The RoSS system is proudly developed by Filipino IT experts. It acts as the official record of absolute ownership, legal or beneficial title or interest in GS. Upon award of government securities to a dealer at the auction, the securities award record are downloaded electronically into the dealer's Securities Principal Account in RoSS. Every sale of government securities by a dealer reduces its Securities Principal Account in RoSS. Conversely, every purchase of government securities by a dealer increases its Securities Principal Account in RoSS. The ownership/interest of secondary market buyer, trustee, pledgee, etc. of government securities is recorded in the Securities Client Account in RoSS. The recording is done by merely keying-in the trade at the respective Dow Jones Market Network terminals of the trade counter-parties and within seconds the trade information is received by RoSS. At the end of trading hours, all matched trades (confirmed by both counterparties) are referred to the Bangko Sentral ng Pilipinas for settlement (debit of dealer-buyer and credit of dealer-seller Demand Accounts). This completes the process of trading in the secondary market. This effectively conforms with the G-30 Recommendations of Delivery-versus-Payment (DvP) through Netting but Same-Day-Settlement.

The DMFAS which is developed and installed by UNCTAD in the Philippine Treasury is intended to further improve the Philippine Treasury's debt management capabilities. DMFAS is a computer-based debt management system which provides accurate and timely debt information for cash flow projection, analysis and policy formulation. It allows debt planners to quickly analyze the impact on the country's overall debt burden resulting from changes in financial and foreign exchange markets.

The IT revolution anchored mainly on TOPNET, ADAPS, RoSS and DMFAS allowed the Philippine Treasury to leapfrog into the era of modernization. With state-of-the-arts auction, registry and debt management systems, the Philippine Treasury had indeed taken the country's debt market by the horns and pulled it into the future.

5. Conclusion

The institutional transformations of the Philippine Treasury achieved in 4 short years is no mean feat. It has caught the imagination of the country's capital market practitioners and international bankers and finance people. The Philippine Treasury shall not rest on its laurels in the face of an ever-changing and -evolving market. It will continue to be the proactive member of the Philippine Bureaucracy, blazing a trail of organizational re-engineering, information technology revolution and skills enhancements of personnel.

SETTING UP A DEBT OFFICE TO ACCESS INTERNATIONAL CAPITAL MARKETS

Peter Engström

The basic assumption underlying this presentation is that *access to international capital markets should be carried out in such a way and manner that the best possible terms and conditions can be achieved - both now and in the future*.

From this assumption, or better, **objective**, will flow a number of, hopefully, logical and coherent conclusions. One area of importance is the organisation and management of the process in order to achieve this objective.

The various functions related to public debt management are frequently divided between several different government ministries and agencies. This can cause serious difficulties and problems, such as slow decision making process, inter-agency rivalries and conflicting attitudes and statements from different officials and agencies.

This may be a mere nuisance factor as long as public debt is limited to official lenders, be they bilateral or multilateral. However, when a country is accessing the international capital markets, such lack of co-ordination and diffusion of responsibilities can be costly in financial terms.

1. What is a debt office?

A Debt Office is a unit that integrates all aspects of both active and passive debt management. The Debt Office should have a co-ordinating role vis-à-vis all other government ministries and agencies, including the Central Bank, on all matters relating to debt management.

In order to carry out its responsibilities effectively and in order to be an effective co-ordinator, the Debt Office must be vested with authority, by law or by decree from the Government or the President's office. But authority from above is not enough. The Debt Office must also have a very high degree of competence, in order to avoid the authority being challenged.

Ideally, a Debt Office should be set up as a separate agency. There are two principal reasons for this. First, being a specialised agency without other responsibilities, a Debt Office can concentrate on its principal mission and reduces the danger of having conflicting objectives. Second, active debt management is an activity that can save very large amounts of money for the government, and by setting up the Debt Office as a separate agency it should be possible to pay its staff members salaries that are competitive with the private sector. If that cannot be done, the danger of training staff only to loose them to private sector employers is very large.

If, for different reasons, it were decided against setting up the Debt Office as a separate agency, the second best location would be in the Ministry of Finance. As the main purpose of debt management is to provide lowest possible cost financing for the government, the principal link is with the Ministry of Finance. The Prime Minister's office can also be considered the advantage being that it provides the necessary authority. A disadvantage could be that the linkage with the Ministry of Finance might be more difficult.

Sometimes, it has been argued that the Debt Office function could be placed with the Central Bank. This can seem logical on the grounds that central banks usually have better paid staff and have more access to international financial market information than ministries. On the other hand, central banks have other priorities than minimising the cost of debt management to the government, and this can easily cause conflicts of interest that are difficult to resolve.

2. The need for authority and co-ordination

In order to be able to achieve the best possible terms and conditions, the borrower must have - or at least appear to have - a well co-ordinated approach to the markets. This is irrespective of whether the borrower is a private company or a sovereign state. In a private company this can be achieved by management order. In the complexities of the management of a state, this is more difficult.

The Government must, at the highest and political level, agree on the decision to approach international capital markets, and must understand that this decision will impose on it certain restrictions of behaviour. By entering the international capital markets, the markets will judge it and its actions and statements, and that judgement will have an immediate impact on the cost and availability of borrowing.

For this reason, Government should provide the Debt Office with the authority to carry out effective co-ordination of (1) the dissemination of economic information, including information on government economic policies, and (2) borrowing by different public sector entities.

Contradictory or apparent contradictory information on the state of the economy and on economic policies can create an impression of bad or incompetent national management, and the markets will charge a price for that!

If different public sector entities are seen to compete for financing also the cost of financing will increase. Of particular importance in many countries is the cost charged by lenders on loans guaranteed by the State. If the State agrees to issue guarantees for borrowings at costs substantially exceeding what the State would need to pay for its own direct borrowings, it will in fact compete with itself, and drive up also its own cost of borrowing.

3. Entry to international capital markets - Entry into a new and very different world

The State that decides to access international capital markets has normally gone through a period of borrowing from official sources of financing, such as the international financial institutions, official bilateral loans, and possibly also project-related suppliers' credits.

That past experience is of limited use when confronted with the totally different world of the international capital markets. The debt managers, and indeed the political leadership of the country, will be faced with very different demands and situations.

Borrowing from official lenders can be characterised by:

- co-ordinated efforts between most major official lenders and donors;
- mostly driven by development objectives;
- largely politically motivated lending decisions;
- the loans are primarily project related and the lenders provide technical project support;
- the legal framework is, if not simple, at least standardised and not subject to negotiation;
- there is a familiarity and mutual knowledge between lenders and borrowers.

On the other hand, borrowing from international financial markets can be characterised by:

- lenders and markets competing for the borrower;
- lenders and markets driven by their own profit targets and generally unconcerned with the development objectives of the borrower;
- the lending decisions and the terms and conditions are determined by market forces;
- loans are typically for general finance purpose and the lenders do not provide any support;
- legal agreements usually have to be formulated under Anglo-Saxon (UK or US) law, with a legal tradition alien to most borrowers - and likely to be substantially different from that of the borrowing country;
- borrowers and lenders are unfamiliar with each other and are basically ignorant about each other.

These differences are so substantial and so significant that they cannot be exaggerated. They mean that both the political decision makers and the debt managers are faced with an entirely new set of issues, situations and problems that their experience from dealing with official lenders leave them ill-equipped to handle.

4. New demands on the political leaders

The political leaders that decide to enter international capital markets, must understand and accept that this will expose them and their policies to the discipline of the international capital markets. And the verdict of that market can be swift and very hard for countries that are seen to pursue policies not in the interest of stable, non-inflationary growth.

They also must realise that market entry will put a market price on their country's debt. That market price can and will be used as a comparison with other countries. This usually has domestic political implications. The media and the opposition will ask why their leaders and their country is rated below other, possibly neighbouring countries, by the financial markets.

The political leaders must also understand that entry to the international capital markets will have implications also for the domestic capital market and, maybe more importantly, for foreign direct investment.

Successful entry to international capital markets is likely to have a positive effect on the domestic market in two ways. (1) By creating international investor interest in the country through a successful international market transaction, foreign investors are also going to become interested in and active in the domestic capital market, thus increasing demand for domestic securities. (2) At the same time, Government's ability to successfully raise financing abroad will reduce its supply of securities on the domestic market. The result should be lower interest rates, in turn generating more foreign investor interest as long as they expect the downward move in domestic interest rates to continue. Of course, failures or perceived failures in the international market are likely to have the reverse and sharply negative impact on the domestic market.

The impact on foreign direct investment is somewhat more complicated.

When foreign businessmen are considering trade with or, even more, setting up operations in a new market, one of their first actions is to call their own bank and ask their advise about the country in question. If that bank has not done their own evaluation and established credit limits for the country in question, the businessman is likely to get an answer that will make him more reluctant to invest.

Now, the State itself can create pressure on banks to undertake this credit evaluation and establish credit limits by entering the international bank credit market, preferably through an internationally syndicated bank credit, lead by a leading international bank. As the lead manager invites a few hundred banks to participate, this will in many banks start the process of credit evaluation, necessary for establishing credit limits, and necessary to ensure that the businessman interested in investing in the country will receive an encouraging reply from his bank.

Also, through a successful and highly visible series of presentations of the country, the economy and the policies, the State can generate a broader international interest in investing in the country, going well beyond the immediate government debt transaction.

The debt manager, ideally the head of an independent Debt Office, is the one that need to make the country's political leaders fully aware of these implications of international capital market access, which go substantially beyond the technical issues related to the specific borrowing.

5. New needs for co-ordination at the national level

As the implications of the market borrowing process goes beyond the relative success or failure of the entry to the international financial markets, there is a strong case to be made for a co-ordinated approach to this process, at the national level.

Presentations of the economic situation and prospects, the structure of the economy and the political situation will need to be made to bankers, to investors and also to rating agencies. These presentations need to be complete and accurate, but they also need to be seen as marketing tools. It is a question of marketing the nation to the international investment community, in such a way as to gain maximum benefit. At the same time, these presentations need to be very factual and correct, as misleading information can cause serious legal problems, and eventually lead to a backlash.

To make these presentations authoritative and effective, it is important that they are supported from the highest political leadership, but also that they are effectively co-ordinated. Input is required from a wide range of ministries, governmental agencies, public sector entities and the central bank. Ideally this information should be consistent. Contradictions will be noted and will raise questions. Contradictions and inconsistencies may not be possible to avoid, but should then be satisfactorily explained.

Financial co-ordination is also important when a country prepares to access the international capital market. As already mentioned, it is important that different public sector entities do not act without strict co-ordination and planning. This can usually be accomplished by governmental decree or guidance. However, it is also useful to achieve effective co-ordination with major private sector entities, primarily banks and larger corporations that may eye the international markets themselves. They will understand that successful market operations by the State will be of help to them and should normally not be averse to participating in a dialogue with the government's debt manager.

The best choice of overall co-ordinator in these areas is the Debt Office. The debt manager must understand all these aspects and is best placed to be the most efficient co-ordinator. The debt manager is also the interface between the international markets and the national entities and must be able to explain the idiosyncrasies of one to the other.

6. New requirements posed by market borrowing

As should be obvious from the above, marked borrowing poses new challenges for the political leaders and the debt managers. In comparison with borrowing from official sources of financing, borrowing from the international capital markets require:

- A different approach;
- A different organisation; and
- Different competence.

One way of describing this is to view the process of accessing international financial markets as a *new and different project, which also is going to be a continuos project, and will require:*

- A specific project organisation;
- Competent management;
- Access to specialist resources.

This can best be achieved by establishing a separate Debt Office, which in addition to the "normal" debt management functions, can ensure that:

- Relevant policies are co-ordinated;
- Investor and rating presentations are co-ordinated, accurate and effective;
- Specialist resources are available and used efficiently;
- Continuity prevails even with changes in government.

7. Co-ordinated policies

Apart from the desirability of a clear and unambiguous general economic policy stance, there are three other policy areas that need to be co-ordinated from the point of view of debt management and access to international capital markets:

- *Public sector borrowing policy*: The financial markets will want to know what the borrowing policy is. They will want to be able to reasonably predict future financings and future debt burden developments. Also, which public sector entities are likely to come to the markets and how they are going to be co-ordinated.

- *The division between borrowing in domestic and foreign markets*: What are the principles that will determine the government's choice between borrowing domestically and in international markets?
- *Policies affecting foreign investors*: This will include matters such as foreign currency and capital movements restrictions, if any, tax rules both on interest income and on profits on direct investments, and any restrictions that may apply to foreign investors.

8. Presentations

One of the most important functions is the marketing of the country and its economy and policies. This requires both written and oral presentations, directed at a variety of audiences - bankers, investors and rating agencies. For a country that is accessing the international markets for the first time, this is particularly important because you are addressing an audience that knows very little about the country, and most probably has pre-conceived notions that need to be corrected.

There are some basic rules that need to be followed if these presentations are going to be effective and successful:

- *The presentations must be made in English*: It can be simple English, but it must be in reasonably good English. This is not so much a problem with written material, but can be a problem with oral presentations. Audiences get bored quickly and the easiest way to bore then is either to have an interpreter or to make the presentation in a monotonous tone! It is also very important that the oral presentations are rehearsed.
- *The information material must be correct and comprehensive*: There will be analysts who will poor over the figures, looking for errors and inconsistencies, to seek to prove that the credit is poor!
- *Problem areas should be highlighted*: Of course one will need to and want to present a positive picture, but in doing so it is important not to hide the problem areas. Everyone knows there are problems, and pointing out the problems and how they are being addressed creates the best impression. That will create a positive impression of a national management that is aware and capable.
- *Follow-up is necessary*: It is important to periodically up-date the information material and circulate it to interested parties, bankers, major investors and the rating agencies. It is useful if these information packs could be made available through embassies in key countries. A continuos programme of such up-dates and of oral presentations to investors and bankers in key markets should also be developed.

Essentially what needs to be developed and maintained as long as the government is an active borrower in the international markets is an effective and active programme of investor relations, including relations with the rating agencies. This is particularly important in periods of difficulties. If the national authorities inform investors and rating agencies about the difficulties and how they are being dealt with, they will be more positive than if they read about the problems in the press.

9. Specialist resources

When the debt managers start discussing entry into international capital markets with international bankers, they will be told that it is an easy process, and that their friendly banker can provide all the assistance required. Neither of these statements is correct.

The banker is supported by a formidable team of specialists in all areas of finance, economics and law. The new borrower normally lacks similar support and cannot find the same competence within the civil service, and, possibly not in the country.

The banker is a salesman, whose job is to sell a transaction to the borrower, and the best bankers do this by asserting that they are the unselfish advisors to the borrower. This is, of course, nothing but salesmanship and should not be trusted. The banker will only keep his job, his salary and his bonus if he can convince the borrower to do a transaction with his bank, and, preferably at terms and conditions that guarantee his bank a nice profit.

This creates a very dangerous situation. The debt manager cannot easily evaluate which of several markets, and market instruments, and lead bankers, and terms and conditions that would be most appropriate. It is as impossible as to ask the new university student to define the course curriculum.

Therefore, the debt manager needs his own specialist support resources. They need not be civil servants and they need not even be nationals. The important aspect is that they should know the international financial markets business.

There are two areas in which the debt manager need to look abroad for these resources:

- Legal advisors;
- Financial market advisors.

By definition, a loan or bond issue in an international market will be executed under the law of that country or under British law. The new borrower might be more concerned with maturity and interest rate than with the legal documentation, but needs to realise that the various legal aspects of the loan documentation can have equally important consequences, for better or worse, than the financial terms of the transaction. This is even more pronounced in the case of loan documentation under British or US law. Anglo-Saxon law is so completely different from the legal systems of most other countries, that specialist advice is absolutely necessary.

The banker may recommend against paying money for an international legal advisor, arguing that his bank's law firm will work in the interest of both parties. This is, of course, not true. The legal documentation is an agreement between two parties, the arranging bank and the borrowing state. The bank's lawyer has to look to the interest of the bank, not that of the borrower. And the interests of the two parties are different. The amounts paid by the borrower for competent legal advice are very small in relation to the loan amount and the costs of servicing the loan, and are likely to produce benefits worth far more than the cost.

Financial advisors are equally important. There are several different markets, several different market instruments, and they all have different characteristics. No bank is so strong in all these segments that they will be able or interested in advising the new borrower which market and instrument would be the most appropriate. Only the experienced advisor can do this. There are also different logical steps in how one plans access to the international markets and executes a progression of consecutive deals that can influence the longer term success and cost effectiveness of the borrowing programme.

It is becoming increasingly common amongst new sovereign borrowers to issue "Requests for Proposal" to a wide range of international banks in order to choose the arranging bank or banks. This is an extremely useful tool for selection and gaining information. However, it is also a difficult procedure to handle and evaluate. Finally, during the actual negotiations on terms and conditions and the loan documentation, an experienced financial advisor can be invaluable.

Again, the cost of retaining such a financial advisor is minute in relation to the total costs and size of the transaction, particularly considering that a successful first transaction will prepare the ground for following transactions. It is also worth noticing that in the country with the most advanced financial markets in the world, the United States, financial advisors are routinely retained by major corporations and public sector entities to assist in organising cost-effective financing.

In two areas, the debt manager need to look for domestic specialist resources:

- Legal advisors;
- Economists.

There will be a need for legal opinions from domestic lawyers and there may well be issues of constitutional and other law as to who can borrow in the name of the nation. For these reasons, it is useful to include experienced domestic legal advisors as specialists in the borrowing team.

Likewise, the presentations of the economic situation and prospects can usually benefit from the assistance of experienced domestic macro-economists, not necessarily civil servants. Indeed, the different perspective offered by an experienced independent economist can be extremely valuable in forming an effective presentation package.

10. The need for continuity

Financial markets value stability and continuity, and considering that most foreign loans have a maturity that goes beyond the election period of any government this is not an unreasonable view. From the national point of view, also, it should be a non-partisan interest that the nation's foreign market borrowings are as cost-effective as possible.

For these reasons, it is important that the approach and relations to the international financial markets do not change too much with changes in government. Continuity in terms of debt manager and market approach when governments change will convey a sense of political maturity that will be appreciated by the financial markets.

Continuity is also required, as mentioned earlier, for the flow of information to bankers, investors and rating agencies, the investor relations.

This continuity, and the confidence it gives to the lenders, can best be provided by a Debt Office that is separate from the political ministries.

11. The Debt Office - the man in the middle

The financial role of a Debt Office is obvious. However, in preparing for, and executing, access to the international financial markets, the Debt Office has an equally important - but more difficult role - as a communicator and an interpreter.

On one hand, the Debt Office and the debt manager is representing the government and the nation vis-à-vis the international markets, bankers, investors and rating agencies. On the other hand, which may be more difficult to accept, the Debt Office also has an important role to communicate the views and attitudes of the international markets to its own government.

To understand this dual role is important to the success of the approach to and relations with the financial markets, and will produce significant financial rewards to the borrower. But this understanding must be shared by the political leadership, as the Debt Office undoubtedly will, from time to time, provide information that will be politically unwelcome.

But shooting or ignoring the messenger does not solve any problems!

ARAB DEBT: WHAT HAS BEEN LEARNED FROM THE 1982 CRISIS

Nabil Abdelwaheb Ltaifa*

1. Introduction

Arab countries[1], like the majority of developing countries in the seventies, had run unprecedented large current account deficits and relied on foreign borrowing in the international financial markets to finance growth and development. This had happened at a time where commercial banks had been looking for ways to recycle the Petrodollars, and official lending had been relatively small. Believing that short term lending was safer than long term ones, commercial banks used short term lending to finance balance of payment deficits running over extended periods.

During the same period, world economy was enjoying relatively high growth rates, and so were exports. Under those conditions, the dominant feeling among banks was that the likelihood of a large number of debtor countries defaulting payment on debt was very small. And then came the slow down in world economic growth coupled with the rise in interest rates in the early eighties. These two factors together helped trigger an international financial crisis, where developing countries were among the first victims.

The above developments brought to light the shortcomings and deficiencies of economic management that had characterized a large number of countries. Since then, and with the assistance of international and regional institutions, several developing countries have adopted stabilization and adjustment programs intended to restore internal and external equilibria. Price liberalization, exchange rate devaluation, fiscal and monetary restraints, and outward looking economic and trade strategies have come to replace the old development strategies. The latter promoted bigger role for government in development and inward looking growth, where price controls, import substitution, and overvaluation of exchange rate played a major role.

Debt restructuring and debt burden alleviation through rescheduling have been the cornerstone of the stabilization and adjustment programs that have been put in place. The International Monetary Fund (IMF), along with other international and regional institutions, and with the help of major industrial countries brokered some multi-stage cooperative arrangements between debtors and their creditors. Such arrangements encourage creditors, official and commercial to assemble in different groupings (the Paris Club for official lenders and the London club for commercial ones) and negotiate with their debtor ways of reducing and paying back their debt. These negotiations were conditional on being preceded by an adjustment program monitored by the IMF.

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[1] Arab Countries refers in this particular context to the 13 net debtor countries members of the Arab league, i.e., Algeria, Djibouti, Egypt, Jordan, Lebanon, Mauritania, Morocco, Oman, Somalia, Sudan, Syria, Tunisia, and Yemen.

Several Arab countries had been or are currently implementing stabilization and adjustment programs under the monitoring of the IMF. A few of them have requested and benefited from debt rescheduling within the framework described above. These countries are Algeria, Egypt, Jordan, Mauritania, Morocco, and Sudan.

Arab countries- Official bilateral and multilteral debt rescheduling Inside Paris Club		
Country	Number of Times	Years
Algeria	2	1994, 1995
Egypt	2	1987, 1991
Jordan	4	1989, 92, 94, 97
Mauritania	3	1989, 1993, 1995
Morocco	6	1983, 85, 87, 88, 90, 91
Yemen	2	1996, 1997

Sources: World Bank Word Debt Tables 1991-97, and different country sources

This paper will attempt to assess the extent to which three of these Arab countries have succeeded in solving their debt problem. Their success will be measured by the sustainability of their current debt situation into the future. To this end, a set of solvency indicators, complemented with an analysis of the macroeconomic policies put in place and their impact on the parameters that have impact on solvency, will be used.

The study will be divided into three parts. Section 2 will briefly lay down the analytical framework for the analysis of debt sustainability. Section 3, is application of the analysis in section 2 to three Arab Countries namely Egypt, Jordan, and Morocco. The study will end with concluding remarks, which will be presented in the last section.

2. The analytical framework

The issues facing a policy maker in charge of solving a debt problem, i.e. reducing the debt stock to a sustainable level, are multidimensional. They have to do primarily with (1) the size of the inherited debt and prevailing imbalances related to economic and social conditions (all systems determining prices, spending and investment patterns, institutions and regulations). (2) Current domestic policies, and (3) policies pertaining to debt relief, debt rescheduling, and international economic and financial developments. The model described below provides the basic framework for analysis. The discussion of policies and issues pertaining to debt sustainability is done whenever it is relevant. The variation in foreign debt stock at any period of time can be expressed as follows[2]:

$$\Delta D = i\,D + G \qquad (1)$$

Where,

ΔD: indicates the change in foreign debt.
i : indicates the average nominal interest on foreign debt.
G : the resource gap, it indicates deficit when (+), or surplus when (-).

[2] For more on debt dynamics and analysis see:
Mario H. Simonsen, "The Developing-Country Debt Problem," in Gordon W. Smith, and John T. Cuddington, (eds.), International Debt and the Developing Countries, a World Bank Symposium, World Bank, Washington D.C., 1985, pp. 101-128.

The definition of resource gap in this particular case is closely related to the change in the country's external liabilities in the future. Hence, during any given period, capital flows that do not increase the countries external liabilities in the future help close the gap if it were positive (deficit), and widen the gap otherwise (surplus). The resource gap, as defined, increases with the rise in the non-interest current account deficit (+) or the decline in its surplus (-), and vise versa. It also rises as more capital flows out of the country for the purposes of direct or *portfolio* investment (the case of capital flight is a typical example). It declines in the opposite case, i.e., when the country attracts foreign investment from abroad. Moreover, the resource gap increases as more foreign assets are set aside by the monetary authorities to build its stock of reserve assets, and declines as part of them is being used for financing.

The above representation of the change in the stock of debt has significant policy implications, as it separates the impact of current policies from past ones on the "overall gap", or the stock of foreign debt. The resource gap as defined reflects to an extent (and not entirely) the efforts and implications of current policies[3]. A negative gap (surplus) puts more strain on a developing economy that is trying to reduce a debt stock to a sustainable level[4]. The impact of such effort becomes even more serious when achieved through import contraction. In fact, a positive gap (deficit) is more of what is expected of a developing economy growing at levels beyond its own resources, and that is considered to be relatively in balance. The sustainability of the gap in this case, is dependent on the ability of the economy to service its debt. One important indicator of such ability is the relative growth rate of its exports with respect to its foreign debt. Equation (2) below depicts this relation[5].

$$\Delta Z = (i - x)Z + g \qquad (2)$$

Where,

ΔZ : indicates the change in the ratio of foreign debt to exports, $\Delta(D/X)$.
x : indicates the growth rate of exports, $\Delta X/X$.
g : indicates the ratio of resource gap to exports, G/X.

Equation (2) shows that the ratio of debt to exports rises as the average nominal interest rate exceeds the rate of growth of exports, for a zero resource balance. This intricate link between the growth rates of relative debt stock, exports, the average interest on debt, and the resource gap is very important. It highlights the importance of liquidity, or the country's ability to raise foreign currency (through exports) to service its foreign debt in the absence of new loans at any period of time[6]. In fact, the faster exports are growing, the more the country is able to generate foreign currency to service the debt. Thus, countries that borrow abroad to finance domestic investments in infrastructure and/or other non-export oriented expenditures, though

[3] Recall that two important components of the resource gap are net capital flows and change in reserves. The former, net capital flows are determined by both domestic medium to long run structural factors as well as short demand management policies. The latter, Change in reserves, is subject to current policies, but also affected by the needs of rebuilding reserves if they had been run down by past policies.
[4] For a discussion of the impact of foreign borrowing on output and income, see:
A. P. Thirlwall, "The Finance of Development from External Sources," in Thirlwall A. P., (ed.), Financing Economic Development, Chap. 4, Macmillan Studies in Economics (1976), pp. 57-59.
[5] See Annex 2 for a detailed derivation of equation 2.
[6] For more on issues related to liquidity, solvency, and repudiation risks, see:
Richard N. Cooper and Jeffrey D. Sachs, "Borrowing Abroad: The Debtor's Perspective," in Gordon W. Smith, and John T. Cuddington, op. Cit., pp. 22-26 of 21-60.

may be solvent in the long run[7], may run into liquidity problems in the short run. Had the liquidity problems not been addressed adequately and in proper time, these countries run the risk of becoming non-solvent, as the lending rates on fresh borrowings rise and less and less lenders (and specially banks) are willing to come to the rescue. The drying up of export financing facilities to these countries could in turn further aggravate this last condition[8], which causes exports to decline and the debt problem to worsen even more.

Equation (2) also shows that the ratio of debt to exports can also rise as the country runs a positive resource gap (deficit), if the growth rate of exports is equal to the average interest on debt. For the debt to export ratio to decline under the latter condition, a negative resource gap (surplus) is required. More difficult and stringent conditions than this plagued a large number of developing countries in the early eighties. The adverse international economic conditions at the time pushed average interest on foreign debt above growth rates of exports. And a solution to the debt problem meant for the indebted countries harsher economic and social conditions at home. In fact, countries wanting to meet their obligation to reduce the debt, or at least the less stringent condition of reducing the debt to exports ratio, were faced with the requirement of reducing imports. Contracting imports in this case helps reduce the resource gap (deficit) in the short run to compensate for a temporary decline in export growth or a rise in interest rate. However, such policy proves to be viable only in the short run. In the long run, the rescheduling of part of the debt combined with a comprehensive stabilization and restructuring program of the domestic economy to boost growth and exports turns out to be a lone solution. The objective of the program is to bring back the debt stock to its sustainable levels at minimum cost to the economy in terms of growth and social hardship. And to facilitate the task of debtor countries and at the same time protect the interests of their creditors, the IMF is given the role of a sponsor of these programs. Under the mandate, it is required to ensure that policies put in place not only lead to an orderly long-term evolution of external indebtedness of the country, but also to conditions that are not damaging to its national prosperity[9]. Sustainability under these conditions means in addition to actually reducing the debt stock itself, adopting actions that reduce the average interest on debt, promote export growth, and improve the resource gap. It is not the objective of this paper to address the nature of these actions. However, analyzing their impact on the debt sustainability parameters for the three Arab countries, subject of this study, is part of our main concern.

3. Sustainability of debt in Egypt, Jordan, and Morocco

3.1. Case of Egypt

Over the period of study, 1985-1995, Egyptian foreign debt measured by the stock of average total debt outstanding and disbursed displayed sharp decline over the period 1985-92[10].

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[7] Long run solvency means that "the debtor has the future resources to service its debt, without the need to borrow forever in order to make interest payments". It is equivalent to having the maximum discounted sum of current and future trade balances being greater or equal to the value of debt at the end of current period.

[8] Export financing facilities are an important source of foreign financing to several developing countries, and maintaining them in times of debt crises are crucial to the countries them selves and constitute an important leverage for creditors.

[9] International Monetary Fund, "Theoretical Aspects of the Design of Fund-Supported Adjustment Programs," IMF Occasional Paper Series, No. 55, International Monetary Fund, Washington D.C., September 1987, p. 4.

[10] Data information and sources for all countries subject of this study is provided in Annex 1.

Likewise, over the same period, the average ratio of total debt outstanding to exports showed a steady decline (see Figure 2), from almost six fold to a little over 200 percent. Total debt service as a percentage of exports, it too declined from almost 40 percent in 1986 to 15.6 percent in 1995. Several factors have contributed to this decline. Egypt benefited from debt forgiveness in 1990 amounting nearly to $ US 13.3 billions. Most importantly, it has implemented an adjustment program since 1991, and has also benefited from debt reduction and rescheduling within the framework of Paris Club, twice in 1987 and 1991[11].

Egypt: Debt sustainability-Analytical graphs

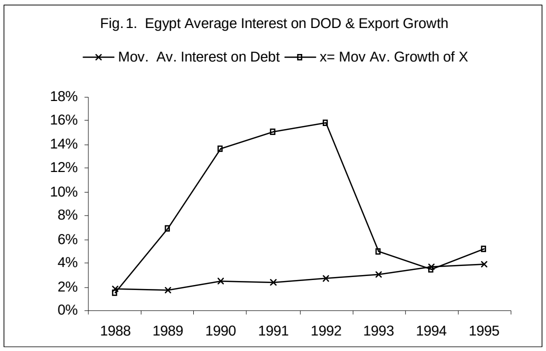


Fig. 1. Egypt Average Interest on DOD & Export Growth

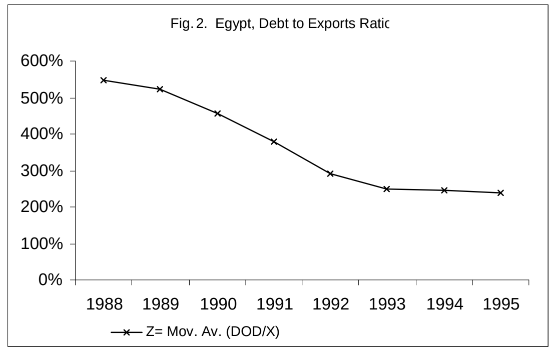


Fig. 2. Egypt, Debt to Exports Ratic

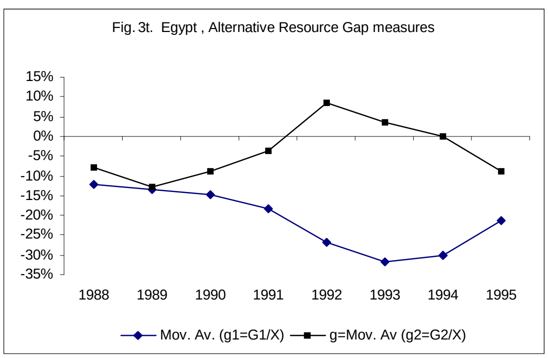


Fig. 3t. Egypt , Alternative Resource Gap measures

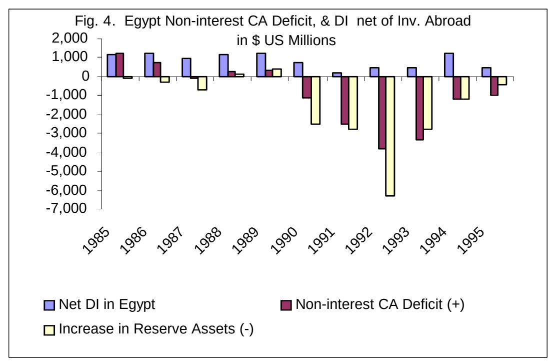


Fig. 4. Egypt Non-interest CA Deficit, & DI net of Inv. Abroad

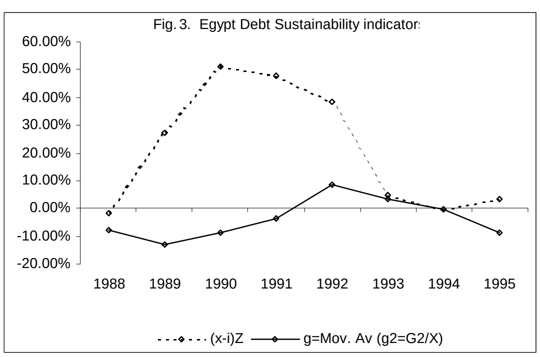


Fig. 3. Egypt Debt Sustainability indicator:

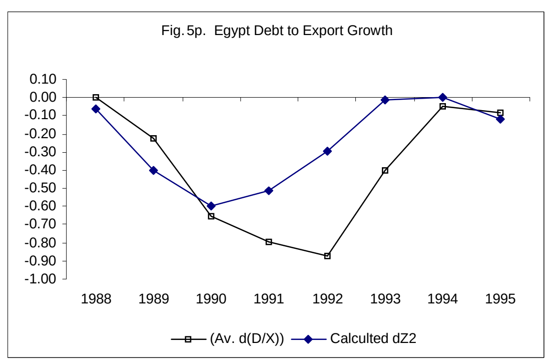


Fig. 5p. Egypt Debt to Export Growth

[11] For an extensive review and analysis of the Egyptian stabilization program, see:
Arvind Subramanian, "The Egyptian Stabilization Experience: An Analytical Retrospective," IMF Working Paper Series, No. 97/105, International Monetary Fund, Washington D.C., 1997.

At this point we proceed with the analysis of Egypt's debt evolution along the framework discussed in section 2. Figure 1 shows an average growth rate of exports surpassing the average interest on debt, almost over the entire period under study with the exception of 1988 and 1994. In fact, export growth had increasingly exceeded the average interest up to 1992, from slightly negative in 1988 to a high margin of 13.2% in 1992. Then it declined to less than 2 % in 1993, and then turned negative again in 1994. In addition to the variability in export growth, the evolution of the excess growth of exports over the interest rate, reflects a slight rise in interest rates from an average of less than 2% in 1988 to almost 4% in 1995.

On the other hand, the analysis of the resource gap (as a percentage of exports) excluding the impact of change in reserve assets shows a negative gap indicating a surplus, over the entire same period (see, Mov. Av. (g1 = G1/X), in figure 3t). Taking into account the rise in reserve assets (see, Mov. AV.(g2=G2/X), in figure 3t), the gap declines to become positive in 1992 indicating a deficit that lasts over to 1993. Although tapering off growth, the rebuilding of reserve assets by the monetary authorities is a necessary part of the adjustment program that started in 1991, and aims at restoring confidence and minimizing liquidity risk associated with Egypt's international outlook. The analysis of the other components of the resource gap detects a rise in the non-interest current account surplus for the years up to 1992 (Figure 4). This is attributed in part to fast growth in exports. Imports, however consistently above exports, they too contributed to widening the gap as they suddenly show a sharp decline in growth starting from 1990, the year of the start of the program. In 1993, they show a negative growth, whereas export growth dips to an average of about 5% from 16% in 1992. In 1994, imports again register a positive but slight growth, however exports continue on increasing but at even more slowly pace. The other component of the resource gap, net investment in Egypt however needed and useful to growth, continues to be relatively timid and volatile over the entire period of study (figure 4).

The relative evolutions of the main elements affecting the change in the debt to export ratio based on calculations according to equation (2) are shown in figure 3, and their net outcome is shown in figure 5p (calculated dZ2). The latter, compared with the growth rate of the actual average debt to export ratio ((Av. d(D/X))), shows a large discrepancy in magnitude up to 1991, before they move closer together along the rest of the period of study.

The fast decline in the debt to export position of the country in the years up to 1992 seems to fade afterwards. Going back to economic fundamentals, the improvement of the debt position of the country is attributed in large to the one time structural corrections that were implemented in the early nineties. First, are the successive devaluations that lead to the reunification of the exchange rate markets in February 1991. Second, the fiscal correction that brought down the fiscal deficit by over 16 percentage points over 4 years (from a deficit of 9 % in 1990/91 to a surplus of 7 % of GDP in 1993/94); with the bulk of the effort was concentrated in just the years 1990/91 and 1991/92[12]. Debt forgiveness and debt reduction, they too contributed a great deal. "As a result of the debt forgiveness and Paris Club rescheduling agreement of 1991, Egypt's foreign interest bill was substantially reduced, estimated at about 8.4 % of GDP (cumulative for the post-stabilization period) or 1.4 % on average for the six-year period."[13]

[12] Arvind Subramanian (1997), op. cit., p.7-8.
[13] Arvind Subramanian (1997), op. cit, p. 14.

3.2. Case of Jordan

Unlike Egypt, Jordan's foreign debt measured by the stock of average total debt outstanding and disbursed, did not start decreasing until 1993, though it had been rising at a decreasing rate over the period 1988-92[14]. In fact, measured as a percentage of total exports of goods and services, the average total debt outstanding peaked to over 270 % in 1992, to decline later on to an average above what it was in 1988, e.g. 221 % of total exports in 1995. Efforts to solve the Jordanian debt problem have started since July 1989, at the start of the first adjustment program and the first rescheduling agreement within the framework of Paris Club of official creditors. Since then, Jordan has had ongoing stabilization and/or structural programs, and 3 more debt rescheduling agreements with official creditors at the Paris Club in 1992, 1994, and 1997. And since 1993, encouraged by the notable increase in official foreign reserves following the record level of repatriation of returnees' savings subsequent to the Gulf Crisis, Jordan shifted its debt management to restructuring the stock of debt on the basis of market-based financing menu. On this basis, it was able during 1993 to, use cash-buy backs at a discount to extinguish $ US 600 million owed to commercial banks, buyback another $ US 100 million from commercial banks, and reach an agreement with London Club creditors (June 1993)[15]. In addition, Jordan received $ US 800 million in the form of debt forgiveness.

Now we turn to the analysis of Jordan's debt indicators based on the framework of section 2. Figure 1 shows two striking features characterizing the Jordanian external outlook: a high but declining average interest on debt from about 6.5 % in 1988 to almost 3 % in 1995, and a relatively volatile growth rate of exports with respect to the average interest rate. In fact, total export growth declined to less than 1 % in 1991, to rise again to over 9 % in 1995.

Jordanian total resource gap, as a percentage of exports (Mov. Av. (g2=g2/x) Figure 3) displays a deficit over the entire period 1988-95. This reflects in part the Jordanian's monetary authority effort to rebuild its stock of net foreign assets, which reached its peak in 1992 (Figure 4). The other important component of the resource gap, non-interest current account balance (Figure 4), shows large variability over the entire period, and consecutive deficits starting from 1991. This is largely attributed to the high volatile imports, which registered a shift from a negative to a positive average growth starting from 1992 (the year of the start of the second phase of the adjustment program). The last component of the resource gap, net direct investment in Jordan, has been relatively insignificant over the entire period (Figure 4).

[14] For more on the Jordanian experience in adjustment and growth, see:
Edouard Maciejewski, and Ahsan Mansour, "Jordan Strategy for Adjustment and Growth," *IMF Occasional Paper Series*, No. 136, International Monetary Fund, Washington D.C., May 1996.
[15] Edouard Maciejewski et al (1996), op. cit., pp. 51-52.

Jordan: Debt sustainability-Analytical graphs

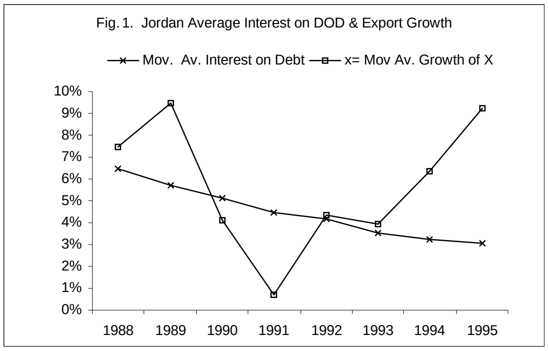


Fig. 1. Jordan Average Interest on DOD & Export Growth

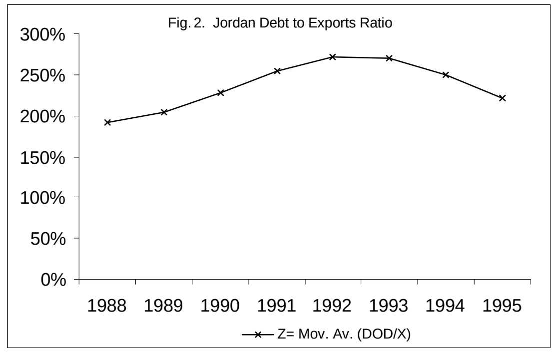


Fig. 2. Jordan Debt to Exports Ratio

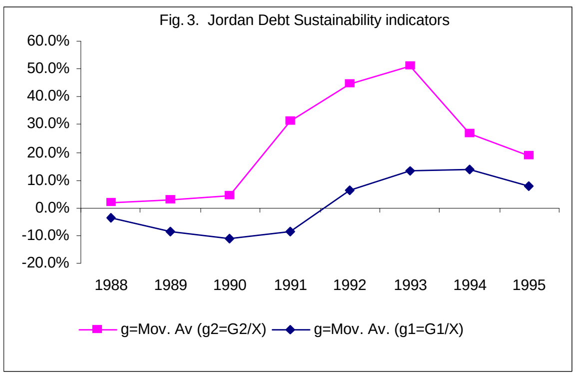


Fig. 3. Jordan Debt Sustainability indicators

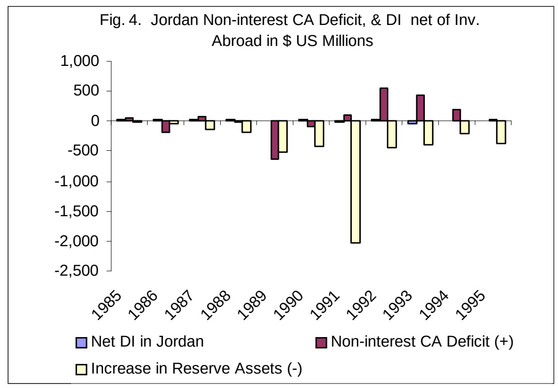


Fig. 4. Jordan Non-interest CA Deficit, & DI net of Inv. Abroad in $ US Millions

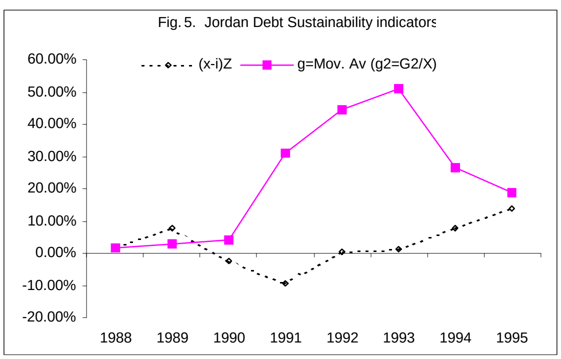


Fig. 5. Jordan Debt Sustainability indicators

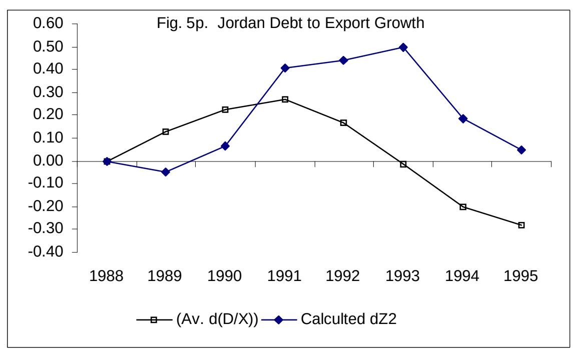


Fig. 5p. Jordan Debt to Export Growth

Figure 5 summarizes the behavior of the two main components of equation 2: excess growth of exports over average interest on debt, and total resource gap. Figure 5p displays their net outcome (calculated dZ2). The synthesis of these indicators relays the difficulty facing the Jordanian economy in overcoming its debt problem. The gain in export growth following the adjustment since 1992[16], is in large annihilated by the surge in imports associated with the return of Jordanian immigrants from the Gulf States. Despite the steady decline in average interest rates, the overall outcome on the ratio of debt to exports continues to be volatile, and this ratio continues to be relatively high, more than 200 % in 1995.

[16] This improvement in exports is also attributable to “strong performance of remittances and nontraditional exports and the strong recovery of tourism receipts” (Edouard Maciejewski et al (1996), op. cit., p. 10.)

The observed decline in debt to export ratio in Jordan seems to be more the result of actions aimed directly at reducing the stock of debt itself (debt forgiveness, buybacks, restructuring, etc…), rather than the result of change in economic fundamentals. The effect of the structural program, as per its impact on debt reduction, appears to be insignificant over the period of study. It could be argued that such period is too short to detect any sensible effect. Nevertheless, it seems that the size of the debt is too large, when compared with the size of the Jordanian economy. Specially, when taken into account its narrow base of production and the dominance of the trade and service sectors on more than two thirds of its economy.

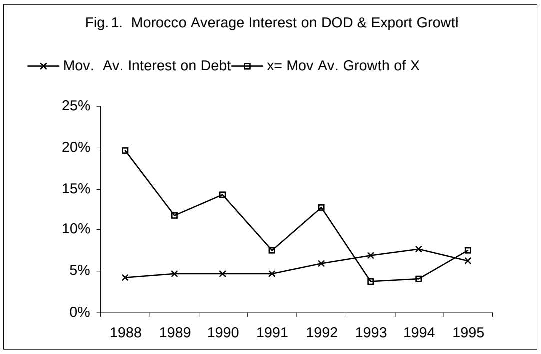
3.3. Case of Morocco

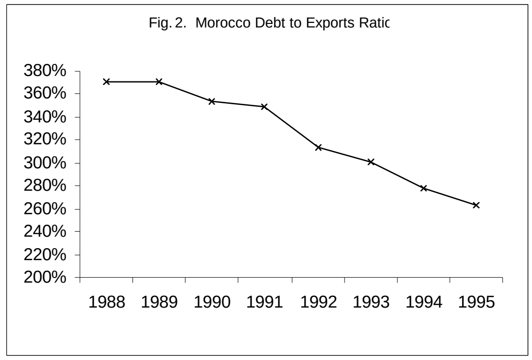
Morocco debt to exports ratio displays a steady decline between 1989 and 1995 by about 100 percentage points, from 370 to 260 % (Figure 2)[17]. Debt service to exports ratio however, has been quite volatile, and is marked by a qualitative increase in 1992 (Figure 6). In fact, it increased by about 20 percentage points, from 31 to 51 % in that year alone. Subsequently, it started decreasing again but no near to where it was before, to reach about 38 percent in 1995. The rise in debt service is largely associated with the rise in interest payments, which increased by more than 115 %, from 1056 million in 1991 to $ US 2272 million in 1992. Since 1983, Morocco has concluded six agreements with Paris Club official creditors, and three agreements with commercial banks within the framework of the London Club. In addition, Morocco benefited in 1990 from a cancellation of a part of its foreign debt that amounts to $ 2.7 billion[18].

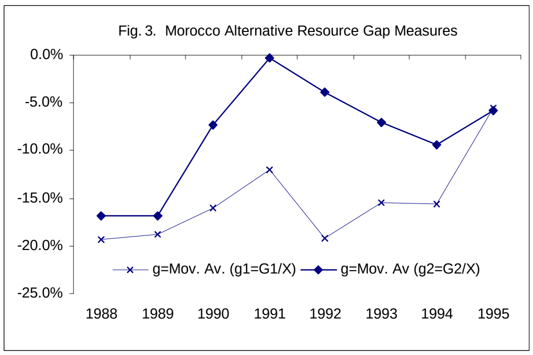
[17] For more on the Moroccan stabilization and adjustment program, see:
Saleh M. Nsouli et al, "Resilience and Growth Through Sustained Adjustment: The Moroccan Experience," IMF Occasional Paper Series, No. 117, International Monetary Fund, Washington D.C., January 1995.

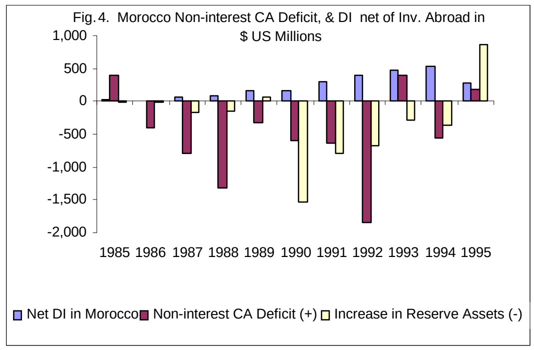
[18] Saleh M. Nsouli et al (1995), op. Cit., p. 51.

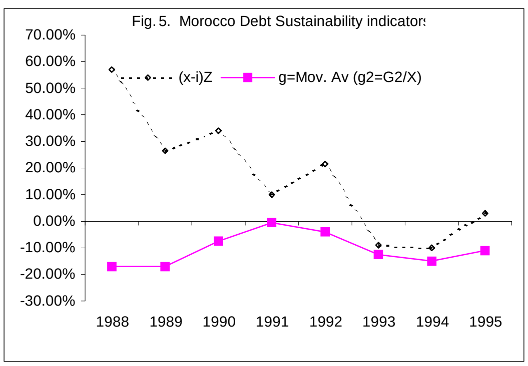
Morocco: Debt sustainability-Analytical graphs

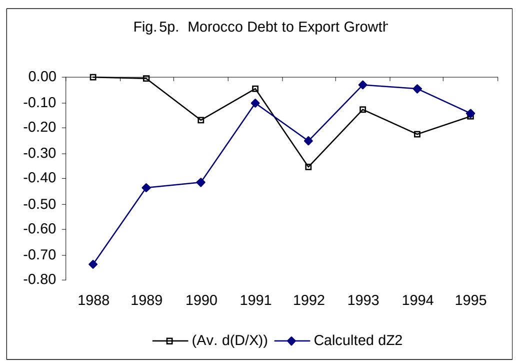


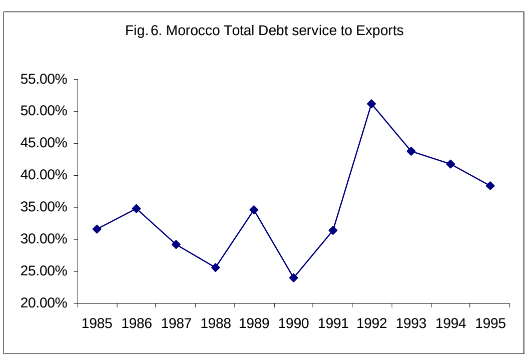












Now, we proceed with the analysis of Moroccan debt with the framework discussed in section 2 in mind. Figure 1 shows that, like Jordan, Morocco average exports growth rates continue to be highly volatile, reflecting the incessant deterioration of Morocco's terms of trade, and the authority efforts to address the problem. These efforts materialized twice in exchange rate adjustments: first during the period 1980-86 (through gradual devaluation of about 30 %), and later in 1990 (using one time devaluation of 9.25 %). The average interest rate on debt, on the other hand, shows signs of steady increase over the same period, peaking to an average of 6.65 % in 1994. As a result, it exceeds the average export rate twice: first in 1993, and then in 1994.

The analysis of Morocco's average resource gap measures depicted by figure 3 shows negative gaps indicating a surplus over the entire period of study, both while including and when ruling out the rise in net foreign assets. This surplus hints to the tremendous efforts that the Moroccan authorities are making to solve their debt problem. It becomes more evident in the sharp decline of the average growth rates of imports, which fell from about 18 % in 1990 to less than 3.5 % in 1993. Especially that, such decline coincided with the decline in export growth rates to an average of less than 4 % in the same year. The analysis of the rest of the components of the resource gap displayed in figure 4, detects a rising trend in net direct investment in Morocco since 1987[19]. The latter helped finance in part the rebuilding of reserve assets, which registered their highest rise in 1990, reaching more than $ US 1500 million.

The summary of the main components of equation 2, or elements affecting the change in the debt to export ratio, is displayed in figure 5, and their net affect is shown in figure 5p. Despite the notable decrease in the debt to export ratio, it appears that a sensible portion of the outcome is a result of the recourse to debt restructuring and better debt management. Structural adjustment as such, has certainly and significantly helped mobilize resources and improve resource allocation in Morocco. It also significantly contributed to relatively improving the balance of payments in the years following the adjustment. However, given the sizes of debt and the debt burden, it seems that a lot more needs to be done to reduce the stock of debt. And that has to be done carefully so that it does not hinder trade expansion and growth, the two critical factors for sustainable development.

4. Concluding remarks

Despite the relatively high stock of debt that remains at the burden of several Arab countries, including the three ones subject of this study, several important lessons have been drawn and developments have taken place since the crisis, where the latter has been the most important cause:

1. The countries learned that borrowing is very costly, and more so, when the borrowed resources are not well allocated. Thus, countries have been more careful about borrowing. They are also more careful about choosing their sources of financing.

2. They also appreciate better the concept that stipulates that resources are scarce, and thus efficient use of resources is not only a priority but also a must. Social considerations are not to be ignored, but they should be addressed efficiently and at minimum cost.

[19] The latter comes as a result of the structural adjustment that has started since 1983, and which significantly reduced price distortions and trade controls, as well as budgetary and monetary imbalances.

3. Inward looking strategies hinder development in several ways, and have proven to be non-sustainable. Reverting to free trade and development through exports is crucial to debt repayment, and encourages efficient use of resources and growth.

4. Debt monitoring and sound debt and financial management are very important aspects of efficient management, and help considerably reducing the stock of debt, the debt burden, and the risks associated with them.

5. Creative mechanisms for debt reduction are very important, and could play a major role in reducing the debt stock. However more needs to be done to find ways of reducing the very large stocks of debt, in addition to repayments from surpluses generated from growth and exports.

Annex 1

Data and data sources

Data on the following variables is obtained from World Bank Global Development Finance 1997, Vol. 2, Country Tables, and World Bank World Debt Tables, External Finance for Developing Countries 1996, Vol. 2, and previous issues:

- Debt = Debt Outstanding and Disbursed;
- Interest Payments;
- Total Debt Service.

Data on the following variables is obtained from the International Monetary Fund International Financial Statistics Year Book 1997:

- Current Account Balance;
- Net Direct Investment = Direct Investment Abroad – Direct Investment in Reporting Economy;
- Exports of Goods;
- Exports of Services;
- Imports of Goods;
- Imports of Services;
- Reserve Assets = Increase in Reserve Assets (-).

The following variables are generated from the original data in the following fashion:

- Non-interest Current Account Deficit (+) = - Current Account Balance - Interest Payments.
- Resource Gap 1 = Non-interest Current Account Deficit (+) - Net Direct Investment = G1.
- Resource Gap 2 = Non-interest Current Account Deficit (+) - Net Direct Investment - Increase in Reserve Assets (-) = G2.
- Ratio of Resource Gap (i) to Exports of Goods and Services = G (i)/X.
- Ratio of Debt to Exports of Goods and Services (t) = Debt outstanding and Disbursed (t-1) / Exports of Goods and Services (t).
- Average Interest on Debt (t) = Interest Payments (t) / Debt Outstanding and Disbursed (t-1).

The data presented in graphs is based on 3 year moving averages and growth rates. Three-year annual growth rates are used for the calculation of Exports, Imports, and Total Debt Outstanding and Disbursed. Three-year geometric averages have been used in the calculation of Average interest on Debt. Three-year arithmetic averages have been used for the calculation of Ratio of Debt to Exports, Ratio of Resource Gap (i) to Exports. The rest of the variables in the graphs depicting the components of the resource gap appear in their simple (non-average) values. Calculated dZ2 is obtained from calculations according to equation (2) in the paper (equation (3) in Annex (2)), and based on elements in 3 years moving average and growth rate values.

Annex 2

Debt dynamics

The variation in foreign debt stock at any period of time can be expressed as follows:

$$\Delta D = i\ D + G \qquad (1)$$

Where, ΔD indicates the change in foreign debt, i indicates the average nominal interest on foreign debt, and G, the resource gap, indicates deficit when (+) or surplus when (-).

Define $Z = D/X$, then we have:

$$\Delta Z = (\Delta D.X - D.\Delta X)/X^2$$

Or also,

$$\Delta Z/Z = (\Delta D.X - D.\Delta X)(X/D)/X^2$$

$$\Delta Z/Z = (\Delta D.X.\ X/D - D.\Delta X.\ X/D)/X^2$$

$$\Delta Z/Z = (\Delta D/D - \Delta X/X) \qquad (2)$$

Substitute (1) into (2), we obtain:

$$\Delta Z/Z = (i + G/D) - \Delta X/X$$

Or also,

$$\Delta Z = (i - x).Z + G/X$$

Where $x = \Delta X/X$.

Or also,

$$\Delta Z = (i - x).Z + g \qquad (3)$$

where $g = G/X$.

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