

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

**PROCEEDINGS OF THE FOURTH INTER-REGIONAL
DEBT MANAGEMENT CONFERENCE
AND
WADMO CONFERENCE**

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Executive summary

This document is a compilation of papers reflecting the panel discussions held by debt management experts and professionals at UNCTAD's Fourth Inter-regional Debt Management and WADMO Conferences which were both held in Geneva in November 2003.

The conferences addressed recent trends in the area of debt management, and in particular aimed at highlighting the consequences that recent developments have had, and will have in the future, for individual national debt offices and for the profession of debt management.

The themes examined include debt sustainability, the development of domestic debt markets, the promotion of regional capital markets, recent developments in Paris Club debt restructuring, collective action clauses and sovereign debt restructuring mechanisms, statistics reporting, institutional arrangements for public debt management and the implications of Basel II for developing countries.

Both conferences were organized by UNCTAD's Debt Management–DMFAS Programme, with the aim of helping countries with developing and transitional economies build their capacity in debt management.

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Abbreviations

AMA	advanced measurement approach
ASEAN	Association of Southeast Asian Nations
BCBS	Basel Committee on Banking Supervision
BEAC	Bank of Central African States
BIS	Bank for International Settlements
CAC	collective action clause
CMCA	Central American Monetary Counsel
CP3	The Basel Committee on Banking Supervision's third consultative paper on the new Basel Accord (Basel II)
CS-DRMS	Commonwealth Secretariat Debt Recording and Management System
DFID	Department for International Development (UK)
DMFAS	Debt Management and Financial Analysis System (UNCTAD)
DMO	debt management office
DQRS	Data Quality Reference Sites (IMF)
DRS	Debtor Reporting System (World Bank)
DSA	debt sustainability analysis
DSBB	Dissemination Standards Bulletin Board (IMF)
FTAP	Fair Transparent Arbitration Process
GDDS	General Data Dissemination System (IMF)
GDP	gross domestic product
G7/G8/G10/G20	Group of seven/eight/ten/twenty countries
HM	Her Majesty (UK)
HIPC	heavily indebted poor country
IDA	International Development Association (World Bank)
IDS	Institute of Development Studies (Sussex, UK)
IFI	international financial institution
IMF	International Monetary Fund
IFMIS	integrated financial management information system
INTOSAI	International Organization of Supreme Audit Institutions
IPMA	International Primary Market Association
IRB approach	Internal Ratings-Based
MEFMI	Macroeconomic and Financial Management Institute of Eastern and Southern Africa
NBCA	New Basel Capital Accord
NEPAD	New Partnership for Africa's Development
NGO	Non-governmental organization
NPV	net present value
OECD	Organization for Economic Co-operation and Development
PDC	Public Debt Committee
QIS	Quantitative Impact Study
RMB	Rand Merchant Bank
SAI	Supreme Audit Institution
SDDRF	Sovereign Debt Dispute Resolution Forum
SDDS	Special Data Dissemination Standards (IMF)
SDRM	Sovereign Debt Restructuring Mechanism
SME	Small and medium-sized enterprise
UN-DESA	United Nations Department of Economic and Social Affairs
UNECA	United Nations Economic Commission for Africa

UNICEF	United Nations Children's Fund
WADB	West African Development Bank
WADMO	World Association of Debt Management Offices
WAEMU	West African Economic and Monetary Union
WAMU	West African Monetary Union
UNCTAD	United Nations Conference on Trade and Development

Opening statement

CARLOS FORTIN

Distinguished Participants, Distinguished Delegates, Colleagues, Ladies and Gentleman,

Let me first of all welcome you all to the Fourth International Debt Management Conference organized by UNCTAD. This conference will be followed by a meeting of the World Association of Debt Management Offices (WADMO) as well as by the Fourth Advisory Group meeting of UNCTAD's Debt Management-DMFAS Programme. Thus, during the whole week, debt management will be at the centre of our attention. Some 300 officials and experts from around 90 countries as well as several international institutions are gathering here in order to exchange views and participate in the debates. This is a great opportunity for all of us to contribute to finding solutions to the problems associated with debt management and UNCTAD is honoured to host these important meetings.

The Fourth Inter-regional Debt Management Conference will take stock of some of the most recent developments of interest to professional debt managers. Important topics this year include the development of domestic debt markets, the promotion of regional capital markets, new approaches to debt restructuring, the use of collective action clauses in bond issues, and the proposal for a Sovereign Debt Restructuring Mechanism. A number of statistical issues arising from the new guidelines for the compilation of debt statistics, and recent research and proposals regarding institutional arrangements for public debt management are also important items on the agenda of this conference.

Public debt management implies complex interactions between public policy and financial transactions within a strategic debt and macro-economic framework. This has implications for the choice of institutional arrangements. Sometimes the importance of reforming and upgrading public debt management is not well understood, and unfortunately it is often in the context of a debt crisis that attention is focussed on the need for institutional capacity building in this area.

In my opening statement at UNCTAD's first conference on debt management in 1997, I

stressed that it was critical for all governments to invest in a professional debt management office. The work of these offices contributes to a Government's reputation in the international financial community. Moreover, establishing a debt management office with sufficient autonomy to do its job effectively, and ensuring that appropriate information systems are in place are key elements in the design and implementation of successful debt strategies.

The challenges that debt managers face certainly differ from country to country, and vary among countries at different stages of development. These challenges require different approaches depending on the specific situation, past experience and future perspectives. In some cases, debt sustainability and restructuring is at the forefront. In others, capital market access or risk management are the major issues. Some of you are more interested in debt accounting and statistics, others in debt analysis or negotiations. But all debt managers present here today share a common endeavour, namely to manage their country's debt in the most effective way. I hope that the coming days will give you the feeling of belonging to a distinguished group of professionals sharing common concerns and ambitions.

In this spirit, UNCTAD played a prominent role in the creation of the World Association of Debt Management Offices (WADMO). The idea for such a grouping was first proposed by the Philippines in 1997 at the first Interregional Conference on Debt Management. At the time, participants agreed that there was a need for a regular exchange of experiences, know-how and information on debt management among officials from debtor countries. On Wednesday, the General Assembly of WADMO will meet again and redefine its future activities. Let me reiterate UNCTAD's support for this association and hope that it will continue to evolve further.

This gathering also aims at enhancing international cooperation, against the background of last year's International Conference on Financing for Development in Monterrey, in the follow-up of which UNCTAD is very much involved. The Monterrey Consensus now pro-

vides a framework for more coherent policies that take account of the interrelations of domestic and international finance, trade and development. It is the basis for a joint – national and international – effort to enhance capacity building in order to strengthen institutions, improve policy formulation and increase policy effectiveness.

Regarding national efforts to strengthen resource mobilization, the Monterrey Consensus includes commitments in four major areas: strengthening governance and participation; implementing sound macroeconomic policies; enhancing infrastructure, social services and social protection; and developing and strengthening the domestic financial system. Building deep and strong domestic financial markets remains a priority for developing and transition economies. The choice of appropriate domestic debt instruments, such as bonds and notes, is of crucial importance in building up these markets, along with the development of sound banking systems and other institutional arrangements aimed at addressing financing needs

On external debt, the Consensus states that "Sustainable debt financing is an important element for mobilizing resources for public and private investment. National comprehensive strategies to monitor and manage external liabilities, embedded in the domestic preconditions for debt sustainability, including sound macroeconomic policies and public resource management, are a key element in reducing national vulnerabilities. Debtors and creditors must share the responsibility for preventing and resolving unsustainable debt situations. Technical assistance for external debt management and debt tracking can play an important role and should be strengthened".

However, it has proved difficult to make the concept of "sustainable debt" fully operational, especially since the performance of the world economy has repeatedly disappointed the expectations built into the scenarios on which the assessment of a country's debt-carrying capacity are based. Even if a country's debt appears sustainable at a particular moment in time, debt sustainability in the medium and longer term depends on the kind and the intensity of economic shocks that an economy may be exposed to subsequently. It also depends on the country's capacity to respond adequately to such shocks, the quality of its debt management and

the access to financing on appropriate terms to mitigate the impact of the shocks.

UNCTAD is fully committed to helping countries build their capacity to manage debt, both domestic and external. In particular, it does this through its Debt Management–DMFAS Programme, which has provided its products and services to debt management offices in Central Banks and Ministries of Finance for more than 20 years. The programme is at the crossroads between international and domestic finance, governance and information technology. In order to help countries achieve their debt management objectives, and choose appropriate policies and ultimately strengthen their ability to respond to financial markets fluctuations, the programme offers an integrated set of solutions in the framework of its technical cooperation projects. The major activity of these projects is the implementation of a standard computerized debt management system, training and assistance in the effective use of the system and advice on various debt management issues, including the development of appropriate institutional and administrative structures. Today, the programme is collaborating with nearly 90 institutions, essentially Ministries of Finance and Central Banks, in more than 60 low and middle-income countries. These countries account for more than \$500 billion, of outstanding public and publicly guaranteed long-term debt, an amount that represents approximately 40 per cent of the total long-term debt of all developing countries. The Debt Management–DMFAS Programme also collaborates extensively with a number of international and regional organisations, in particular the World Bank, the IMF, MEFMI and Pôle-Dette.

The functioning of this programme along with its funding and future activities will be discussed at the end of the week in the DMFAS Advisory Group, and I would like to encourage you to provide your valuable input to that meeting as well.

Let me end by thanking you all for being here and wishing you a successful week of meetings and very profitable deliberations.

Thank you Mr. Chairman.

PART I

DEBT SUSTAINABILITY AND THE DEVELOPMENT OF DOMESTIC MARKETS

Domestic debt sustainability:**Summary of panel discussion**

Moderator: Dr. A. M. Maruping, Executive Director, MEFMI¹
Panellists: Mr. Greguire Laourou, Finance Minister, Benin
Mr. Anderson Caputo Silva, National Treasury, Brazil
Mr. Luis Foncerrada, University Anahuac del Sur, Mexico
Mr. Phakamani Hadebe², National Treasury, South Africa

Debt sustainability and the development of domestic debt markets

The panel concluded that sound macroeconomic and fiscal policies are a precondition for reaching debt sustainability. It also highlighted the need to go beyond traditional indicators and to view debt sustainability as a process that needs closely coordinated fiscal, monetary and debt management policies. Domestic debt markets should be developed gradually. Longer-term issues could be dealt with as investor confidence develops as a result of prudent macroeconomic management. The panel also agreed that there has to be a balance between investors' portfolio needs and the objective of governments of long-term, sustainable market development.

¹ Macroeconomic and Financial Management Institute of Eastern and Southern Africa

² Mr. Hadebe is Deputy Director General of the Asset and Liability Management Division of the National Treasury, South Africa. He was speaking on behalf of Mr. Trevor Manuel, South Africa's Minister of Finance.

Public debt sustainability and development of debt markets

A. M. MARUPING

Preamble

At the invitation of UNCTAD, through its Debt Management–DMFAS Programme, the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI)³ had the pleasure of participating and sharing experiences with other international stakeholders at UNCTAD’s Fourth Inter-Regional Debt Management Conference, and to later on attend the meetings of the World Association of Debt Management Offices (WADMO) and DMFAS Advisory Group.

MEFMI was honoured to chair and moderate at one of the key sessions at the start of the conference. The session articulated well on the topical issues of public debt sustainability and development of debt markets. These closely inter-linked topics generated fruitful deliberations on public debt sustainability and related demand-side issues, on the one hand, and the development of debt markets, which essentially addresses the supply of financing, on the other. In addition, the MEFMI delegation had an opportunity to contribute to deliberations on external debt statistics and all other topics that were discussed at the conference and two subsequent meetings. This paper briefly summarizes some of the key points to note with respect to the conference’s thematic issues of public debt sustainability and debt markets development.

Public debt sustainability

MEFMI shared its experiences during the conference’s deliberations on the thematic topics of public debt sustainability and development of debt markets. These issues, which are also central to some of MEFMI’s capacity building endeavours in Eastern and Southern Africa, are

relevant in varying degrees to all sovereign borrowers. It is therefore important to ensure that:

- Public debt is prudently managed under a conducive environment of macroeconomic stability, fiscal sustainability, low interest cost and manageable risk in the raising of funding for sovereign entities;
- Best practices are fostered through a holistic balance-sheet approach to the integrated management of sovereign assets and liabilities, including public external and domestic debt and contingent liabilities. To this end, a number of MEFMI member States (e.g. Malawi, Tanzania and Zambia and the region in general) are at different stages of instituting integrated financial management information systems (IFMIS) to consolidate the control of the various elements of public financial management, including debt related information;
- Sovereign debt management receives the necessary high-level and political support for debt sustainability to be maintained;
- There is close coordination between debt management and its objectives and other relevant policy operations, such as cash management, fiscal policy and budgeting, monetary policy operations, and related international efforts such as through the Heavily Indebted Poor Country (HIPC) Initiative and Paris Club;
- There are appropriate and dynamic legal frameworks, effective institutional arrangements and location of offices that are responsible for coordinating, managing and accounting for public debt;
- The quest for orderly international frameworks for resolving debt problems and ensuring equitable HIPC creditor participation is intensified. This is critical in view of the litigation being experienced by some HIPCs from some external creditors;
- Autonomous public debt management offices (DMOs) are ideal as they confer distinct organizational and staffing advantages and flexibilities not ordinarily open to debt

³ MEFMI is a regionally owned institute with 10 member countries: Angola, Botswana, Lesotho, Malawi, Namibia, Swaziland, United Republic of Tanzania, Uganda, Zambia and Zimbabwe. Its aim is to improve human and institutional capacities in the critical areas of macroeconomic and financial management.

management offices which are “embedded” in ministries of finance and/or central banks;

- In practice, however, most debt management offices in developing countries are still embedded within the structures of these agencies. The challenges under these circumstances are therefore to enhance coordination, information flows and staff retention, while continuing to explore the possibilities of restructuring debt functions so that they fall under single entities in the long term;
- Regardless of where the debt office is located, it is critical to ensure that, in addition to effective coordination, smooth information flows, and staff retention, there is a professional segregation of duties in the day-to-day operations into front, middle and back office functions;
- It should be emphasized that debt offices require the provision of adequate numbers of qualified, trained, experienced and motivated staff, supported by the necessary infrastructure, technology and financial resources;
- Debt management offices should also institute and document proper systems and procedures that routinely guide debt operations, preserve institutional memory and promote high professional standards for best practice.

Development of debt markets

In addressing the challenge of debt markets development, one needs to distinguish between, on the one hand, the already functional emerging markets and, on the other hand, the markets that are still in their infancy. The majority of low-income countries, many of which are also highly dependent on official external financing, fall into the latter category. For these countries, it is important to recognize that:

- Their primary markets are still new, which makes them relatively illiquid and shallow. They tend to be dominated by a few players from a weak undiversified investor base, which limits competition that is often necessary for efficiency;

- Trading is usually concentrated in a few unsophisticated instruments, under an environment of weak regulation and supervision, restrictive exchange controls, limited expertise and evolving payment systems. This scenario affects investor perceptions about safety, risk, transaction costs and thus ultimately the potential for these markets to grow;
- Fully-fledged secondary markets may still be some way from being established in many low-income economies, where the markets are concentrated mainly on the short end (short-term instruments) and the “buy-to-hold” culture holds sway. This is mainly due to weak investor confidence in longer-dated instruments.

The way forward for undeveloped markets would be to address, on a case-by-case basis, the key constraints to legal, institutional, operational, technological and capacity requirements for developing efficient and robust markets. These challenges include the need to:

- Reform legislation and strengthen supervision with a view to increasing the regulated entry of new domestic and foreign players to create a diversified investor base;
- Improve the variety of, and demand for market instruments, investment alternatives and also enhance liquidity;
- Develop a benchmark yield curve as a government’s pro-active initiative;
- Foster market confidence through measures that improve credit-rating, safety, risk, stability, macroeconomic, institutional and socio-political perceptions;
- Enhance trading, information and payments systems, depositories, risk management, and technical and technological capacities and expertise;
- Build capacity that is geared to attaining international best practice, through the provision of technical and other training, in a conducive macroeconomic policy environment;
- Raise awareness and promote leadership and initiative in the development of the markets;

- Harmonize and eventually integrate the smaller markets to enhance liquidity, market players and diversify instruments: The possibility to pool regional resources to increase the viability of the fragmented small markets needs to be actively pursued.

Conclusion

The levels of development, and types of risks and opportunities in debt markets of the different developing countries are bound to remain heterogeneous. They could be viewed as a continuum that ranges from the rudimentary markets to the truly emerging ones. A differentiated approach in addressing their needs is therefore called for on a case-by-case basis.

The long-term universal objective should, however, remain that of aspiring for well regulated and supervised domestic markets that are liquid, diversified, competitive, harmonized and, ultimately, integrated first regionally and later on internationally. This would broaden the range of choices of domestic borrowing instruments available to debt offices, alongside the traditional external financing options. In turn, the wider choice of debt instruments would enhance opportunities for designing more sustainable public debt strategies, through lowering the cost and risk for the sovereign borrowers, as an integral part of holistic and integrated public financial management.

Overview of the domestic debt of the Republic of Benin

GRÉGOIRE LAOUROU

The domestic debt of the Republic of Benin represents only 2.5 per cent of its total public debt.⁴ The portfolio has six basic components, the status of which was as follows as at 31 December 2002:

“Autonomous Amortization Fund 2000-2005” debenture loan

To finance its budget deficit for 2000, the Beninese Government decided to make use of national savings, by issuing a debenture loan to the amount of 5 billion CFA francs repayable over five years, two of which would be deferred at a rate of 8 per cent gross per year. In fact a total of 5,005,180,000 CFA francs had been raised by the closing of subscriptions.

This decision is partly explained by the Government's desire to give itself some room to manoeuvre and more flexibility to cope with falling external aid.

In 2001, 2002 and 2003, the planned interest was paid to subscribers. Repayment of the first third of the capital began in 2003.

National Investment Fund

The National Investment Fund was set up in 1973 to encourage and facilitate the reinvestment of profits from profitable non-wage activities in high-priority economic development projects.

The State took 10 per cent of the profits of firms established in Benin and only returned them after the firm had made an investment approved in advance by the Expert Commission on Investment.

However, in light of the difficulties experienced by the State in returning funds invested in this way, the Conference of the Active Forces of the Nation decided in February 1990 to abolish contributions to the National Investment Fund.

This debt to private or public/private firms amounted to 4,967,865,000 CFA francs in April 2000.

The debt was repaid by one of two methods:

- For amounts of not more than 1 million CFA francs, a flat repayment at a 50 per cent discount for full settlement;
- For amounts of over 1 million CFA francs, contributors are offered two options:
 - A flat repayment at a 50 per cent discount;
 - A 100 per cent payment by means of an issue of refundable securities, interest-free for five years.

The outstanding debt as at 31 December 2002 was 2,890,047,480 CFA francs.

Securitized non-wage arrears

These are arrears owed to certain local suppliers of the Government, and amounted initially to 479,467,006 CFA francs. This debt was repaid by means of an issue of negotiable, five-year, non-interest-bearing stock certificates. The various securities issued were paid regularly at maturity and the outstanding debt as at 31 December 2002 was 205,918,273 CFA francs.

Non-securitized non-wage arrears

There is a plan for the gradual payment of non-securitized non-wage arrears. The outstanding amount as at 31 December 2002 was 2.6 billion CFA francs.

⁴ Source: Autonomous Amortization Fund (CAA) and General Accounting Office of Benin.

Wage arrears

Wage arrears here refer to the accumulation of government employees' unpaid wages. There were strong fluctuations in these arrears between 1998 and 2002; 623,121,089 CFA francs remained outstanding as at 31 December 2002. Payments were the result of a government decision to pay off back wages as and when State administrative procedures for staff were regularized.

Consolidated liabilities of former State-owned banks that have been liquidated

The amount outstanding for this debt has been changed into refinanceable securities held in the new banks' portfolios. The interest rate is 5 per cent, with 2 per cent covered by the Central Bank of West African States (BCEAO) and 3 per cent by the State.

As at 31 December 2002, the outstanding debt amounted to 12,860,000,000 CFA francs.

In total, the amount of outstanding domestic debt as at 31 December 2002 was estimated at 24,184,266,842 CFA francs, or 2.5 per cent of public debt, which was estimated at 965,784,266,842 CFA francs.

On debt sustainability

LUIS FONCERRADA

Let me elaborate on the concept: there is a family of indicators that have been used to assess sustainability. They are based on fiscal budget constraints and debt service present values, that is, the present value of debt service compared with the present value of future primary surpluses.⁵ It has also been argued that an alternative measure, and on occasion a better indicator, could be the fiscal revenues compared with the debt service.⁶

The use of these indicators allows us to elaborate templates where we can measure and compare the variables and their critical relations through time. And, I am convinced we should make systematic use of them.

But let me underline that, as good as they can be, they are only that: indicators. And like all indicators for the future, they greatly depend on projections, and projections depend on assumptions. So that is what they are, indicators of probable solvency, of possible liquidity and also of probable vulnerability; indicators, if you want, of one of the aspects, but only one of the aspects, of sustainability.

What is “sustainability”, then? Sustainability is not just a group of indicators – and certainly it is not just a synonym for solvency. It is much more than that.

I would like to propose, and invite you to consider, a different approach. Add other elements to the indicators analysis, and by doing that improve both the concept of sustainability and its assessment.

So let me state the following: sustainability is a *process*, a series of actions and functions geared to sustain, to maintain the debt flows, the borrowing and the debt service. It is not just indicators; it is a process.

And I would like to list the five aspects that I believe are critical to this process.

1. Legal framework and institutional structure

The design, achievement and continuous improvement of a good legal framework, and of an efficient institutional structure for all functions regarding debt management. This is a fundamental condition.

2. Coordination and communication

The establishment of an institutional practice of continuous coordination and communication among the debt management unit, the fiscal area, and the monetary authorities is as essential as having the legal framework and the institutional structure. One cannot work without the other.

3. Market development

Sustaining debt is also, and probably mostly, developing and sustaining a market. The will and ability to develop domestic markets is essential to the process. The identification and application of all available methods to develop the market (i.e. use of market makers), is essential. A continuous presence and analysis to monitor the market behaviour are key elements of achieving sustained development.

4. Staff

The importance of the qualification of the staff cannot be overstated. The careful selection and continuous training of the persons in charge is the only way to assure a successful maintenance of markets and solid debt management. This aspect is probably the most critical. The staff should be able to match the borrowing re-

⁵ See for instance: Chalk N and Hemming R “Assessing Fiscal Sustainability in Theory and Practice” (April 2000); also IMF’s, “Assessing Sustainability” (28 May 2002); and the recent “Sustainability Assessments – Review of Application and Methodological Refinements” (10 June 2003); also Dinh H “Fiscal Solvency and Sustainability in Economic Management”, just to mention a few examples.

⁶ See IMF’s “The Report on Workshops on Debt Sustainability in Low Income Countries, in Paris, Berlin and Accra in May/June 2003” (July 2003)

quirements with the best risk-weighted financing, and they should certainly be able to thoroughly understand the effects of different financing options on the macro variables. It is fundamental to have attentive, thoughtful and proficient personnel. The recent experience of Mexico is a result, undoubtedly, of a skilful staff.

5. Tools

It is indispensable for the staff to be using the best available tools (technical tools and software) to achieve the best possible planning and control. The old and simple financial programming can, if systematically and thoroughly used, do a great job. That has been our experience. It will always be a powerful tool. Asset-liability management, and the recently introduced balance sheet approach can and should be used as important complements. Sensitivity analysis, done systematically, will certainly be a definite and important source of help. A good template with a good family of indicators, including that mentioned above, is essential to assess risks and to put together early warning models or systems.

Let me recapitulate: sustainability is a live process. It is a series of actions and functions that take place everyday in a well-established legal framework and a well-established, and functional, institutional structure.

Given that sustainability is a process integrated by these five aspects, the next question is:

how do we then assess it? The answer is simple: We cannot just compare present values of debt service and future fiscal surpluses that will only assess one of the several aspects of the process. Instead, in order to have a fine and reliable assessment of the real sustainability of debt, we need to assess each one of the above-mentioned aspects.

For each of these, we need to establish a few well-defined concepts and/or variables, which help us determine and assess, with the greatest possible accuracy, the process of policy decision making, as well as its steps and its performance. Thus, the monitoring of the markets, of its development, and the effectiveness of any action, can really be evaluated. The training of the team and the use of technical tools and ad hoc software, complement the assessment. Sustainability is then assessed and eventually achieved. Solvency, consequently, is the success of carefully maintaining the debt. It is the result of sustainability, the result of this process.

Fiscal policy and debt management have, at the end, as we all have experienced in our different countries, critical impacts on real wages and employment. They drastically affect the lives of human beings. Fiscal sustainability and debt sustainability are imperative, so keeping a good process and carefully assessing it are critical. The achievement of sustainability is working hard in all and every one of these aspects. The assessment allows rectification and improvement of the process.

PART II

PROMOTING REGIONAL CAPITAL MARKETS

Promoting regional capital markets:

summary of panel discussion

Moderator: Mr. Trevor de Kock, Division Manager, Treasury Department, African Development Bank

Panellists: Mr. Sergio Edeza, Treasurer of the Philippines
Mr. Jose Adrian Vargas Barrantes, Treasurer of Costa Rica
Ms. Jorge Barboza, Executive Secretary, Central American Monetary Council
Mr. Surinder Kathpalia, Managing Director, S/SE Asia, Standard & Poor's, Credit Market Services, Singapore

Promoting regional capital markets

Discussion focused on the benefits of developing regional capital markets as an alternative financing mechanism to bank borrowing and one that overcomes some of the constraints faced by developing countries when issuing debt instruments in international bond markets. The Latin American and South-East Asian initiatives were used as examples of the benefits of developing regional capital markets, as well as the difficulties faced by countries involved in such initiatives. The main benefits of regional markets identified were their higher liquidity compared to domestic markets and their greater absorptive capacity for large issues. However, the panel concurred that a number of issues still needed to be addressed, such as the need for greater transparency, the need for harmonized tax regulations, improved reporting procedures, the development of new instruments, and the creation of mechanisms for enforcing creditor rights.

Promoting regional capital markets in Africa

TREVOR DE KOCK

Firstly I would like to welcome you to this session, commonly known as the “graveyard” session, just after lunch. I am sure, however, that the panellists have interesting experiences that will keep you all from succumbing to the forces of nature!

We have a distinguished list of panellists with us today. But, before we get to the panellists, I would like to say a few words from the experiences, though limited, in Africa on regional capital markets.

I need not elaborate on the fact that Africa faces daunting economic challenges. We have debt markets covering the full spectrum of development from many small and undeveloped economies to the much larger and more sophisticated South African market where most instruments available in the developed economies can be traded (South Africa has some US\$ 55 billion in outstanding debt with Botswana and Namibia immeasurably lower). We have countries with very low debt burdens like Botswana at some 10-15 per cent of GDP but also those with high debt burdens like Zambia (> 200 per cent of GDP). The most appropriate way of moving forward in this environment may best be achieved by regional capital markets and pooled market infrastructure, in large part to minimize the costs associated with small local markets. We can use the analogy of a national airline, which I recall has been used in the past in this context. Is it a national imperative to have your own market (airline) and start from scratch? Could the objective of issuing your paper be equally achieved by using a more developed market in the region and so issue your own bonds and money market paper into that market or can a dual listing work? They may be a start.

In that context, the Swaziland Posts and Telecommunications Corporation recently created a domestic Medium Term Notes (MTN) programme that has also been listed on the Bond Exchange of South Africa, despite differences in settlement regimes, South Africa has T+3 electronic net settlement while Swaziland has physical settlement. The point is that the processes

can be modified to make things work. Mr. Tom Lawless, Chief Executive Officer of the Bond Exchange of South Africa makes the following two recommendations: Look and learn from others around you and do not be afraid to ask for help – you cannot live long enough to make all the same mistakes as others have, again!

Africa is also able to boast a truly regional market. Almost 30 years ago to the day (14 November 1973), the West African Monetary Union (WAMU) was established through the foresight of the member states seeing the need to create a common financial area to consolidate the foundations for regional integration. WAMU consists of eight countries (Benin, Burkina Faso, Côte d’Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo).

The regional financial market of the West African Economic and Monetary Union (WAEMU) was created in 1996. This region has succeeded in creating the critical mass of market demand and supply, the absence of which is very common among the smaller economies in developing countries. Needless to say that the single currency of the Union, the CFA franc, was a key factor in creating this critical mass. The pegging of the regional currency to the French Franc and now, of course, to the Euro has helped to keep inflationary pressures under control, which has also aided the development of the bond market.

Although still at an early stage of its development, the bond market in the WAMU region has shown relatively rapid growth since the commencement of the regional stock exchange in 1998. The rationale for pursuing a regional approach was the decision to widen the investors and potential issuers’ base, a step that would result in guaranteeing increased liquidity in the market, the need to reduce the cost of transactions through economies of scale and reduce the training period of market operators. Such an approach would also enable the regional stock exchange to become visible on the international capital market, a possibility that may be denied to any national project.

The issuers that have tapped this regional market have comprised state governments, a regional development bank, financial institutions and non-financial institutions, generally in equal proportions. However, not all the governments of the eight member states have tapped the market, Côte d'Ivoire, Benin and Burkina Faso having been the major state issuers. One of the problems associated with the regional model is who to regard as the benchmark issuer. In the national model, the government is clearly the most likely candidate for creating a benchmark yield curve, but in the regional model there are eight governments; which one does one choose! In the case of WAEMU, the West African Development Bank (WADB) or BOAD⁷ to use its French acronym, is the oldest and largest bond issuer and many market participants regard its bonds as being the (proxy) benchmark.

The last point I want to make is that under the New Partnership for Africa's Development (NEPAD) framework, developing domestic financial and regional capital markets and improving regulation is one of the collective priorities over the next few years to promote capital flows that will assist in the development of local financial markets. Indeed the Financial Markets Initiative of NEPAD sets out an ambitious agenda for market development, including:

- Strengthening domestic markets, through establishing sound regulatory frameworks and legislation, strengthening national banking regulation and supervision, implementing modern payments systems, strengthening and development of bond markets; simultaneously with; and

- Harmonising regional markets, through legislative and regulatory harmonisation, sharing of market infrastructure, and movement towards capital control liberalisation; both leading to a movement toward the free flow of capital in the region.

I want to end with a quotation from a recent workshop on capital markets development hosted by the United Nations Economic Commission for Africa (UN-ECA) and Rand Merchant Bank (RMD) in Johannesburg from 27 – 29 October 2003. The Chairman of RMB, Mr. Paul Harris stated: “The African Renaissance being promoted by President Thabo Mbeki and other African leaders will not happen unless the continent develops its soft infrastructure – that is, sound, well-regulated financial markets. Hard infrastructure such as roads, buildings and telecommunications are the easy part, soft infrastructure is much harder to put in place. It involves the creation of a sound legal and regulatory framework free from political interference – one in which investors can have confidence and contracts can be enforced.”

With this brief background, let's hear from the panellists.

⁷ La Banque Ouest Africaine de Développement

Programme to harmonize the public debt markets of Central America, Panama and the Dominican Republic

JORGE BARBOZA

Introduction

The domestic markets of the countries in the Central American region⁸ are very small, so that it is difficult to develop efficient domestic public debt markets in each of them. However, as the outside world sees the region as a single trading and financial area and as the current securitized domestic debt of the seven countries is estimated at \$17 billion (including central government and central bank debt), there is an adequate practical basis for creating a successful regional public debt market. An additional factor is the consolidation of the regional financial system as a result of the expansion of the main domestic banking organizations throughout the region through such means as bank mergers, the acquisition of established banks and strategic alliances. This process is expected to proceed apace in the near future.

In this context, the programme to harmonize the public debt markets of Central America, Panama and the Dominican Republic, which is being implemented by the executive secretariat of the Central American Monetary Council⁹ together with the central banks, finance ministries and securities market regulators, aims to develop domestic markets for securitized public debt as a step towards the creation of a regional public debt market that would offer issuers and investors greater competition and liquidity, as well as a large volume of securities.

Basic features of the proposed market model

The organization of the public debt markets promoted by this programme is based on a strategy of joint action to develop the market by the public sector and the private sector, with the former taking the lead. It is based on the following six basic principles:

a) Development and deepening of the domestic public debt market in the local currency, in order to minimize exchange risk and reduce financing costs. Some countries in the region are currently giving priority to the euro-market¹⁰, which entails higher issuance costs. The premise underlying this approach is that the development of the national and regional market is very important, as the international market is not always an option, especially when a country's economic situation deteriorates, and the costs of access to it are usually higher.

b) Implementation of a programme for regular, scheduled public debt issues, in order to ensure there is a sufficient volume of securities for various maturity terms. This is fundamental to reaching a critical mass of fungible securities that generate maximum market liquidity, which will require the treasuries in some countries in the region to modify their current practice of making placements in keeping with their cash needs or of tailoring issuances for public institutions or special government programmes such as those providing some kind of special support for the agricultural sector or for housing or other typical programmes;

c) Separation of the wholesale and retail markets. The organization and development of the secondary public debt market requires a clear conceptual distinction to be made between the wholesale segment and the retail segment. The model relies basically on the development of the wholesale segment, which is run by large financial intermediaries - mostly banks, institutional investors and adequately capitalized brokerage firms. In this market, financial intermediaries trade securities in order to adjust the inventories in their own portfolios or on behalf of large clients and investment or pension funds. Allocations to small investors are made "naturally" through the wholesale intermediaries. In this way, small investors benefit more in terms

⁸ Comprising Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua and Panama.

⁹ Web site: www.secmca.org.

¹⁰ The five countries' sovereign debt placed on the euro-markets currently totals US\$ 10.5 billion, with an average weighted nominal financial cost of 8.61 per cent.

of price transparency and the liquidity of their investment;

d) Implementation of a monetary policy that supports the management of the liquidity of the financial system. In this respect, coverage and the method used for measuring compliance with the policy on bank reserve requirements should support liquidity management, by allowing a large part to be used for transactional purposes (securities payments or bank transfers). In addition, where there are Lombard facilities for injecting liquidity, these facilities should be available at a single price, not at staggered rates that might distort the market;

e) Development of an efficient and secure infrastructure. Systems for the liquidation of securities and payment systems should conform to the relevant international principles;

f) The regional market as the ultimate objective. The countries in the region will derive more benefits if their domestic public debt markets are organized and run with a view to setting up a regional public debt market rather than being limited to the domestic level. An expanded market would have a bigger capacity and would undoubtedly be more attractive for national and international savers.

Expected benefits of the programme

The programme is expected to bring four main benefits:

a) It will leave the region less vulnerable to external shocks: by deepening the securities markets and promoting the establishment of a regional capital market, it will leave the region less vulnerable to external financial shocks and thus more attractive to international investors;

b) It will reduce issue costs: it will create the conditions in which the cost of servicing the public debt can be minimized while at the same time guaranteeing stability in financing it;

c) It will make monetary policy more effective: it will generate a liquid secondary market so that central banks can properly perform their task of implementing monetary policy by means of market instruments; and

d) It will help stabilize the financial system: by creating the markets and infrastructure

necessary for financial entities to use market instruments to manage liquidity efficiently, it will help make the system more stable as liquidity risk will be reduced.

Components of the first phase of the programme

The first phase of the programme, from April 2001 to May 2003, benefited from the technical cooperation of the Multilateral Investment Fund of the Inter-American Development Bank, and consisted of three components: (1) the definition of standards for the organization of public debt markets; (2) the organization of workshops to provide guidance and technical training; and (3) the introduction of a regional information system and development of a web site.

Regional standards

As a result of the training workshops referred to in the next section, a set of regional standards was drawn up to harmonize public debt markets. Domestic markets are being designed for each country and the regional mechanism will be built in accordance with these standards, which are grouped in the following eight broad areas:

a) Organization of the primary market. In this area, the following are defined: issuance policies, under which placement must be carried out by competitive bidding under a regular, scheduled issue programme to which only capitalized intermediaries have access; the treatment of placements by public bodies; the characteristics of securities; their issue by tranche; and a policy for progressively extending maturity terms, gradually building up a critical mass for each of them;

b) Management of State liabilities. Guidelines are provided on the organization of institutions managing debt; the necessary coordination between central banks and finance ministries; the advisability of gradually substituting securitized debt (eurobonds) for domestic securitized debt and of converting special debt into standardized debt;

c) Organization of liquidity markets and monetary policy. It is proposed to separate placements corresponding to quasi-fiscal debt

from those used for monetary regulation, in an attempt to extend the maturity terms of the former; to give priority to banks as counterparts of central bank operations; to set out the conditions for promoting the organization of liquidity markets of a wholesale type; and to use public debt as an instrument of monetary policy;

d) Organization of integrated domestic secondary wholesale markets. Guidance is given on how to organize these markets under the leadership of the public sector and the concept of market creators is introduced as a prerequisite for deepening markets and generating benchmark prices for securities;

e) Infrastructure. A series of principles to be followed in building efficient and secure systems for the compensation and liquidation of securities and payments systems is established, including: compliance with rules of access and the neutrality of government bodies; immobilization or irreversible dematerialization; registration of securities in balance form; use of ISIN¹¹ codes; use of delivery versus payment (DVP); and bilateral gross liquidation in wholesale markets, and multilateral net liquidation in retail markets;

f) Conventions for calculating public debt. Standards are established for such calculations to ensure that prices and yields in the countries of the region can be compared with each other. Basically, international conventions for calculating such indicators are followed;

g) Regulation of collective investment and secondary public debt markets. Standards for investment funds and other regulatory norms are introduced for participants in secondary public debt markets;

h) General strategy for the development of a regional wholesale public debt market. Account is taken of the manner in which the regional market is to be realized - it will basically be the result of the natural integration of domestic markets developed in accordance with regional standards.

An analysis and action plan relating to these standards was drawn up for each participating country, describing the action that needs to be taken in order to adopt them. Such action

is divided into four phases, which are expected to be implemented in the period 2003-2006. In order to monitor implementation of the action plans and address additional issues that would help in the organization and harmonization of the regional public debt market, the Technical Committee on Regional Standards was set up, and meets two or three times a year.

Guidance and technical training

The project also envisages a major effort to train officials from participating institutions, namely, central banks, finance ministries and securities market watchdogs from the countries in the region, in various aspects of the organization of public debt markets. For this purpose, eight three-day workshops were held on the following specific themes:

- Primary public debt market (El Salvador, October 2001);
- Secondary public debt market (Honduras, November 2001);
- Conventions for calculating public debt (Costa Rica, May 2002);
- Monetary policy and payment systems (Guatemala, July 2002);
- Bookkeeping, compensation and liquidation of securities (Panama, October 2002);
- Public debt management, quasi-fiscal debt and its implications for monetary and fiscal policy and secondary markets (Dominican Republic, December 2002);
- Practical approach to the organization of primary, wholesale public debt markets and liquidity markets and integrated management of State liabilities (Managua, Nicaragua, February 2003);
- Regulation of securities markets, public debt and liquidity management: collective investment, intermediaries and secondary markets (Costa Rica, March 2003).

It is worth pointing out that the eight workshops were attended by over 200 mid-level and senior officials from the institutions concerned, with an average of 46 participants per workshop. Moreover, 83 per cent of the participants attended three workshops and 52 per cent

¹¹ International Securities Identification Number.

four workshops, which is a very satisfactory turnout.

Information system and web site

Finally, it was planned to establish a public debt information system based on a web site that would be designed and set up to collect all the information available on the public debt of the countries in the region so that it can easily be consulted by any national or international investor. When the system becomes operational, hopefully by the beginning of next year, the system will give access to the following information on participating countries:

- Characteristics of instruments (ISIN code, maturity, currency, coupon, type of settlement, tax regime and legal basis);
- Issuers, i.e. the central bank or finance ministry, instruments, currencies and maturities;
- Ratings of the countries and/or issues, provided by the Fitch, Moody's and Standard & Poor's rating agencies, with a recent history;
- Characteristics of auctions (type, award mechanisms, periodicity, minimum investment, form of liquidation, bidders or authorized agents, etc.); timetables; results; and dates of upcoming auctions, with direct links to issuers;
- Equivalent prices and yields by maturity term and instrument;
- Balance of total internal and external public debt and servicing costs, both in relation to GDP;
- Secondary market operations;
- Links to the Central American Monetary Council web site, where monthly and annual economic reports on the countries can be found, as well as links to central banks, finance ministries, securities market

watchdogs and stock exchanges, where more detailed information can be found;

- Daily economic news updates; information on relevant documents and events.

It should be pointed out that as progress is made towards debt standardization, it will be possible to compare prices and yields for the various instruments.

Second phase of the programme

A month after the non-reimbursable technical cooperation of the Inter-American Development Bank came to an end in May 2003, the programme entered a new phase in which countries began to implement their respective action plans, while training continued to be provided in national workshops and the public debt information system was refined. This second phase is expected to be completed by the end of 2006, and technical cooperation will be provided by the Office of Technical Assistance of the United States Treasury and the Central American Bank for Economic Integration.

Final thoughts

There is growing conviction that the implementation of this programme will bring ample benefits to the countries in the region, in terms of lowering the cost of public debt, developing a deep secondary public debt market and creating an infrastructure for compensation and the liquidation of securities and for a more efficient, secure and transparent payment system. The programme is also seen as an important step towards the gradual formation of a Central American capital market and as a way of attracting greater external savings, given the possibility of building up portfolios of public and private securities in the different countries in the region. This has been recognized by the Governments of the countries involved, which are giving their full support to this initiative, as reflected in the implementation of their respective action plans.

PART III

RECENT DEVELOPMENTS IN PARIS CLUB DEBT RESTRUCTURING

Recent developments in Paris Club debt restructuring:

Summary of panel discussion

Moderator: Barry Herman, United Nations Department of Economic and Social Affairs (UN-DESA)

Panellists: Mr. Emmanuel Moulin, Secretary General, Paris Club
Mr. Paul E. Habeshaw, HM Treasury, United Kingdom
Mr. Bjorn Brede Hansen, Royal Norwegian Ministry of Foreign Affairs

Recent developments in Paris Club debt restructuring

The panel concluded that the Evian approach, put forward by the G-8 and the Paris Club creditors, represents a promising innovation in debt restructuring. The main innovations are its explicit focus on debt sustainability (i.e. long-term solvency rather than short-term liquidity problems) and the possibility of debt reduction for low- and middle-income countries, which previously occurred only on an ad hoc basis. The Evian approach is driven by the demise of the Sovereign Debt Restructuring Mechanism (SDRM) proposed by the International Monetary Fund (IMF), the growing importance of private creditors in emerging-market lending, and progress by the IMF and the World Bank in developing tools for analysing sustainability. The panel stressed that the Evian approach, applicable to all non-HIPC countries, does not introduce any new terms but rather introduces a new case-by-case flexibility that enables debt sustainability through a number of channels including write-offs, extended use of debt swaps, and changes to the cut-off date. Several concerns were raised, including some related to the IMF's role as the ultimate judge of sustainability, the continuing link between the Paris Club and IMF conditionality, the difficulties in establishing a clear methodology for changing the cut-off date, burden-sharing among creditors of the Paris Club, and the participation of non-Paris Club creditors

The Paris Club and the Monterrey Consensus

BARRY HERMAN

It is fitting to introduce a discussion of policy reforms in the Paris Club by setting it in the context of the “Monterrey Consensus”, which was adopted by the Heads of State, Ministers and other Senior Officials present at the International Conference on Financing for Development in Monterrey, Mexico in March 2002.¹² The Monterrey conference was a special moment in the evolution of global oversight of the international monetary, financial and trading system in that it brought together for the first time governments of developed and developing countries and the key institutional stakeholders at leadership levels, as well as business leaders from different parts of the world and advocates from non-governmental organizations concerned about the global economic system and development. It was also a special moment in that by adopting the Monterrey Consensus, the world’s governments set certain international reform processes in motion and gave a political impulse to many others. While it would be wrong to say that the recent Paris Club reforms originated in Monterrey, the international community committed itself there to a deeper review of the way it handles debt crises and I think one can fairly say that the new Paris Club reforms are one outcome of that review.

The governments, international institutions, private creditors and civil society advocates that gathered in Monterrey did not see external debt only as a problem. Quite the contrary, the Monterrey Consensus argued that properly managed foreign borrowing should be “an important element for mobilizing resources for public and private investment” (para. 47). Indeed, the Consensus called for strengthening technical cooperation to aid countries in their debt management and debt tracking capabilities. The Debt Management–DMFAS programme, in which many of the countries at this conference participate, is a prime example of such cooperation.

The Consensus went further, however, in saying that “debtors and creditors must share the

responsibility for preventing and resolving unsustainable debt situations” (para. 47). This requires, in turn, that all relevant information on the debt and its servicing obligations should not only be collected by the debtor authorities, but also be made publicly available on a timely basis. One could even argue that it would be desirable for a debtor and its domestic and foreign creditors to be in virtually “continuous conversation” on matters related to the management of its debt, which can be arranged at modest cost these days through the Internet.¹³

Unfortunately, the volatility inherent in the international financial and trading system is such that even countries with strong domestic policies and good government/creditor relations can and do slip into debt crises and require international assistance, including debt relief, to emerge from them. As the Paris Club is the central forum for restructuring debt owed to government creditors, it can look forward to having much work to do in future years.

The effort to reform the Paris Club is thus very important to the global financial system. This is especially the case, as I believe it is no exaggeration to say that no one loves the Paris Club except its own member governments. The Club has been attacked by organizations representing private creditors, as well as by social critics. The private creditors say the Club has been far from transparent in how it operates and has been unfair in that it gives proportionately less relief on obligations to its own member governments than the international community expects of private foreign creditors. In particular, until the advent of the most recent reforms, a basic principle of the Club in addressing the

¹² See United Nations, *Report of the International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002* (A/CONF.198/11), Chapter I, Resolution 1, Annex.

¹³ See Barry Herman, “Mechanisms for dialogue and debt-crisis workout that can strengthen sovereign lending to developing countries,” in Ariel Buirra, (ed.), *Challenges to the World Bank and IMF: Developing Country Perspectives* (London: Anthem Press, 2003), pp. 203-226. For a practical approach, a prototype of which can be found at www.globalclearinghouse.org, see Barbara Samuels, II, “Strengthening information and analysis in the global financial system: a concrete set of proposals,” United Nations Department of Economic and Social Affairs, Discussion Paper No. 23 (June 2002).

situation of debt-distressed middle-income countries was that it would only agree to capitalize and reschedule repayment owed to governments, whereas private creditors would have to swap their non-performing loans or bonds for new claims with a lower face value or that paid less interest. The mood in the private financial markets only a few years ago was well captured by the editorial in the September 2000 issue of *Institutional Investor* magazine, which was titled, "Paris Club: reform or die."¹⁴

The Paris Club has also been criticized regularly by non-governmental observers, both because of its closed deliberations on the amount of debtor country relief it would agree to accord in any specific case and the requirement that the governments of debt-crisis countries repeatedly return to the Paris Club for further rescheduling of debt service as it falls due. The reason for giving only partial and temporary relief of debt servicing obligations has been to keep the debtor country in crisis "on a short leash" so as to maintain pressure on the government to implement its IMF and World Bank adjustment programmes. This requires almost annual visits to the Paris Club, each followed by a sequence of bilateral negotiations with each creditor in the Club to implement the "agreed minute". Also, while the Paris Club has generally followed pre-set guidelines on the relief it gives to the debt-servicing obligations of different groupings of countries, it departed from those guidelines in politically important cases, notably those of Poland and Egypt in 1991 and the Federal Republic of Yugoslavia in 2001.

Viewing this from the ground inside debtor countries in crisis, the non-governmental organizations that operate local development projects became profoundly frustrated at the huge gap they witnessed between the professed international official concern to reduce poverty in the world and the actual policies that the international community promoted in poor countries. This disappointment was effectively mobilized in what became the anti-debt Jubilee 2000 Campaign and that led the Group of Seven to sponsor the Heavily Indebted Poor Countries (HIPC) Initiative in 1996, to then enhance it in 1999,

and to meet the pledge to qualify 20 countries for HIPC relief (reach the "decision point") by the end of the Millennium Year. Also, while the Paris Club treatment of HIPC debt went through a series of iterations that slowly acknowledged the depth of the insolvency of HIPCs, little was done for non-HIPCs. Certain of the latter countries are as insolvent as HIPCs, if not so poor in terms of average per capita income. Indeed, the current Paris Club reforms aim to address precisely the needs of insolvent non-HIPCs, as the presentations by the speakers to follow will explain.

Before beginning that discussion, it may be useful to recall what the Monterrey Consensus concluded about overall reform of the international debt-restructuring process. Noting, first of all, "the importance of re-establishing financial viability for those developing countries facing unsustainable debt burdens," the governments at Monterrey welcomed the initiatives that had already been undertaken to reduce outstanding indebtedness and invited further national and international measures in that regard, including, as appropriate, debt cancellation and other arrangements (para. 48). The Consensus went on to comment upon and recommend ways to further strengthen the HIPC Initiative (para. 49), and stressed the broader need of the International Monetary Fund (IMF) and World Bank in making policy recommendations, including on debt relief, to respond to "fundamental changes in countries' debt sustainability caused by natural catastrophes, severe terms of trade shocks or conflict" (para. 50).

The Consensus then addressed the directions in which further reform of the international machinery for debt restructuring might go:

"While recognizing that a flexible mix of instruments is needed to respond appropriately to countries' different economic circumstances and capacities, we emphasize the importance of putting in place a set of clear principles for the management and resolution of financial crises that provide for fair burden-sharing between public and private sectors and between debtors, creditors and investors... We also encourage exploring innovative mechanisms to comprehensively address debt problems of developing countries, including middle-income countries and countries with economies in transition (para. 51)."

¹⁴ See also a feature article in that issue of the magazine by Brian Caplen, "Paris Club comes under attack" and the Policy Paper of EMTA (Trade Association for the Emerging Markets), "Burden-sharing in 2001: Now is the time to reform the Paris Club," 13 February 2001 (on the Internet at www.emta.org).

A few months before the Monterrey Conference, the First Deputy Managing Director of the IMF, Ms. Anne Krueger, proposed one such innovation, the “Sovereign Debt Restructuring Mechanism” (SDRM), and that proposal became a focus of international discussion in 2002 and early 2003. The staff of the Fund developed and modified the proposal in a series of iterations following consultations with private creditors, legal experts, NGOs and governments, including in a public panel discussion on the margins of the Monterrey Conference itself. While the proposal did not win sufficient support to move to the stage of enactment, it was the first important effort to squarely address two central shortcomings in the way external debt crises of governments are handled by the international community.

The first and most important shortcoming was that there had been no clear means to ensure that when the debt restructuring negotiations with each group of eligible creditors was completed, the total relief would be enough to place the debtor country in a sustainable debt situation. The second key shortcoming was that there was no formal mechanism to ensure comparable and appropriate sacrifices by each class of creditors (or to define comparability and appropriateness). In short, the IMF Staff offered the SDRM proposal as a mechanism that would deliver a debt restructuring that was adequate and fair to all relevant parties (although critics did not believe it would actually do so).

The key feature in the SDRM that aimed to address comparability and appropriateness of

overall relief was the proposal to cluster a debt-crisis government’s creditors into different classes (bondholders, banks, etc.), facilitate negotiations of each class of creditors with the sovereign, and through a creditors joint committee see that the final set of agreements met the adequacy and fairness criteria. The IMF was ambivalent about whether official government-to-government debt would constitute one of the classes of creditors and in the final version of the proposal that question was left unresolved.

Had the SDRM been adopted and official creditors included, the Paris Club would have become moot. It would have, in effect, been subsumed in the SDRM, although the Club itself might have continued to meet to discuss strategies to apply in the negotiations that their creditor class would undertake in the SDRM. Not surprisingly, Paris Club members preferred to keep restructuring of bilateral official debt outside the SDRM. Their representatives went so far as to argue at meetings on the SDRM organized by IMF that the Club functioned satisfactorily and that no new international debt workout mechanism was needed, certainly none that would treat bilateral official debt.

Nevertheless, soon after the SDRM was taken off the international negotiation table in April 2003, the finance ministers of the G8 turned their attention precisely to reforming the Paris Club.¹⁵ It was their proposed changes that were adopted in October 2003 and it is to these changes that our panellists today will now direct their attention.

¹⁵ See Group of 8, “Finance Ministers’ Statement,” Deauville, France, 17 May 2003, Annex (www.g7.utoronto.ca/finance/fm030517_communique.htm).

Remarks on the “Evian Approach”

PAUL E. HABESHAW

I would like to thank the organisers of this conference for their kind invitation, and Mr Herman for his introduction. Although the earlier agenda listed this slot as one for a “Representative of the G7”, I would like to make clear that I speak solely for the United Kingdom.

Context of “Evian”

I would like to start by making three observations about the context of the “Evian Approach”. First, I think there has been a growing divergence between the Paris Club practices and developments in financial markets. The growth of the private sector in the provision of finance to developing countries, in particular through the bond markets, poses challenges to the way the Paris Club goes about its business.

Second, we have seen advances in the methodological tools available to us. The IMF and World Bank have done considerable work on Debt Sustainability Analyses, and work continues to refine the methodology. The UK is fully supportive of this work and believes it enables official creditors to tackle debt sustainability concerns in a more systematic way.

Third, I believe the “Evian Approach” should be viewed as one element of the broader crisis resolution agenda alongside: the growth of collective action clauses; a possible Code of Conduct for issuers and lenders; and the work programme being pursued by the IMF following the lack of consensus over a possible Sovereign Debt Restructuring Mechanism.

The view of the UK on what “Evian” means

Moving from the context, I would just like to touch on what the UK wants out of reform and what we think “Evian” means. The overriding aims of reforms to sovereign debt restructuring processes should be:

- To facilitate comprehensive restructurings that result in debt sustainability;

- To ensure restructuring minimises intra-creditor and debtor-creditor coordination problems; and
- To ensure we have a more predictable system and so increase the efficiency of sovereign debt restructurings.

So how does “Evian” relate to our objectives? **Sustainability** is at the heart of “Evian”. It’s about taking a long-term perspective to deal comprehensively with a problem, rather than standardised reactions to immediate financing problems. The concept of **phased** treatments reinforces this long-term approach.

“Evian” is also about **flexibility** within the Paris Club. The approach argues that we should tailor Paris Club debt treatments to the specific financial situation faced by the debtor. This new flexibility and the commitment to better consultations with the private sector hold out the promise of better coordination between all parties.

I believe the “Evian Approach” requires the Paris Club to be more **systematic** in how we address long-term debt sustainability problems. Moving away from standard terms may reduce the predictability of terms, but “Evian” ensures our objective of sustainability is predictable.

The UK's view of the key challenges

Of the key challenges the UK expects as we implement “Evian”, I’d like to highlight three. First, the Paris Club needs to use Debt Sustainability Analyses (DSAs) to inform decision-making. This is as much art as science. We need to build on the DSA’s assessment of debt dynamics in such a way that we can come to a reasonable estimate of levels of debt sustainability for individual countries. The methodology of how we go about this is still under development but, even though our final objective is clear, I have no doubt it will be difficult and contentious.

The second issue is coordination with the private sector. The Paris Club agrees that better coordination is needed but we are still trying to

identify practical options for modalities. There are a number of concerns including ensuring that consultation adds value, that the interested parties are able to have their voices heard, and that, if appropriate, confidentiality can be respected. I do not think there is an obvious solution so we need to think this through carefully.

Third, and linked to the two issues I've just mentioned, is transparency. "Evian" clarifies the Paris Club's objective – debt sustainability. But stakeholders need to have confidence that the Paris Club will act reasonably and consistently in pursuit of that objective. While issues of confidentiality will arise at various junctures, the UK believes that there should be a presumption in favour of transparency wherever possible.

Conclusion

So, in conclusion, I would like to finish by repeating that the UK strongly welcomes the "Evian Approach". We believe "Evian" enables the Paris Club to put **debt sustainability** at the heart of its deliberations. It is a **flexible** approach that allows treatments to be tailored to financial need. And it increases predictability by encouraging creditors to be **systematic** in addressing debt sustainability issues.

Thank you for your patience and kind attention.

The Evian approach – Talking points

BJØRN BREDE HANSEN

What it is and what it isn't

- The Evian approach applies to all non-HIPC and middle-income countries, to the extent that they qualify for debt rescheduling (they must have an IMF programme in place), and whether they receive reduction or only flow relief.
- The question is not whether a country would obtain “Evian treatment” or not; all non-HIPC countries are “Evian cases” to the extent that they request a debt rescheduling.
- The question is whether they would obtain traditional treatment (rescheduling, filling of short-to-medium term financing gaps by way of postponed payments) or “comprehensive treatment”. That is, a phased, multi-year treatment with initial flow relief, perhaps followed by debt reduction in the event that the debt is deemed clearly unsustainable, provided the country in question is “on track” with its economic reform programs.
- Very importantly, the Evian approach does not mean the introduction of new *terms*. It is a new, flexible framework for action, no more and no less.

What's new?

- The key novelty is that **long-term debt sustainability** shall also be the guiding principle for debt relief for middle-income countries, as has long been the case for the poorest countries (the HIPC countries). In preference to merely filling short-term financing gaps.
- Comprehensive debt sustainability analyses (DSAs) may or may not lead to the granting of debt reduction.
- Debt reduction as such is not entirely new to middle-income countries. Countries like Egypt, Poland and ex-Yugoslavia have obtained notable debt reduction. However, this has been so on a purely *ad hoc* basis,

perhaps driven as much by geopolitical concerns as those over debt sustainability. What is new is that the option of debt reduction for middle-income countries has been explicitly formulated; put down on paper and broadcast on the internet (see Paris Club website www.clubdeparis.org). It is very much part of the public domain.

- Although many debt-rescheduling agreements have been divided into phases, the option of a phased, multi-year approach is also new.
- More active policy on updating cut-off dates. The Paris Club has rescheduled post-cut-off date debts when this has been necessary to produce credible debt relief agreements. Still, there is reason to expect more activism in this field in the future. In my opinion, it is totally out of place to have 20-year old cut-off dates; then the risk of moral hazard is more on the creditor than on the debtor side of the equation. This change is long overdue.
- More coordination with private sector creditors. This is not new and started long before Evian, but will probably be strengthened through pre-negotiation (*ex ante*) consultations.

What will basically remain the same?

- The *ad hoc*, case-by-case, approach. It is a very flexible approach. Again, the Evian approach should not be confused with new terms. There are no new terms, just options, and perhaps added flexibility (for creditors).
- The strong link to IMF conditionality will remain intact. (If anything, the phased approach may in fact lead to even stronger linkages between debt relief and program implementation over time).
- The IMF will not become a judge regarding debt sustainability. The conclusion as to whether or not a debt is to be considered unsustainable will ultimately rest with the

creditor countries, although the analyses will be conducted by the IMF.

- Debt reduction will only be given in exceptional cases (as today). What will be seen as constituting “exceptionality” may change, but this remains to be seen.
- No fixed criteria or indicators for unsustainable debt. The Evian approach is not a HIPC initiative for middle-income countries (it is not a “HIMC”)!

Potential problems/challenges in implementation

- Defining un-sustainability in the absence of fixed indicators. (*When does a debt become unsustainable?*) No debt/export-ratio; no debt service/exports-ratio (as in HIPCs). I am not advocating the introduction of fixed criteria for which I do not think there is any support among creditors. Nevertheless this is a problem.
- Tension between “unsustainable debt” and “only exceptional cases”? This may leave room for different interpretations, coloured by nuances in creditor positions.
- How, in concrete terms, will cut-off dates be updated? (On a purely *ad hoc* basis?) This remains to be seen. There are a lot of hidden, and not so hidden, agendas among creditors. I am a bit worried as to how this issue will be resolved.
- Phased approach: Paris Club creditors should be careful not to make things overly complicated.
- Coordination with the private sector. Implementation of comparability of treatment. Always a challenge, this will be no less so with the Evian approach.

Norway’s position

- Norway has strongly and actively supported the Evian approach (and more vocally than many other G8 countries).
- In cases where debt burdens are deemed clearly unsustainable, we should not fool ourselves into thinking that we could somehow get by with flow treatments (“*you just can’t kill a virus with penicillin*”).

We have seen too many examples of repetitive treatments of the same debtor countries, coming back to the Paris Club six or seven or even more, times. Evian terms are an antidote to “Houston addiction”.

- In unsustainable cases, debt reduction would be an appropriate policy response, provided the countries in question are fully and continuously committed to economic reform and poverty reduction. Debt reduction should clearly be linked to a “track record”.
- No need for fixed criteria/indicators, but will not rule out “less than mechanistic markers” some time in the future, based on experience.
- It should be kept in mind that cut-off dates are meant to preserve and protect the creditworthiness of debtor countries (and the claims of creditors). Therefore, very aggressive updating may not necessarily be in their interest. There is a need to find a sensible balance – a middle ground.
- We are happy with the option of using flexible instruments, such as debt swaps, as part of a comprehensive treatment (not only as a supplement). That is; we have serious problems with traditional, bilateral swaps, which we think are plagued with severe inefficiencies. Instead, we have floated ideas on what we call “multilaterally coordinated debt-for-development swaps” (collective swaps).

Conclusions

- Through the Evian approach, the Paris Club has lifted a taboo, in its explicitly naming debt reduction as an option for middle-income countries with unsustainable debt.
- Clearly, this is a contribution to more orderly, timely and predictable economic crisis resolution.
- It should be recalled, though, that the aim of the Evian approach is primarily to expand policy options; it will not represent the opening of a Pandora’s box of indiscriminate, across-the-board debt reduction for middle-income countries. To the extent

that there are inflated expectations out there, I think it important that these be adjusted.

- It is not a giant leap, but it is an important and significant step forward.
- It is not a fixed prescription, not a final recipe.

- It is very much a work in progress
- There will be a lot of learning by doing.

Recommendation: read both the press release and the Paris Club's working paper, also published on www.clubdeparis.org – a very wise move by the secretariat, strongly recommended by Norway, for the sake of transparency.

PART IV

COLLECTIVE ACTION CLAUSES AND SOVEREIGN DEBT RESTRUCTURING MECHANISMS

**Collective action clauses:
summary of panel discussion**

Moderator: Mr Matthew Fischer, International Monetary Fund

Panelists: Mr Robert Gray and Clifford Dammers, International Primary Market Association (IPMA)
Mr Pierre Jaillet, Banque de France
Mr Carlos Steneri, Ministry of Economy and Finance and Central Bank of Uruguay
Dr Kunibert Raffer, University of Vienna

Collective action clauses and sovereign debt restructuring mechanisms

It was concluded that collective action clauses (CACs) are becoming increasingly common in sovereign bond issues, and that fears of higher spreads and debt costs for emerging-market bonds have not materialized. The panel outlined the work of several bodies, including the private sector, the G-8, and the G-20 in encouraging the use of CACs in member States' foreign bond issues. A presentation by the International Primary Market Association (London) favoured this market-based contractual approach over a more statutory approach and stressed the importance of standardization of CACs. It addressed concerns about CACs' creating multiple fragmented bondholders' committees (which lead to higher restructuring costs for emerging-market issuers). It also highlighted that, in cases of the restructuring of bonds with CACs, creditors will naturally come together when debtors negotiate in good faith.

It was concluded that the demise of the Sovereign Debt Restructuring Mechanisms (SDRM) proposal still left a number of options for sovereign debt restructuring that future research needs to address. These include the use of CACs, various Code of Conduct proposals, and changes to the IMF's access policy. The recent voluntary debt reprofiling of Uruguay was presented as a case of innovative restructuring based closely on consultations and best practices deriving from the market. Overall, panellists felt that conclusions still needed to be drawn from the debt crises of the 1980s and 1990s and that more work was needed to establish clear incentives for sovereigns to deal with debt problems *before* a crisis, and to create a system that ensures transparency and availability of debt data.

Collective action clauses

ROBERT B. GRAY

Cliff Dammers and I would like to thank UNCTAD for the invitation to speak at this Fourth Inter-regional Debt Management Conference. We appreciate the opportunity to address such a broadly based gathering of government debt officials on the topic of Collective Action Clauses, which I will immediately abbreviate as CACs. As you are aware, I represent the International Primary Market Association, which is also easily abbreviated to IPMA.

IPMA was established 19 years ago as the London-based trade association for banks active in the underwriting of international debt and equity securities. Our main focus is on encouraging a set of market practices that will maintain the attractiveness of the international bond market for issuers, investors and the underwriting firms that are our members. The underwriting community relies for its existence on its ability to balance the reasonable expectations of issuers and investors in the interest of maintaining an efficient market for all participants. We estimate that US\$1.6 trillion was raised in our market in 2002 on a public syndicated basis and a further \$600-800 billion on a private non-syndicated basis. So our market is highly successful. And our market practices have had to evolve with it. Much of the success of our market results from IPMA's success in the harmonisation and standardisation of market practices on the basis of consensus. IPMA has long been of the view that a standardisation of market practice in the use of Collective Action Clauses would contribute to a more orderly and efficient market for emerging market finance. IPMA is pleased by the degree of consensus in the private and official sectors in favour of CACs. The official sector view was well expressed in an IMF paper released just last week under the title "Crisis Resolution: Next Steps".¹⁶

I recommend this paper to you, particularly in the way that it places the issue of CACs within the broader context of a more stable financial system. I quote: "the case for collective action clauses is strongest if they are viewed as one of several interdependent changes in the international financial system, which together

promise to make the world a safer financial place but none of which is feasible in the absence of others". Even though we have our differences with the IMF on the concept of a statutory sovereign bankruptcy regime, both sides agree on the crucial importance of effective creditor co-ordination in the orderly resolution of sovereign debt crises. CACs are intended to provide a reasonable basis upon which a debtor and its creditors can agree to modify a bond or loan contract, while still respecting the contract's sanctity. At the end of the day the acid test with CACs is whether their wholesale introduction into bond and loan contracts can and will contribute to a more robust international financial architecture.

First, I will provide a historical perspective on CACs, focussing in particular on different market practices in the London and New York bond markets. I will look at the difference in the creditor dynamic in the bond and loan markets. I will refer to the differences between a market-based approach to restructuring based on CACs and a Code of Conduct and the statutory approach based on the concept of a sovereign bankruptcy regime. I will explain why the bond market has relied on exchange offers to achieve sovereign debt restructuring.

Cliff will outline our work in the so-called "Gang of Six"¹⁷ trade associations in drafting model Collective Action Clauses and a Code of Conduct. He will explain what we mean by Collective Action Clauses, the specific contractual provisions. He will also detail the differences between our model CACs and those actually adopted by the Government of Mexico, explaining why Mexico did not choose to adopt all our clauses. He will update you on how other sovereign issuers have followed in Mexico's wake, both from the emerging markets and the European Union.

Finally, since CACs are very much a work in progress, I will discuss some of the remaining issues with CACs. In particular the benefit of standardising CAC language, the issue of aggregation and the challenge of improving bond-

¹⁶ IMF Working Paper No. 03/196

¹⁷ IPMA together with five other trade associations

holder voting procedures to make CACs more effective in practice.

Let me start with a brief definition of Collective Action Clauses, of which there are essentially three types. First, qualified majority voting which specifies the percentage of creditors whose vote is sufficient to amend key terms such as the payment of principal and interest in a manner binding on all the creditors. Second, enforcement which requires that the decision to sue the borrower be made by a suitable percentage of the creditors, typically 25 per cent. Third, engagement that details the basis on which creditors select a representative, typically a creditor committee, which is tasked with representing the creditors interests in negotiations with the debtor.

Bonds subject to English law have included CACs going back to the late 19th century. But sovereign bonds subject to New York law have not included CACs, or certainly not qualified majority voting clauses. This is why to a large degree the core of the recent debate on CACs has been on convincing the US investor community that the use of CACs does not represent a threat to their interests. There is some irony in the fact that it should be the investors that have had to be persuaded that CACs are not a threat to their position. When CACs were introduced in England in the 1870s, it was because of the perceived benefit in achieving effective coordination among investors: CACs were designed to protect the majority of investors from the actions of the minority of investors. As a result of the 1939 Trust Indenture Act the US market went in the opposite direction: this Act prohibited reductions in amounts due under a publicly issued corporate bond without the consent of each bondholder. Although the Act was limited to corporate bonds, no separate body of practice developed for sovereign bonds for the simple reason that there was virtually no foreign sovereign bond issuance in the US market between the 1930s and the 1990s.

When we talk about collective action the key issue is indeed effective creditor coordination. The IMF proposal for a sovereign debt restructuring mechanism in late 2001 reflected the Fund's scepticism that, as a strictly practical matter, creditor coordination could be made to work without a strong statutory underpinning. The IMF argued that it required a statutory approach to achieve effective co-

ordination across "a diffuse and diverse creditor base, with different creditors able to seek enforcement of their rights in different legal jurisdictions". The problem was identified by Anne Krueger of the IMF:

"(Collective action clauses) typically only bind holders of the bond issue in question a country with an unsustainable debt burden will require a comprehensive restructuring across a broad range of indebtedness, potentially including different bonds issued under different jurisdictions, bank loans, trade credits and some official claims".

In sum, the IMF supports the use of Collective Action Clauses but they believe them to be necessary but not sufficient: their belief is that the effort to achieve collective action among private sector creditors should be reinforced by a sovereign bankruptcy mechanism. They draw the analogy with the corporate sector where debts can be restructured in the shadow of a court administered bankruptcy procedure. The IMF could not conceive that a broad range of loan and debt instruments could be restructured if each had to be restructured individually, within the four corners of each instrument. So it proposed that there be an aggregation of claims across instruments for voting purposes. Since aggregation would effectively amend contract terms retroactively, the IMF recognised that its SDRM would require approval by its member countries and a change in the IMF's own Articles of Agreement. The unanswered question remains whether market based restructuring can work without aggregating voting claims.

The G-7 has left the door open to the SDRM by supporting further work by the IMF on "proposed approaches to sovereign debt restructuring that may require new international treaties, changes in national legislation, or amendments of the Articles of Agreement of the IMF". But the G-7 has stressed that this should not delay the "expeditious implementation" of a market-oriented approach to the sovereign debt restructuring process in which Collective Action Clauses would be incorporated into individual debt contracts. The private sector response has also endorsed the use of Collective Action Clauses in sovereign debt contracts.

So the choice really boils down to whether the market-based approach using CACs favoured by IPMA or a statutory approach premised on aggregation is the best way to restructure

sovereign debts. Our voluntary approach is clearly preferred by the issuers. Understandably they have been concerned that a statutory approach would weaken investors' appetite for their bonds.

We do recognise that the problem of creditor co-ordination has become more acute since the 1980s. There is some nostalgia for how easy sovereign debts were to restructure in the 1980s. The challenge then was to restructure long term syndicated loans. This was achieved by voluntary standstills and the provision of new money, leading finally to absolute debt reduction through the Brady Plan. Brady-style debt exchanges were the ultimate market-oriented form of sovereign debt workout. Starting with Mexico, over 20 countries carried out Brady debt exchanges, with over \$170 billion of Brady bonds put in issue. In the 1980s, burden sharing fell on the banks rather than bondholders because bonds were such a small percentage of the outstanding claims on emerging markets debtors. How things had changed by the late 1990s. The Rey report after the 1994 Mexican financial crisis stressed that bonds had become such an important part of finance for emerging markets that they could no longer expect privileged treatment. Now in Argentina we are seeing virtually the entire burden falling on private bondholders.

Cases like Argentina have emphasised to bondholders the weakness of their negotiating position, and the need for IPMA and the other trade associations to fight their corner. Bondholders depend on their power, individually or collectively, to sue defaulting issuers. The threat of litigation is the key bargaining level available to bondholders, and is the only real card that they have to play. Bondholders value contractual rights they have, such as their ability to freeze assets of the sovereign debtor in foreign jurisdictions. But they are very aware of how difficult it is to enforce claims against sovereign governments. Bondholders have been awarded a number of judgements against Argentina but have not been able to enforce those judgements.

Let me turn to the question of how bondholders organise themselves. In a loan restructuring it is typical for a steering committee to be formed that will coordinate the formulation of the restructuring proposals with the sovereign debtor. The process will follow an established

framework of practice about which there is a high degree of consensus among the banks. It is rare to find a bank resorting to any individual remedies available to it. In the absence of a creditor committee, the same degree of consensus is harder to achieve in the case of a bond restructuring. There is a greater likelihood of creditors failing to vote at a bondholders' meeting. Bondholders who might otherwise accept a restructuring proposal will be less willing to do so if they see other creditors being paid off. This inter-creditor dynamic can have a much stronger influence over the outcome of a bond restructuring than over a loan restructuring. Despite the challenge IPMA is more optimistic than the IMF that Collective Action Clauses can be made to work across a broad range of individual bond issues without the need to resort to a statutory regime. The key is transparency: if bank lenders or holders of an individual bond issue feel that they are being treated fairly in relation to other creditors, they are very likely to co-operate. And if the necessary majority cannot be achieved for whatever reason exchange offers are an alternative market-based remedy. More on exchange offers later.

It is argued that debt restructurings based on the use of Collective Action Clauses or exchange offers are prone to disruption by "rogue" creditors. This view has it that rogue creditors are able to obstruct a restructuring by taking control of one or more bond issues and holding out for better terms. This would support the argument for aggregation of multiple bond issues for voting purposes, so as to dilute the ability of any rogue creditor to hijack the process. IPMA does not doubt that aggregation could be effective in eroding the power of the rogue creditor, but we question the desirability of imposing a statutory aggregation scheme on outstanding bond claims, asking:

- At a philosophical level, do the benefits of aggregation outweigh the demerit of direct interference in contractual rights?
- At a more practical level, is the need for aggregation proven?

The evidence is that major bond restructurings have taken place in Ecuador, Pakistan, Russia, and Ukraine without the process being obstructed by rogue creditors. Even in the most widely cited example of "rogue-ish" behaviour, the 1997 restructuring by Peru was threatened

but not disrupted. Suits are not brought during the period in which a sovereign is genuinely acting in good faith with its creditors and openly engaged in a constructive dialogue. The use of Collective Action Clauses (and judicious decisions by the Courts) could further reduce the risk of rogue creditor problems that may exist, without the need to create an SDRM.

The debate on how to achieve effective creditor coordination that followed the SDRM proposal started from a low level of market awareness. There was a general anxiety to avoid changing contracts in a way that could frighten investors from purchasing emerging market bonds because changing the contract would be too easy for borrowers. If bonds are too easy to restructure, debtor countries may be tempted to treat debt restructuring as an acceptable alternative to debt payment rather than as a final resort when all else has failed. CACs had not been the subject of much attention despite the emphasis that was placed on Collective Action Clauses in the Rey report published following the Mexican tequila crisis. As Chairman of a trade association that represents underwriters, I would be the first to admit that the subject of CACs had not been figuring in negotiations before bond issues were mandated or even in the pre-launch negotiations. The inclusion or not of CACs was left to the issuer's and the underwriter's legal teams to negotiate on an *ex post* basis.

IPMA first focused its attention on CACs four years ago when we carried out a study of current market practice for a broad range of emerging market and OECD bond issues. Our study looked at as many different sovereign issuers as possible and also examined contracts from the same issuer under different governing laws. Our research confirmed that borrowers tended to follow the market practice that was typical for each market: as a result they accepted 100 per cent bondholder approval in their New York contracts while including qualified majority voting provisions in their English law contracts. What was discouraging was the lack of transparency in the case of many bond issues: with important creditor coordination provisions such as bondholder meeting provisions often buried in fiscal and paying agency agreements, to which an investor would have difficulty gaining access. One of the points that we took away was the need to rethink how bondholders are enfranchised: it suggested to us the merit of a broader use of written resolutions for voting

purposes, rather than the use of bondholder meetings. I will return to this subject later.

I believe that bondholders are increasingly aware that their interests are best served by collective action, even if that means accepting limits on their ability to act individually. It is helpful that there is no apparent difference in the trading performance of bonds under English law compared to those under New York or German law. In no case has a rating agency made a rating distinction between bonds issued under different governing laws. To the best of my knowledge no restructuring has favoured one group of bondholders over another due to differences in creditor protection within contracts.

There is a greater understanding that unbridled freedom of individual action for one creditor can negatively affect other creditors holding the same instrument. Qualified majority voting is also good for the debtor: it reduces both the incentives for any bondholder to seek an individual settlement and the ability of a rogue creditor to hold to ransom the prospect of a reasonable debt settlement. The key issue is how we can institutionalize the principle of collective action to make creditor coordination more efficient and more effective. The challenge in our market and perhaps to a lesser degree in the United States, is how to bring bondholders to the negotiating table. It is particularly difficult to identify and mobilise holders of bearer bonds, which are still a feature of our market. Where bondholders need to be lobbied, it has to be done through the international clearing systems, Euroclear and Clearstream, and through advertisements in the financial press. The international clearing systems will not disclose to an issuer or its advisers the identity of those who have positions in the bonds. Notices or requests for proxies are given to the clearing systems, which pass them on to their participants. These participants are typically custodians, who in turn are expected to pass all communications on to the beneficial owners. But the issuer or its advisers have no way to know whether that has actually happened. Should the beneficial owner wish to vote its bonds, the chain operates in reverse. If an issuer is in default, the clearing systems will seek to have defaulted bonds withdrawn from their system to be held by the beneficial owner directly.

In practice there are few recent cases where a sovereign debtor has attempted to achieve a

restructuring through the amendment of existing bond or loan terms. The exchange offer has been more usual. Exchange offers have been used in a variety of countries including Ecuador, Ukraine, Pakistan and Uruguay. Exchange offers will be the basis of the Argentine restructuring. New bonds, providing the borrower with a measure of debt relief, are offered in exchange for the outstanding bonds. Recently most exchange offers have used the so-called *exit consent mechanism*, under which a creditor accepting new bonds under the exchange offer also votes to amend the terms of the old bonds in a manner that disadvantages any residual holder of the old bonds. As a result bondholders are strongly motivated to accept an exchange offer in order to avoid being left holding existing bonds which have been tainted by amendments to their terms instigated by the exiting holders. The use of exchange offers is a pragmatic response to the difficulty of getting bondholders to a meeting to vote to amend their bonds. But exchange offers have their disadvantages. Inevitably with an exchange some of the original bondholders, either because they are hostile to the idea or merely passive, will not tender their bonds. The part of the original bond issue that remains outstanding can fall into the hands of rogue creditors, who may then become a thorn in the side of the debtor. Far better that the original bond should be amended so as to bind all creditors.

The exchange offers for Ukraine and Ecuador certainly attracted high levels of bondholder support, well over 95 per cent. The high response level was due to a combination of factors – including the energetic efforts of the banks executing the exchange offers and the effectiveness of the exit consent mechanism – but equally important was the flexibility that allowed the bondholders to vote their bonds through written proxies and even through the internet. There is no reason why the same techniques should not be used to encourage bondholders to vote when asked to approve amendments to bond contracts.

The United Mexican States pioneered the use of Collective Action Clauses in a global bond governed by New York law. The Mexico bond is a good example of how CACs can be structured to balance the interests of both issuer and bondholder. The majority action level at 75 per cent was lower than some investors might have liked, but Mexico gave something back to investors by broadening the range of reserve

matters where any amendments would require approval, thereby making the use of exit consents more difficult.

In the debate on CACs, most attention has been paid to the majority action clause. It is now accepted that a supermajority rather than unanimity should be required for amending core provisions, such as modifying scheduled principal or interest payment dates or amounts, the so-called reserved matters.

How should the supermajority be defined? It should reflect the market experience to date with hold-out creditors, those who may withhold their vote in the hope of getting a better deal, but it should also recognise that an apparent hold-out creditor may merely be a passive creditor, which may value its anonymity. Nor can we ignore the potential for sovereigns to influence the process by acquiring or controlling creditor positions. However, the majority is defined, the denominator should exclude debt held or controlled by the sovereign debtor.

Issuers are now proactive in deciding whether or not to include any CACs in their bond documentation. Debt issuance programmes give them a particular opportunity to standardise their bond documentation. The market would welcome standardisation; it is important that these clauses be as uniform as possible.

In the period during which bond issues are launched and sold, there is little time for investors to gauge the pros and cons of different provisions. Their main concern is whether a given bond represents good value relative to other investment opportunities. The least desirable outcome would be for a particular issuer's CACs to become a source of competition: for example, if an underwriter marketed itself to an issuer as being able to launch an issue with a lower qualified majority level than its competitors, or if an issuer argued that a lower percentage of bondholders should be allowed to amend its bond terms because it had stronger credit than other issuers. What we need is for emerging-market and OECD issuers from a broad credit spectrum to follow Mexico's example. European Union issuers have stated their willingness to include CACs in their foreign currency bonds, as has Canada. I am not convinced that issuers should be given financial incentives by the official sector, including the IMF itself, to introduce them. If issuers need incentives to adopt these clauses

that sends a strong signal that they may be undertaking something that is not in their interest. From their side, investors would view a system of incentives as official interference in the workings of the market. Far better that CACs should be adopted because they represent a win-win situation for issuers and investors – for issuers because they will be less vulnerable to the risk of rogue investors, and for investors because workouts should be more predictable and less protracted.

IPMA believes that trustees could play an important role in improving creditor coordination. First, a bondholder trustee offers the best opportunity for effective creditor coordination. For a start, no bondholder can take unilateral action without involving the trustee. Litigation must be carried out by the trustee, and any recoveries through litigation are shared pro-rata among all the bondholders.

With a trustee too, sharing becomes a practical reality. The concept of sharing is that if one creditor makes a recovery from the debtor, it should share it on a pro rata basis with the other creditors. Without a trustee at the centre of the process, it would be difficult to either induce a creditor that had made a disproportionate recovery to disgorge the excess or to determine which bondholders would be entitled to share.

The second benefit of a trustee is that it provides a useful channel for communication between issuer and bondholders, given that legally at least, neither the lead manager nor a fiscal and paying agent has any responsibility to communicate. Many US investors seem to have some antipathy to the use of trustees, apparently grounded in the belief that US trustees have been very passive. Trustees do stick closely to the text of the indenture in deciding what they are authorised to do. But trustees timidity need not be a fact of life. In the international market, we have seen trustees take unilateral action to put a debtor into default without consulting with bondholders because it believed that the circumstances justified such action.

The so-called "Gang of Six" trade associations twinned the release of its model collective action clauses with a proposal for a Code of Conduct for both debtors and creditors. We proposed that the Code be developed as a joint initiative of the private and official sectors, with an important role for the G20. The Code con-

cept recognised that there were some matters that could not be dealt with on a contractual basis. From IPMA's view point the manner in which a debtor engages with its creditors post-default is a major issue. A good example is the issue of creditor committees.

Why are creditor committees important and why should the Code provide for them? You will recall that the private sector's original model Collective Action Clauses included an engagement clause. The engagement clause anticipated that, post-default and subject to a positive bondholder vote, a representative bondholder committee would be formed with which the debtor would engage in good faith and whose reasonable expenses would be borne by the debtor. The idea of an engagement clause was supported by both the official sector and the private sector, because they would better define, as a procedural matter, the process of how issuers will engage with their creditors in resolving any crisis that may arise during the life of the bonds. The absence of engagement provisions unfortunately puts at risk the perceived benefits of CACs and their potential effectiveness because without effective engagement there is simply no mechanism to ensure that bondholder interests will be adequately protected. The engagement clause has proved unpopular with issuers, starting with Mexico. One reason may be a concern that a separate creditor committee would be established for each of its bond issuers (leaving aside the matter of loans), and that the issuer could be drawn into a plethora of bilateral negotiations and an unimaginable level of expenses. If that is the only objection, I believe that is something that we can fix in the Code.

I am certainly convinced that bondholders, discouraged by recent events, will expect the Code to include a framework for negotiation between the debtor and its creditors. Why do bondholders believe that creditor committees are so important post-default? For a start because in the absence of a trustee, no particular party is necessarily representing their interests or keeping them informed of developments. Investors that do not feel well informed and satisfied that a deal is fair between different classes of creditors will be tempted to shun or even vote against an exchange. Outright hostility, including litigation against the debtor, increases. A well functioning creditor committee can reduce that risk.

Last month the IMF produced a paper on the process for sovereign debt restructuring within the existing legal framework, which also argued strongly for creditor committees:

“In circumstances in which creditors have organised a representative committee on a timely basis, the debtor’s interests would normally be well served by elaborating a restructuring proposal in close co-operation with this committee”. The private and official sectors are on the same page as far as the value of creditor committees are concerned.

Let me elaborate on why creditor committees are also of benefit to the debtor:

First, a debtor should wish to consult with its creditors on the design and process of a restructuring strategy. But it may wish to limit discussions to a narrow group due to confidentiality concerns. To quote the IMF again, “creditor committees have generally provided an effective vehicle to achieve confidential exchanges of information”.

Second, the existence of a creditor committee will assist the process of identifying bondholders. Once a creditor committee has been established bondholders will be motivated to make contact with it. This will give the debtor a clearer picture of its bondholders and could even help identify potential holdouts earlier in the restructuring process.

A legitimate borrower concern with including engagement clauses in a broad range of its bond contracts could be the risk of a proliferation of creditor committees bond issue by bond issue. There is no easy answer to this concern. And this is where it may be distinctly preferable for the creditor committee concept to be included in a Code rather than in individual bond contracts. For example, the borrower could limit its liability to pay professional expenses to the reasonable expenses of a single committee. This would encourage the consolidation of indi-

vidual creditor committee initiatives at an early stage after a default has occurred.

After a default, consultation should be replaced by negotiation and a creditor committee should be an integral part of that process. We could use the framework of a Code of Conduct to set out precise rules as to how the creditor committee should operate, perhaps looking at best practice in the corporate sector.

Both issuers and investors can benefit from bringing sovereign debt crises to a quick resolution. Bondholders typically are not a homogeneous group; as a crisis develops, they tend to become even less homogeneous. The introduction of CACs into loan and bond contracts is an essential step forward. Protracted restructurings are not in the interest of either investors or issuers. From the creditors’ viewpoint, the evidence is that the longer a bond is in default, the lower the recovery rate. From the borrowers’ viewpoint, unresolved debt claims can help deny them further access to capital markets. CACs can help expedite the restructuring process.

We may take some comfort from knowing that sovereign debt restructurings were even more difficult in the past. Some nineteenth century reschedulings dragged on for sixty years. In the 1920s and 1930s Thomas Lamont of J P Morgan negotiated with the Mexican Government on behalf of the International Committee of Bankers, which acted at that time for no less than 200,000 foreign bondholders. In the 1930 rescheduling, all accrued but unpaid interest was fully forgiven and the principal was rescheduled into a 45-year sinking-fund bond. Lamont had some battles with the official sector over the importance of protecting bondholder interests; ironically, perhaps, his main opponent was the US Government in the form of Secretary of State Dwight Morrow. It is gratifying that the level of cooperation between the official and private sector has moved to a different plane since those distant days, not least in the consensus in favour of Collective Action Clauses.

Code of Conduct: the current debate

PIERRE JAILLET

The international community has clearly failed to draw all the lessons from the international financial crises of the 1980s and 1990s:

- **Much can be done to improve prevention;** the nature and onset of crises are still difficult to anticipate; analysis does not differentiate very clearly between solvency and liquidity risks; and debt sustainability remains highly unpredictable.
- **The need for cooperation increases with the risk of contagion,** the opening of capital accounts and changes in the holders of sovereign debt (mainly a few big international banks in the 1980s, but nowadays a myriad of investors in bonds).
- **The cost of crises is still considerably underestimated:** the costs are economic and social for the issuing countries (serious risk of destabilization), financial for investors (a “haircut” of 75 per cent or more), more diffuse and wide-ranging, but still considerable, for the international community (cost of bail-outs for the international financial institutions and thus for the international “taxpayer”), which also faces possible costs in terms of its reputation and credibility in cases where the handling of major crises is considered to have been indecisive (e.g. in Argentina).
- **Recent incidents illustrate the need for a comprehensive, clear and predictable framework for crisis prevention and management,** to deal with the harmful factors that give rise to crises and that complicate efforts to resolve them: policies on indebtedness and moral hazard, failure to observe the restrictions on access to international financial institutions’ services, little involvement of the private sector, etc. At the same time, such a framework needs to be flexible enough to cope with cases as different as those of Russia, Turkey, Argentina, Brazil and so on.

The international debate today: complementary rather than interchangeable approaches

Since the beginning of the decade and against the backdrop of the Turkish and Argentine crises in particular, the international debate has concentrated on three approaches:

- **A judicial approach,** as exemplified by the proposal of the International Monetary Fund (IMF) for a sovereign debt restructuring mechanism (A. Krueger, 2001), which aims to provide a comprehensive framework for dealing ex post with the problem of sovereign debt by means of various legal instruments (e.g. debt aggregation, suspension of legal action or the establishment of a dispute-settlement forum). This proposal did not go down well with the international community as a whole because of the legal and technical problems it poses (not the least of which is that it would require a change to the IMF Articles of Agreement), even though the International Monetary and Financial Committee has recommended that work in this area should continue.
- **A contractual approach,** which would facilitate ex ante the process of restructuring sovereign debt by making wider use of collective action clauses in bond issues. This approach is certainly popular, since such clauses have been included in recent bond issues by several big countries (including Mexico, South Africa, Brazil and Turkey), but there are still some doubts about its usefulness as a comprehensive multidimensional crisis-management framework.
- The idea of a **code of conduct** for restructuring sovereign debt was proposed by, among others, Jean-Claude Trichet, the governor of the Bank of France, to the G-20 in New Delhi in November 2002. The aim is to produce a non-judicial (or “voluntary”) comprehensive framework to encourage cooperative and orderly crisis-management at the least cost to all parties. The code of conduct should really be seen

as an umbrella approach that complements the sovereign debt restructuring mechanism and, particularly, the collective action clauses, which are in fact among the tools it would draw on.

Key features of a code of conduct

A code should define a set of **general principles**, including:

- The need for regular dialogue between issuers and creditors at an early stage;
- Equitable sharing and transparency of information;
- Equitable representation of creditors;
- Comparable treatment for all creditors; and
- The maintenance or earliest possible re-establishment of normal financial relationships.

A code should also define a “**road map**” setting out the roles and commitments of the various parties in the analytical and renegotiation phases. The road map needs to be sufficiently flexible to fit different crisis scenarios. The code should therefore reduce uncertainty before and during the restructuring process, while also reducing moral hazard for the debtor and discouraging creditors from going it alone.

Lastly, a code should provide a “**tool box**”, that is, it should offer access to all or part of a range of instruments and internationally recognized good practices in terms of dialogue mechanisms, information-sharing arrangements, investor representation, mediation, new finance, possible agreement on a moratorium, etc.

State of play

In the past few months, fruitful consultations and preliminary technical work involving representatives of the private sector, emerging countries and the public sector (G-7, IMF, etc.) have been carried out informally, and have identified several key points on which there is either agreement or disagreement:

- There is clearly a broad consensus on the intrinsic nature of a code, which should be

flexible and voluntary and should strike a balance between the rights and obligations of the various parties involved in sovereign debt crises. Similarly, there is little argument that a code can only be effective if certain preconditions are met: an improved ability to assess the sustainability of debts at an early stage and clearer conditions for access to IMF resources. Furthermore, it is vital to have an incentives system that is compatible with the voluntary and flexible nature of a code - a system that brings together market pressures and peer pressures and, of course, ownership by all the protagonists of the non-binding rules. A code can only work if it is seen by all concerned as a win-win option.

- The main disagreements concern:
 - The **scope** of a code of conduct: the private sector would like to strengthen the obligation to make information available to issuers in the prevention phase, but this idea is strongly resisted by representatives of emerging countries. It is true that the many obligations linked to observance of standards and codes represent serious administrative constraints from their point of view. Issuers therefore prefer to focus on “resolution” issues in the discussions on the code.
 - **The role and nature of consultations between issuers and the private sector**, whose representatives would like to go further than the current arrangements for the representation of investors in emerging countries, though the latter find these arrangements quite satisfactory.
 - **The role and nature of “creditors’ committees” in the pre-default and default phases**; the private sector would like to entrust quite extensive responsibilities to these committees in the restructuring process.
 - **The details of the implementation of the precepts of the code** raise many questions, such as on whether or not there is a need for a monitoring body or how to ensure both its neutrality and acceptance of its arbitration decisions by all concerned.
 - Lastly, a sensitive point in the discussions concerns **the possible role of the IMF** and, more generally, the

funding policy of the official sector, as well as the conditions for granting new loans while old ones are still outstanding.

In conclusion, the idea of a code of conduct is making headway despite the inevitable difficulty in reaching agreement between the private sector and the issuing countries on several key points. The International Monetary and Financial Committee and the G-7 (meeting in Washington in spring 2003 and in Dubai in September) have recommended that work in this area should continue. The G-20, which is undoubt-

edly the most relevant forum today for discussing the prevention and resolution of sovereign debt crises, reaffirmed at the end of October 2003 (in Morelia, Mexico) its interest in pressing on with the work on the code and advocated the establishment of a working group consisting of issuers and representatives of the private sector, to whom members of the G-20 can provide assistance. The G-20 alternate has been requested to present a status report on progress in the work at a meeting in March, to be chaired by Germany.

Voluntary debt reprofiling: the case of Uruguay

CARLOS STENERI

Introduction

During the 1990s, Uruguay was one of the most successful examples of an issuer of debt in international capital markets.

Clean credentials stemming from its long-time performance as a reliable debtor, together with the implementation of sound macroeconomic policies, paved its way to tapping markets paying low yields and getting long maturities during the 1990s. In 1997, Uruguay's sovereign debt was rated Investment Grade by Standard & Poor's, Moody's and Ficht. In the same year, it was able to issue a 30-year bond maturity, in dollars, with a spread over US Treasuries of 136 basic points. This fact, together with other further issuances in local currencies (e.g. Chilean peso), in the Eurobond and Japanese capital markets meant that the country had reached the zenith as an issuer of foreign debt.

In fact, the country had joined the exclusive club of emerging economies that issued investment grade debt. In Latin America, only Chile and much later El Salvador and Mexico pertained to that exclusive category.

A sudden reversal in the mood of the capital markets put in motion a chain of regional events which triggered the deepest financial crisis in Uruguay in recent history.

As a consequence, Uruguay's capability to service its debt was severely imperilled, obliging it to find a solution to what was an unexpected problem.

The road to debt crisis

The Russian debt default in 1998 contributed to the reversal of the financial flows directed at emerging economies. This had important consequences, in particular on Uruguay's large surrounding regional economic partners. Brazil was obliged to float its currency in January 1999, and there was a sharp contraction in its domestic absorption. As a result, its demand for regional exports plunged, causing deflationary pressures on Uruguay and Argentina. This ended

up having strong adverse consequences on both countries.

At that time, Uruguay's policy makers believed that the negative external shock stemming from Brazil was temporary. This line of thinking came from a lack of historical antecedents. Regional economic history had taught that sharp exchange rate nominal devaluation was followed by an equivalent increase in domestic inflation. Therefore, the real exchange rate after a short period could stay unmodified at the same pre-devaluation level. But this was not the case. The expected surge in inflation did not take place and a substantial real exchange rate devaluation continued. But that information was not available *ex ante* and Uruguayan authorities decided to apply short term countervailing policies. This was translated by the implementation of counter cyclical actions to compensate, what was believed to be a short-run phenomena. In consequence, during 1999-2000, Uruguay put into place policies financed mostly with external debt. This began to deteriorate the strength of the country's external accounts. Given the assumption of the short-term nature of the deflationary forces, however, the administration believed that the situation could be managed through gradually reducing domestic absorption and the relatively high cushion of foreign reserves. The implicit postulate was that the country would be able to roll over debt maturities through its continuous access to capital markets.

The collapse of the Argentinean economy triggered a sequence of unexpected shocks. The inflexibility of its relative prices – stemming from the Convertibility law and wage rigidities – together with endemic fiscal imbalances, were the original causes that impeded an orderly but necessary adjustment in that country for mitigating the negative external shock. The final outcome was a spiral of desperate economic policy changes that added more noise than solutions to an unstable situation. Central to this economic policy misconception were the partial modifications of the exchange rate regime and the implementation of a domestic debt exchange that did not give major benefits in terms of cash flow alleviation. These actions were taken without solving two of the basic problems that lead to

the critical situation: endemic fiscal imbalances, and the unsustainable exchange rate appreciation. These were not helped by the rigid macro-economic environment.

These inflexibilities lead to a sharp increase in unemployment, a substantial GDP contraction and a further deterioration on the fiscal accounts within the context of a sudden stop in the availability of external financing. The financial sector was next in line to suffer the consequences. Its implosion was the beginning of the end.

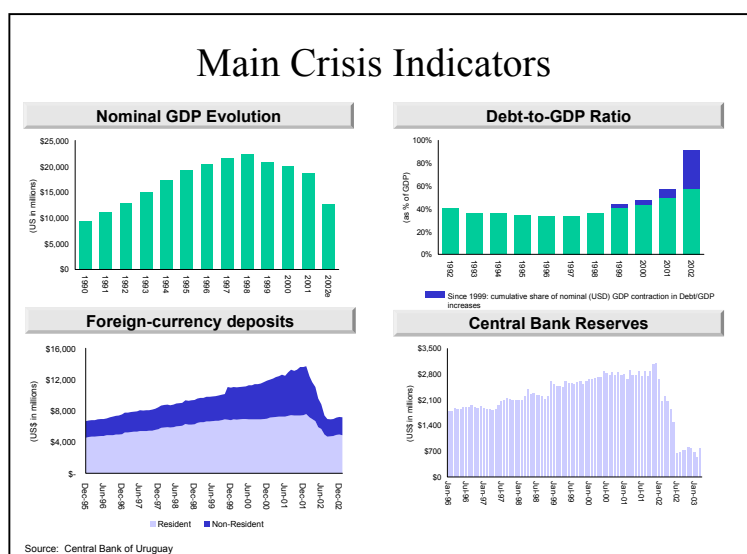
The Convertibility Law was abandoned in 2001. Argentina's GDP growth collapsed (more than 12 per cent during 2000-2), and the currency depreciated more than 150 per cent in real terms. The financial sector suffered from a series of mistaken policies, first the asymmetric "pesification" of bank balance sheets, and then with the freeze of bank deposits. All these lead to a credit crunch, which put further pressure on economic activity.

As a result, conditions for regional contagion were set, Uruguay being its first casualty. Facing these facts, Uruguay tried to deal with it through accelerating the crawl of the devaluation path (early 2001) and through drastically reducing public expenditures in real terms. These measures were not enough to neutralize the negative impact Argentina, erosion on economic activity being the result. A series of banking malpractices discovered in Uruguay (1Q 2002) ignited the strongest financial crisis in the country's recent history. An unstoppable run on bank deposits began, (May 2001) depleting during a short period of time the Central Bank reserves and leading to a need to float the currency to protect the scarce reserves remaining. To face the banking crisis, the international community through the IMF, put in place a special aid financial package (1.8 billions dollars). As a result, the government decided to re-programme public bank deposits and liquidate four insolvent private banks.

The rapid deterioration of the financial system had a severe impact on credit lending, resulting in a vicious cycle of less credit and then further additional economic contraction. The depreciation of the currency reduced nominal

GDP in dollars by more than 50% (US\$ 23 billion in 1998 to US\$11 billion in 2003).

Finally, the "proud creditor" ceased to be unexpectedly. The country's capabilities to honour its debt obligations were dramatically imperilled, when year 2003 already presented a challenging calendar of debt maturities. The prolonged reversal in financial flows to the emerging economies (their sudden stop) and, the deterioration of Uruguay's terms of trade, posed an additional constraint to solving the problem through conventional means.



Searching for the way out

Uruguayan authorities faced a twofold challenge: to preserve its status as a trusted creditor and simultaneously obtain debt alleviation.

The only feasible way to achieve those two apparently antagonistic objectives was through the implementation of a voluntary debt exchange, which assured creditors' rights and gave a feasible external payments calendar, given the country's economic conditions.

In this matter, no international experience was available. Most recent debt exchanges (Ukraine, Pakistan, Ecuador) in one sense or another were not voluntary and weakened the respective creditors' rights. To the eyes of Uruguay's authorities, none of them were a suitable strategy to follow.

Moreover, the international financial community looked like it was not well prepared to offer a suitable alternative to solving the prob-

lem. The IMF, who were directly engaged in these previous and recent debt exchanges, agreed on mechanisms not suitable to Uruguay's needs.

In addition, IMF new thinking about how to solve this type of crisis was connected with the Sovereign Debt Restructuring Mechanism (SDRM). This approach pursued the implementation of a “statutory” framework containing general and universal rules and new institutional frameworks to address debt problems. The SDRM basic building blocks are the following. First, an agreement between debtors and a special creditors' majority has to be in place. Secondly, during debt negotiations legal protection to debtors has to be provided. Thirdly, uniformization of negotiations criteria through the creation of an independent forum is needed. Finally, the IMF chart has to be modified to allow its participation in these kinds of procedures. In consequence, from Uruguay's viewpoint, this strategy was separate from the principles applied in a voluntary debt exchange strategy.

The polar alternative to this approach was the utilization of Collective Action Clauses (CAC), which could be defined as a “contractual approach” achieving goals through the universal application of the types of clauses already included in a wide spectrum of financial instruments, mostly in the private sector.

The basic idea behind this approach was to regulate the manner through which debtors and creditors voluntarily modify bond terms using special vote majorities

Other market-friendly alternatives existed, but at that stage were quite embryonic.

Therefore, given the situation for inducing an exchange suitable to Uruguay objectives, the most suitable road was to include Collective Action Clauses in the new exchange bonds, with the utilization of an Exit Consent. Its objective would be to stimulate bondholders' participation while penalizing potential holdouts.

In financial terms the exchange has to create value, but preferably only to participants, discriminating against free riding strategies.

The challenge was then to design a course of action in which both creditors and debtors would be better off playing a sort of game ap-

plying cooperative strategies. In short, the goal was to implement a voluntary exchange through which the creditors accepted to provide some sort of debt alleviation and country generating value to participants through policies directed at strengthening economic growth and in consequence strengthening the country's debt servicing capabilities.

If the game was not played in a cooperative way, the country would be forced by circumstances to default on its debt and all parties involved would suffer additional losses. A crude example is the following. At the time of the pre-exchange, the Uruguan debt quotation was around 50c -the typical level for distressed bonds. If the game (exchange) was played cooperatively, a substantial upside in price quotations was expected (40-50 per cent). On the contrary, if the country defaulted its debt, its quotation would plunge to levels close to 15-20c. The potential losses of the bad outcome were deterrent to behaving as a maverick bondholder. But in any case, these facts did not fully dilute the temptation to hold out during the process, and benefit from free riding the deal. In fact, the collapse of the deal was an event with non-zero probability.

Design of the overall strategy

The strategy to design a voluntary debt exchange minimizing the temptation to free ride relied on some basic building blocks.

The first and the starting point, was to approach markets with the purpose of conveying to them that a liquidity but not a solvency problem could arise, due to extreme adverse regional conditions. Also, to let them know that the country was willing, as in the past, to fully honour its debt obligations – fact disrupted by extraordinary events which required extraordinary actions in consultation with creditors. .

The idea to convey to bondholders was that the cost of default prevention (debt alleviation) was cheaper than an aggressive solution (unilateral default). This approach showed that Uruguay aimed to continue servicing its debt, setting aside the option of any unilateral disruption in the flow of debt payments. Central to the approach was to show that the “willingness to pay” was ever an essential attitude of the country. The challenge was then to present adequate arguments that make credible that kind of behaviour.

In practical terms the exchange had to provide breathing space while waiting for the improvement of external conditions and to regain economic growth, both preconditions to dissipating the liquidity problem in place. Therefore, a message to convey was the need to reduce external payments during a certain period. In other words, the draft proposal envisaged some ideas about some sort of bond maturities extension, but did not mention any explicit cut in nominal bond values.

The strategy's likelihood was helped by the fact that most of Uruguay's debt was contracted paying low fixed coupons as short term maturities were not substantial. Both characteristics are quite unusual for emerging economies and showed the good debt management in action. Therefore, substantial debt alleviation could only be achieved through "extension bond maturities".

Also, during talks with market players, the announcement from the beginning of the equal treatment of domestic bondholders *vis-a-vis* foreign creditors was crucial as this would assure that each creditor category would be asked for the same level of sacrifice in order to help to achieve the outcome. In the same vein, the financial exchange structure had to be time equivalent all along the curve. Therefore, by definition the Net Present Value reduction of the exchange was equivalent along the entire yield curve (swap equivalence). In other words, all bonds – independent of their maturity – should face the same "sacrifice".

The inclusion of the polemic issue of an Exit Consent was presented as a way of protecting participants from potential free riding rather than as a tool to force the exchange.

Finally, the approach's likelihood was facilitated by the relatively scarce dispersion of creditors (most of them international), and the low exposition of the domestic banking system to Uruguay's debt. This fact assured that the financial sector, already weakened by the crisis, would not suffer from additional damage through the exchange.

Some notes on the consultative process

The consultative process was prior to the final design of the debt exchange strategy. Its

purpose was to convey information to all market players (including multilateral institutions) to promote the conditions needed to articulate a cooperative "game theory"¹⁸ strategy among all the parties involved.

Uruguan authorities believed that the challenge ahead was to induce cooperative behaviour between the debtor and their creditors, based on a game theory where some sort of "prisoner dilemma"¹⁹, was in place.

Using one of the known feasible outcomes of traditional game theory, a way to induce cooperative behaviour was to provide information to the "prisoner A" (creditor) on what attitude "prisoner B" (the country) would take if the other side accepted to play the game under certain circumstances. Given the traditional result if prisoner A cooperates (participates in the exchange and gets new bonds) and prisoner B has the same cooperative attitude (pays the new bonds but put some uncertainty – exit consents – on payments of hold outs) both parties would be better off. The non-cooperative solution (no participation-default) at the end would be more expensive for both parties. These are in a nutshell the forces that drove the exchange. The trick was how to unleash them.

In fact, the debtor had more information about the likelihood of the different alternatives (i.e. future economic policy, treatment of free riders, NPV equivalence along the curve, and equal treatment between domestic and international creditors and even the likelihood of default).

Therefore, a necessary condition to force cooperative strategies was to share information and to get feedback from the creditors on different issues to be included in the final proposal.

During that process launched informally during the second half of March 2007, the market players showed a mature and deep knowledge of the forces that drove Uruguay to its difficult situation, the risks involved, and the potential benefits if the exchange was successful.

¹⁸ Game theory assumes that each player will pursue the strategies that help him or her to achieve the most profitable outcome in each situation.

¹⁹ The Prisoner's Dilemma is one of the best-known models in game theory. It illustrates the paradoxical nature of interaction between participants with opposing interests.

From the beginning, they understood that a cooperative strategy had a high up side in bond market quotations. Conversely, a failure could mean additional losses, plunging bond prices to default levels (15-20 c).

The main message received as a condition to participate in the exchange was their preference for a straightforward maturity Extension Alternative rather than to accept principal or coupon reductions.

Second, they showed concern about the potential liquidity of the new instruments. The answer was the acceptance to provide a benchmark bond alternative.

Thirdly, intercreditor equality treatment was raised several times (local versus international, short versus long maturities). In consequence, the preservation of the relative terms' structure along the curve through comparable Net Present Value impact on all the bonds was a determinant on the final design of the proposal.

Finally, Collective Action Clauses (CAC) were accepted without resistance, despite the inclusion of an "aggregation" provision, through which a super majority could modify each bond (i.e. maturity, money, coupon) if a minimum vote was reached in that class. In fact, the aggregation provision would give some sort of insurance to cover the risk of a potential future distressful event – though the action of a super majority vote which tries to synchronize actions, benefits and penalties among bondholders who are trying to solve the problem.

In conclusion, the consultative process confirmed most of the initial assumptions that laid the ground for the building of the exchange proposal

The inclusion of CAC and exit consent

The exchange proposal included state-of-the-art legal tools. It is important to highlight that from the start the legal components played a crucial role in the goals achievements. This type of exchange is a mix of financial engineering coupled with sophisticated legal provisions as well as an exercise on persuasion about the feasibility of the actions proposed, all of which is directed towards market players.

Previous exchanges (Pakistan, Ukraine, and Ecuador) were not voluntary in one sense or in the other. As was already said, Uruguay's authorities faced the challenge of setting conditions through which all parties involved pursued a cooperative strategy during the exchange process. CAC inclusion assured that a cooperative game could be played in the future, if needed, without major disruptions either through a global exchange or on a bond by bond basis. This assured the prompt wipe out of potential risks of insolvency if a liquidity problem arose due to impaired payments flows.

According to our view, CAC inclusion is crucial to assuring voluntary creditors participation if problems arise. It is a close substitute to provisions applied to private debt in distress (Chapter 11), in order to find a less onerous solution avoiding bankruptcy (default) costs. The inclusion of the "aggregation" concept, as a way of assuring that a super majority could modify "reserve"²⁰ aspects" of the bond is an additional assurance that in a distressed situation all creditors will equally share the burden of a new exchange if the debtor situation deteriorates once again.

In other words, "aggregation" means that whilst individual creditors may have less control over their individual series, the higher aggregate threshold gives them greater protection, while lower thresholds for each class prevents other creditors "playing upon" individual issues. In the proposal, Uruguay's CAC voting thresholds were stringent and based on aggregate principal outstanding amount. For non-reserve modifications a vote representing 66 2/3 per cent was required. For reserve modifications was necessary either to achieve a vote of 75 per cent for each series or – aggregation criteria – 85 per cent for all bonds and 66 2/3 per cent of each series. In order to avoid the risk that the issuer could manage future votes,²¹ new bonds issued in contemplation of a vote and owned or controlled directly or indirectly by the issuer were disenfranchised to participate in a vote. This marked the first time that sovereign bonds included an "aggregation" clause. Also the total

²⁰ Reserve subjects are i) the money terms, sovereign immunity, governing law, jurisdiction, ranking and mandatory exchange.

²¹ Mexico's CAC included in a bond issued in March 2003 were criticized because left open the possibility that bonds held by the issuer could participate in a vote.

replacement of most of Uruguay's debt by a new class of securities points out an unusual opportunity to have aggregation immediately applied to a large share of the sovereign debt stock.

The Exit consent provisions were the other tool to give incentive to a cooperative behaviour in the exchange. In other words, to put in place some kind of penalties -disincentives- for maverick bondholders. Exit consents were previously used in the Ecuadorian exchange (February 2001) as a lever to induce bondholder's participation and penalize free riding.

Uruguay's Exit Consents in some sense were more aggressive than Ecuador's. They allowed, i) to carve out the waiver of sovereign immunity from New Bonds payments; ii) to delete the cross default and cross accelerations provisions; and iii) to remove listing requirements.

Under these new conditions, the old bonds became automatically subordinated to the New Bonds, becoming less liquid and de-categorized as a common supplier credit.

Exit consent provisions became effective if the exchange offer was completed and a 50 per cent voting threshold was achieved.

Other provisions

As a way of diluting the chances of those "hold outs" looking for the attachment of flow payments of the new bonds²², a trust indenture mechanism was introduced in substitution of the fiscal agent. In fact, money deposited in this entity to be paid to bondholders might be attached. The Trust Indenture mechanism surmounts this weakness due to the fact that this entity belongs to the bondholders' community as a whole, and in consequence is out of the reach of the country sphere. Therefore its assets are not attachable for third parties to pay "old bonds".

Additionally, the proposal included "regulatory incentives" to encourage participation of domestic financial institutions. In this regard, the

Superintendence of Banks indicated that the old bonds would become non-tradable securities due to the suspension of stock market quotations. As a result, the old bonds would become subject to a 100 per cent risk-weighting (instead of zero-risk weighting) in banks capital-adequacy ratios. In addition, when "old" bonds were used as collateral provisioning requirements would be higher and credits ceilings reduced.

On the other side, exchange houses and offshore banks will not be allowed to use the "old" bonds to constitute mandatory deposits at the Central Bank. Finally, the Central Bank declared that it would not accept old bonds as collateral for liquidity assistance, and a provisioning requirement higher than 50 per cent would be applied to for bonds held in bank's books rated "default" or "selective default", which is the rating expected for the "old bonds". The de-listing of the old bonds from the Montevideo Stock Exchange were addressed to provide incentive for the participation of Pension Funds, as these institutions are not allowed to hold unlisted instruments.

As a final comment, the Chilean regulatory authorities helped in the participation of two Chilean peso denominated bonds hold by Pension Funds in that country. In fact, under the Chilean regulatory framework, pension funds were not allowed to acquire speculative grade bonds. Since the new bonds would be graded as such, the Chilean authorities allowed the exchange by considering the new "bonds" as an "acquisition".

Conditions of the offer

In April 2003, Uruguay's total debt amounted to US\$10.7B. This was divided nearly equally between the private sector (55 per cent) and multilateral institutions (45 per cent) (See Table 1). The exchange consisted of three concurrent offers split according to the national jurisdiction under which the bonds had been issued. Eligible securities comprised: i) 46 domestically issued bonds and Treasury Bills, for an amount of \$1.6 billion; ii) 18 international bonds issued under foreign law, accounting for \$3.5 billion; and iii) one Samurai bond issued in Japan, accounting for about \$250 million. Domestic law bonds could be exchanged through a custodian or broker, or directly to the Central Bank. Foreign law bonds could be exchanged by submitting applications to a password protected

²² Recent episodes (Ellis Associates vs Peru, showed that flow payments were at the mercy of attachment from some class the bondholders (vulture funds) which profited holding old bonds, attaching flow payments, suing the debtor and finally forcing an agreement with the country. In this case the bonds were paid at face value

Internet site. The Samurai bonds terms were to be changed at a bondholders' meeting held in Tokyo.

The Samurai bond was the only class of bond which already included Collective Action Clauses (CAC). As a consequence, only this type of bond was exchanged using the provisions included in the contract. This was the first time that a sovereign debtor applied this rule in Japan²³. The conditions of the offer were quite stringent as a way to destimulate hold outs, showing the country's willingness to eliminate for once and for all, the constraints imposed by the service of the debt and get breathing space to regain GDP growth. This fact was a necessary condition to finding a way out of a very difficult situation that could degenerate quickly into an insolvency problem.

In such an endeavour, Uruguay completed the offer if the bonds presented to the exchange were: i) at least 90 per cent of the total eligible debt, and ii) at least 90 per cent of the total eligible debt maturing on or prior to 31 December 2008 (including the Samurai bond). This two-joint benchmark assured that the participation of the short-end of the curve was crucial to achieving the objectives.

In the case that the bond participation was less than 80 per cent, the country would not complete the offer. If participation was between 80-90 per cent, Uruguay reserved the right to accept the transaction depending on the composition of the bonds tendered.

The results of the debt exchange

The principal amount tendered was US\$5.15 billion, amounting to an overall participation of 92.9 per cent across all bond categories. Its participation breakdown was as follows:

- Domestic	98.7 per cent
- International	89.6 per cent
- Samurai solicitation ²⁴	100 per cent

(See table 2, page 75)

²³ Worldwide, this represents the third use of CAC's by sovereign in recent years, after Ukraine (2000) and Moldova (2002).

²⁴ At the bondholders' meeting of Samurai bonds, holders of 80 per cent bonds were represented (mostly by proxy). Over 99 per cent of the quorum casted votes in favor of amending the payments'

Bondholders' participation was exceptionally high by any standard and the debt alleviation provided was better than initially expected by the authorities. There was a broad participation – institutional, and retail, domestic and international. Domestic retail participation was pushed by strong actions by brokers and custodians to contact their clients. International bond participation was high on average, but the same variance in the participation among instruments took place, especially to a certain high degree of non-participation among certain types of bonds. U.S. dollar global bonds in participating rates were over ninety per cent. But, the euro denominated bonds had participation rates under eighty per cent. This was possible perhaps to a conjunction of facts; among them lower sophistication of retail and European bondholders lengthy post-launch registration procedures in Europe, and a lack of information among European bondholders about the characteristics of the exchange.

Brady bonds participation was low (60 per cent on average) and one bond (New Money bond issued in 1991) reached only 25 per cent, and as a result the exit consent did not become effective (see table 2). Several factors explained that. First, some banks held these notes valued at par since the original Brady deal. To participate in the exchange meant to mark the new bonds to market, causing significant accounting losses. Secondly, principal and interest payments (18 months) of Par Brady bonds were collateralised reducing the potential gains in participating in the exchange. Finally, the fact that these bonds were issued by the Central Bank, gave them the "implicit" assurance that monetary authorities are quite reluctant to default indebtedness, including bonds²⁵.

Net Present Value reduction by the deal was slightly higher for domestic than international bonds. In average, the reduction was around twenty per cent, using a rate of discount of sixteen per cent (closer to implied yields at

terms. Under the CAC, the remaining holders were bounded by the majority decision.

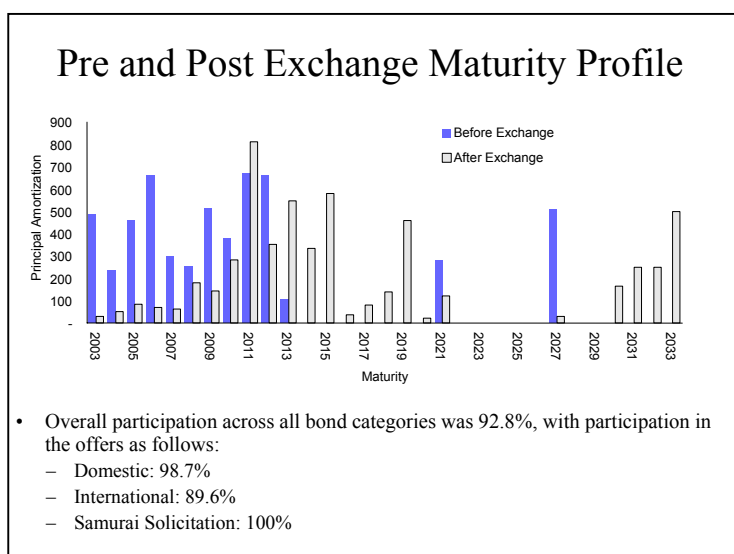
²⁵ In fact, the inclusion of Brady Bonds in the exchange was a risky action because its failure to participate could endanger the whole exchange, as a very high benchmark was set to go ahead with the deal. But, authorities were tempted by the fact that the exchange would liberate valuable collaterals (nearly 40 c in Brady Par Bonds) which helped to finance the deal.

the settlement date. Using the post-exchange discount rate (twelve per cent), the NPV reduction would be around thirteen per cent. Summing up, the NPV reduction was achieved by lengthening maturities at the average coupon of seven per cent, while market yields for Uruguay debt were much higher. Up front cash payments were relatively modest, and were mostly to pay

accrued interest on the old bonds. Also, they were utilized as a way to sweeten the participation of bondholders in the short segment of the curve. In total, cash payments at settlement amounted to US\$120 million, including \$31 million in upfront payment of principal and \$89 million in accrued interest on the old bonds exchanged.

The effects of the debt exchange results

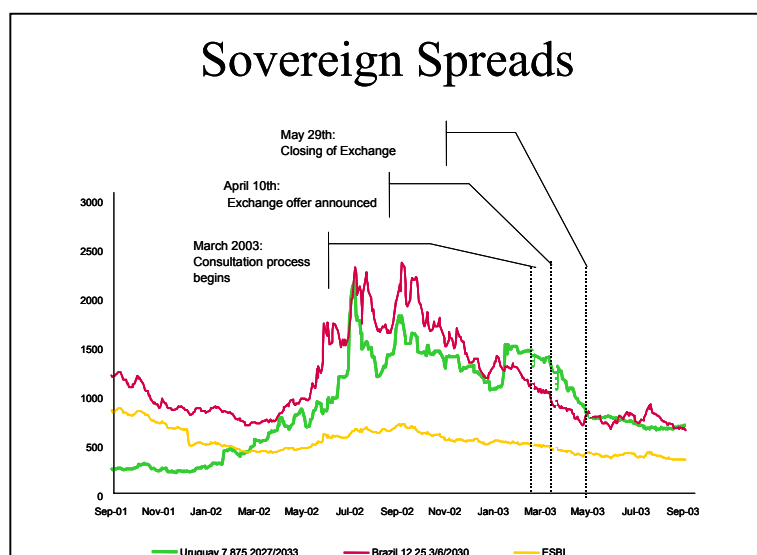
A successful debt exchange was a necessary condition to regaining growth. The exchange operation diminished the debt burden through an extension of flow amortizations, creating breathing room to all economic agents.



In average annual terms savings were tantamount to 5.1 per cent of GDP during 2003-2008. In order to achieve the virtuous cycle of more economic growth together with the improvement of debt sustainability, long run fiscal consolidation was needed. Debt sustainability dynamics simulations required that GDP grows on average three per cent annually and the primary fiscal surplus in average had to present at least the same level (3 per cent plus of GDP) up to year 2010.

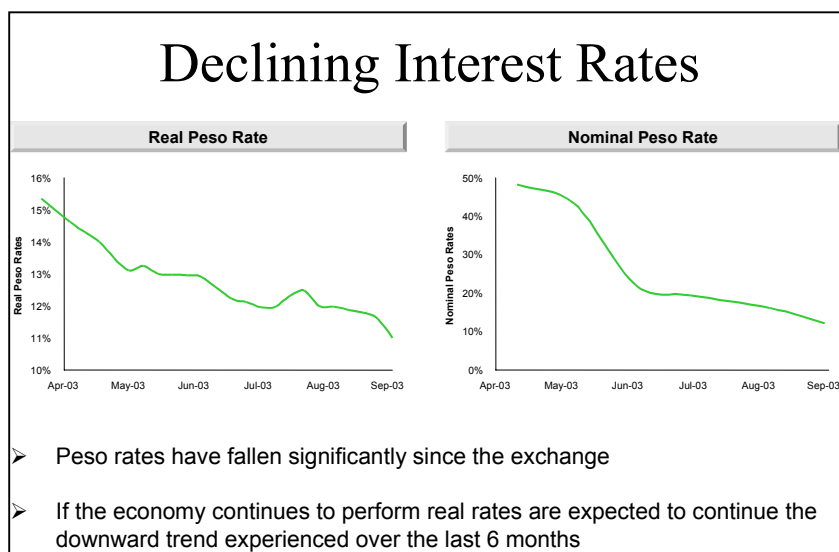
Those quite stringent conditions were achieved and surpassed during the second half of the 1980's, during a period

when the Uruguayan economy was overcoming the debt crisis of that decade, together with a sudden stop of international capital flows. In short, the projected scenario was not so good in the sense that the debt problem was fully solved through the exchange. Further actions to assure fiscal consolidation and growth policies were essential ingredients to achieving that goal.



After the exchange, some preliminary results were promissory. First, Uruguay's sovereign spreads tightened in a continuous pace, converging towards Brazilian spreads (see Figure i) which belonged to a two notch higher rated debt than Uruguay's (S&P B-, Moody's B3).

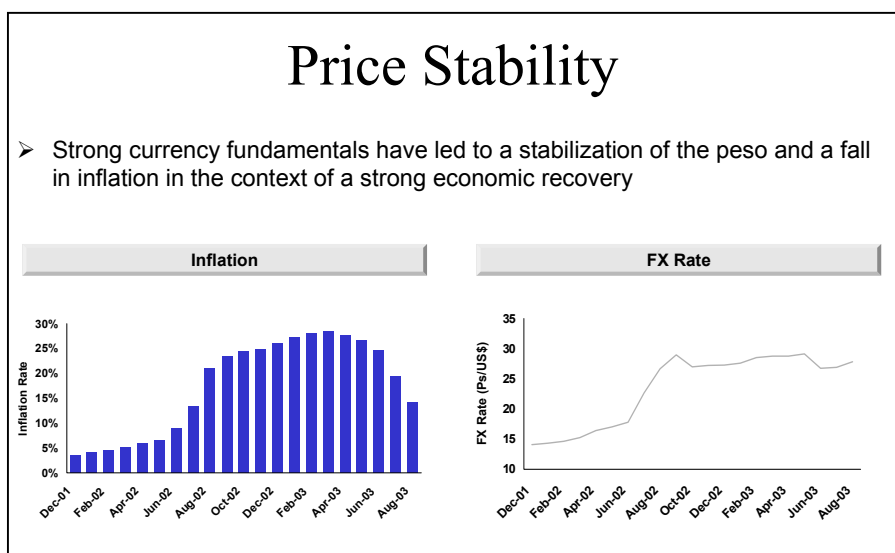
Second, domestic interest rates began to decline steadily since the exchange. In November 2003, its level is close to the pre-crisis figure (early 2002).



Thirdly, this fact is linked with real exchange rate behaviour. A steady melting down of the sharp currency devaluation overshooting took place and is continuing that trend. The nominal exchange rate quotation six months after the exchange (November 2003) is practically the same as a year ago, in spite of a pure float in place and an inflation rate close to 12 per cent.

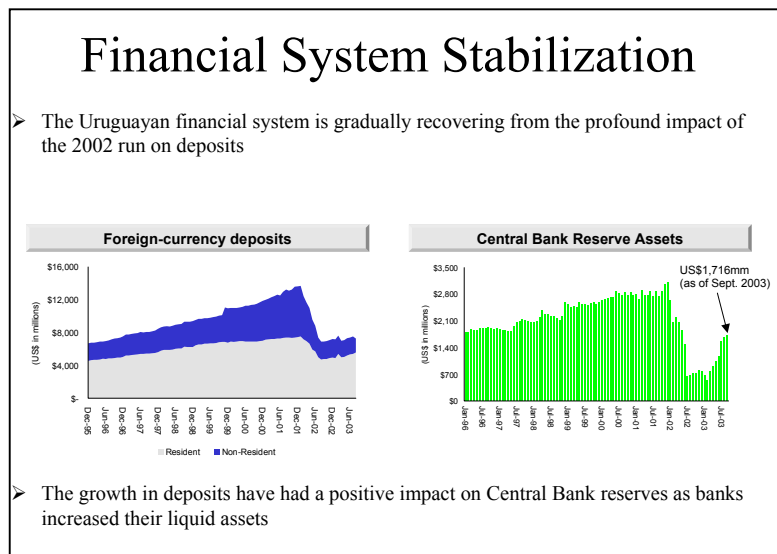
That outcome reinforces the debt sustainability dynamics, as the nominal GDP in dollars increases by the effect of the currency appreciation, fact that invigorates the Debt / GDP indicator.

Fourth, price stability is regained.



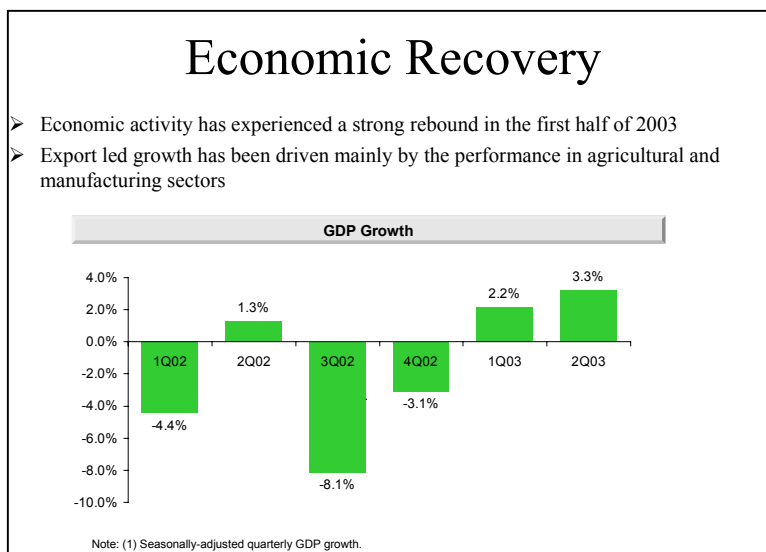
At the beginning of 2003, annual projected inflation was close to 20 per cent. At the end of the year, that figure is revised to be close to 11 per cent and for the next year around eight per cent.

Fifth, the trigger of the crisis – the financial sector destabilization – reversed course.



Bank deposit inflows continued, strengthening bank liquidity. Central Bank international reserves increased more than 1.2 billion dollars (11 per cent of GDP) between August 2002 – November 2003.

Finally, economic recovery is in full bloom.



The timid signals on economic growth detected in mid-2003, are confirmed through a robust growth trend (10 per cent plus for 2003). The economy is well positioned to catch up the benign international environment expanding exports. Without any doubt, the voluntary exchange helped to clear the way for such an outcome in two ways: first by providing breathing space to the economy and lightening the burden of the debt, and second, wiping the debt subject off the table.

The post-exchange market verdict

The market reaction was very favourable; surpassing most optimistic expectations Uruguay's tapped the international markets in October 2003, only five months after the exchange settlement. The size of the issue was 200 million dollars²⁶, bond maturity three years and currency in Uruguay pesos adjusted by CPI²⁷, a fact that is quite unique for most emerging markets issuers

²⁶ The issue was oversubscribed for an amount of 500 millions.

²⁷ consumer price index

in recent history. The yield paid was in line with the post-exchange markets quotations (10.3 per cent).

On top of these positive results, the ability to issue bonds nominated in local currency open the road towards “voluntary” de-dollarization of the debt.

Conclusions

The main conclusion is that market players are mature enough to understand the rules of the game in place when they invest in emerging markets. Risk and payments disruptions could be more frequent than in other markets. But rewards are much higher. In consequence, they are prone to accept mechanisms to disentangle unexpected difficult situations in collaboration with the debtor.

In consequence, the “statutory approach “ does not seem to be adequate for this kind of negotiated preventive solution, like the “voluntary exchange negotiated by Uruguay. Perhaps its role is suitable for the world of “unilateral defaults”.

The preventative approach to debt alleviation is a suitable alternative for countries, which realized it in time before it becomes a solvency problem. In this scenario voluntary debt exchanges seem to be more troublesome to achieve.

The candid dialogue with market players is essential for two reasons. First, it provides a rich feedback on how to improve the proposal, and most important of all, it generates an atmosphere of trust that is crucial to achieving the desired results.

The combination of CAC and Exit Consent works perfectly to catapult the deal. Other legal and regulatory provisions such as Trust Indentures help to immunize the exchange from risks of payments attachments, and disincentive potential hold-outs.

Finally, the market after the exchange does not show signals of strain against the country, which was obliged to ask for debt relief. Uruguay’s ability to tap the market at current post exchange yields five months after the exchange are the best proof that the “voluntary “ debt exchange was the best strategy available.

Table 1: Uruguay. Structure of Public Sector Debt as of end-2002¹

	U.S. dollar millions	Share of total debt		U.S. dollar millions	Share of total debt
Total	10,770				
Market Debt	5,737	53.3%			
			Currency composition		
International bonds	3,253	30.2%	U.S. dollars ²	7,664	71.2%
Domestic bonds	1,508	14.1%	Euros	443	4.1%
Domestic US dollar bonds	256	2.9%	Yen	253	2.4%
Domestic peso bills	109	1.0%	Pounds sterling	43	0.4%
UI-indexed bonds	178	1.7%	Chilean pesos	292	2.7%
Brady bonds	432	3.9%	Uruguayan pesos	288	2.7%
			SDRs	1,786	16.6%
Multilateral loans	4,494	41.7%			
			Residence of holder³		
IMF	1,786	16.5%	Total debt		
World Bank	718	6.7%	Nonresident	6,932	64.4%
IDB	1,949	18.0%	Resident	3,838	35.6%
Others	41	0.4%	<i>Of which: market debt</i>		
Bilateral loans	257	2.4%	Nonresident	2,528	44.1%
			Resident	3,209	55.9%
Others	282	2.6%			
			Interest rate composition		
			Fixed	4,622	42.9%
			Floating ⁴	5,677	52.7%
			Inflation-indexed	471	4.4%

Sources: Central Bank of Uruguay and Fund staff estimates

¹ Includes the central bank but excludes state banks from the definition of "public sector". Excludes deposit liabilities of the public sector.

² Assumes that all multilateral loans (apart from IMF), bilateral loans and "other" debt use in US dollars.

³ Assumes that all domestic securities are held by residents, unless reported as held in custody by domestic custodians for non-residents. Also assumes that one-third of the

⁴ Assumes that all multilateral, bilateral and "other" debt is floating.

Table 2: Uruguay - Participation in Debt Exchange, Bond-by-Bond

(In millions of U.S. dollars)

Bond	Maturity date	Coupon	Currency	Total exchanged	Maturity option	Liquidity option	Participation rate	Remaining hold-outs
<i>Total (including yen</i>				4981.9	1608.4	3373.6	92.5%	408.2
<i>Maturing up to 2008</i>				2436.5	1203.0	1233.5	93.5%	151.5
<i>External (excluding yen)</i>				3126.6	664.5	2462.1	98.2%	388.4
<i>Domestic (eligible bonds)</i>				1599.3	687.8	911.5	98.8%	19.8
International Bonds								
Global 2003	11/18/03	2.875	US\$	180.8	88.0	92.8	94.42%	10.7
Global 2006	9/26/06	8.375	US\$	95.1	60.8	34.4	97.59%	2.4
Global 2008	4/7/08	7	US\$	228.7	63.3	165.3	95.42%	11.0
Global 2009	5/4/09	7.25	US\$	225.3	39.0	186.3	93.31%	16.1
Global 2010	6/22/10	8.75	US\$	264.6	66.7	197.9	96.63%	9.2
Global 2012	1/20/12	7.625	US\$	404.2	68.5	335.7	98.58%	5.8
Global 2027	7/15/27	7.875	US\$	476.9	0.0	476.9	93.50%	33.1
Euro 2005	9/26/05	7	euro	193.7	107.8	85.9	74.23%	67.3
Euro 2011	6/28/11	7	euro	167.3	135.3	32.0	71.58%	66.4
Global 2009	3/25/09	7.875	US\$	245.9	25.0	220.9	99.04%	2.4
Yen 2006	3/14/06	2.5	JPY	256.1	256.1	0.0	100.00%	0.0
CLP 2007	5/29/07	7	CLP07	124.5	0.0	124.5	100.00%	0.0
CLP 2011	3/15/11	6.375	CLP11	132.7	2.2	130.5	100.00%	0.0
NMB	2/19/06	libor	US\$	6.7	1.7	5.0	25.48%	19.6
DCB	2/19/07	libor	US\$	43.6	6.1	37.5	79.29%	11.4
GB DCB	2/19/07	GBPlibor	GBP	25.8	0.0	25.8	66.03%	13.3
Par A	2/19/21	6.75	US\$	138.1	0.0	138.1	55.20%	112.1
Par B	3/21/21	6.75	US\$	22.8	0.0	22.8	74.78%	7.7
Float 2007	4/26/07	libor	US\$	150.0	0.0	150.0	100.00%	0.0
Domestic Bonds								
Float 06/03 s.32	6/15/2003	libor	US\$	37.8	32.9	4.9	96.32%	1.4
Float 09/03 s.33	9/22/2003	libor	US\$	36.6	13.9	22.6	96.44%	1.4
Float 12/03 s.34	12/27/2003	libor	US\$	39.0	15.9	23.1	97.26%	1.1
Float 03/04 s.35	3/22/2004	libor	US\$	37.4	13.5	23.9	92.61%	3.0
Float 06/04 s.36	6/27/2004	libor	US\$	24.8	3.8	21.0	97.37%	0.7
Float 09/04 s.37	9/27/2004	libor	US\$	28.9	5.6	23.3	97.55%	0.7
Float 11/04 s.38	11/7/2004	libor	US\$	12.0	3.1	8.9	98.68%	0.2
Float 12/04 s.39	12/20/2004	libor	US\$	28.6	4.2	24.4	98.23%	0.5
Float 03/05 s.40	3/27/2005	libor	US\$	34.7	3.3	31.4	99.21%	0.3
Float 06/05 s.41	6/23/2005	libor	US\$	52.6	11.0	41.7	97.69%	1.2
Float 09/05 s.42	9/29/2005	libor	US\$	31.1	9.4	21.7	99.51%	0.2
Float 12/05 s.43	12/22/2005	libor	US\$	25.4	3.7	21.7	99.09%	0.2
Float 04/06 s.44	4/8/2006	libor	US\$	35.0	8.5	26.5	99.60%	0.1
Float 06/06 s.45	6/12/2006	libor	US\$	50.1	7.5	42.6	98.83%	0.6
Float 08/06 s.46	8/20/2006	libor	US\$	128.1	10.7	117.4	99.21%	1.0
Float 12/06 s.47	12/2/2006	libor	US\$	48.1	7.2	40.9	98.87%	0.6
UGB 7 5/8 (fixed s.02)	3/5/2007	7.625	US\$	108.2	98.0	10.2	99.74%	0.3
Float 5/09 s.48	5/15/2009	libor	US\$	31.8	2.5	29.2	98.19%	0.6
Float 02/10 s.52	2/25/2010	libor	US\$	82.4	4.1	78.3	99.43%	0.5
UGB 8 (fixed s.03)	2/25/2010	8	US\$	46.0	40.6	5.4	99.66%	0.2
Float 03/11 s.53	3/23/2011	libor	US\$	10.6	3.4	7.2	97.24%	0.3
Float 05/13 s.54	5/29/13	libor	US\$	105.4	0.0	105.4	100.00%	0.0
UGB 7 1/2 (fixed s.30)	3/23/2011	7.5	US\$	297.9	244.4	53.5	99.57%	1.3
UGB 9 3/4 (fixed s.31)	3/28/2012	9.75	US\$	39.9	21.9	17.9	99.70%	0.1
Float 06/12 s.49	6/30/2012	libor	US\$	47.6	3.2	44.4	99.10%	0.4
Float 08/12 s.50	8/15/2012	libor	US\$	28.4	2.0	26.4	99.94%	0.0
Float 08/12 s.51	9/22/2012	libor	US\$	33.9	2.7	31.2	98.93%	0.4
UGB 7 (fixed s.29)	12/16/2005	7.5	US\$	25.0	25.0	0.0	100.00%	0.0

Source : Central Bank of Uruguay

The present state of the discussion on restructuring sovereign debts: which specific sovereign insolvency procedure?

KUNIBERT RAFFER

Four proposals regarding the debt crisis are presently on the table: Collective Action Clauses (CACs), a voluntary Code of Good Conduct for debt re-negotiation proposed by the Banque de France, and two models of sovereign insolvency. The latter are the IMF's Sovereign Debt Restructuring Mechanism (SDRM) and my model emulating the basic principles of US municipal insolvency, called Chapter 9 in the US, which was taken up by non-governmental organizations (NGOs), most notably the Jubilee movement. To avoid the word insolvency many NGOs prefer to call it the Fair Transparent Arbitration Process (FTAP). Often it is alleged that the former two proposals contradict or preclude sovereign insolvency. This is fundamentally wrong. Helping creditors to organise, to be able to act more quickly and efficiently, CACs are a helpful component of any insolvency rather than a contradiction to it. The proper functioning of fair insolvency procedures depends on the full ability of parties to defend their legal and economic interests. Creditors must be able to act efficiently – whatever helps them to do so is welcome. The Code of Good Conduct demands fair representation of creditors, an expeditious and co-operative process, fair burden sharing, preserving the debtor's financial situation, reaching debt sustainability as soon as possible, also arbitration – briefly, many elements of Chapter 9 insolvency.

Whenever CACs or the Code should be able to prevent formal insolvency procedures this would be great. The very existence of an insolvency mechanism would be helpful in making these options more efficient. Sovereign insolvency is a solution of last resort, an emergency exit necessary and useful, but better avoided. Any sane interceptor pilot insists on having an ejector seat and on making sure it works perfectly. But no sane pilot uses it for ending routine flights, or if (s)he can land the plane. Like an emergency seat, insolvency is not an easy way out. It is a thorny choice, not least to the debtor.

By contrast, the two models of sovereign insolvency, the IMF's SDRM and my Chapter 9 based debt arbitration do contradict each other.

This paper will list the similarities of these two models, the concerns about the SDRM, and the specific differences of an international Chapter 9.

Similarities of Chapter 9 and the SDRM

- *Recognising the necessity of sovereign insolvency*: Eventually recognising the need for an orderly framework to determine which part of their debts insolvent debtors can actually pay was quite a break away from the IMF's traditional debt management. So was Krueger's (2001, p.8) correct statement that this would reduce restructuring costs. There is full agreement between both alternatives (cf. Raffer 1989, 1990, 2002).
- *Verification*: After denying the need and even the possibility of registering and assessing debts in the way usual in any domestic insolvency procedure, the IMF (2002, p.68) meanwhile demands specific checks regarding "for example, the authority of an official to borrow on behalf of the debtor", echoing what I, (Raffer 1990, p.309) had demanded, nearly in my own words (Raffer 1993a, p.68).
- *Stay-standstill*: The idea that the debtor government's demand for an insolvency procedure should automatically preclude further lawsuits and legal enforcement by creditors during insolvency procedures (Raffer 1990) was taken up by the IMF. Nevertheless, the Fund's position remains unclear. In various documents the IMF has proposed quite different things ranging from an "implicit support to a temporary standstill" by the IMF (Krueger 2001, p.5) or the Fund's endorsing of a stay to variations allowing creditors to vote on it with or without the "hotchpot" rule. One may, however, say that stays are at least possible in both models – a similarity already including differences.
- *(Private) Creditors Fully Subject to Arbitration*: Raffer (1989, 1990, 2002) has always been clear that all creditors should be

subject to arbitration. The IMF exempts multilateral institutions from the SDRM, remaining evasive about Paris Club members that are also its main shareholders. Their claims may or may not be covered by the SDRM. All IMF documents, though, are clear that private creditors would be fully subject to arbitration – both a similarity and a difference to my model where private and public, including multilateral – creditors would be treated equally.

Concerns about the SDRM

Understandably, the SDRM immediately raised many justified concerns. First, it would have meant no real change in debt management. The IMF would continue to take the important decisions as it has done so far. Krueger (2002, p.4) puts it in a nutshell: "The Fund would only influence the process as it does now, through its normal lending decisions". Considering that the first adjustment measures were implemented in Sub-Saharan Africa some thirty years ago, and the Fund's success there as well as in other debtor countries, this is hardly encouraging.

There is concern about the strong institutional self-interest behind the SDRM, a strong increase of the Fund's importance. The IMF's Board determines sustainability – and thus automatically the amount of necessary debt reductions – as well as the debtor's economic policies. One variant gives the IMF the right to endorse the standstill. The whole SDRM procedure – down to absolutely minor details – is to become part of the Fund's Articles of Agreement. The "new judicial organ" (now called the Sovereign Debt Dispute Resolution Forum, SDDRF), the selection criteria for its members, or even classification rules for the many creditor classes the IMF imagines would all become enshrined into the Fund's statute. The Fund proposed to help debtors to choose which debts to include into their SDRM-procedures. The SDDRF would be an IMF organ unable to challenge the Board's decisions. This "statutory approach" would firmly and officially install the IMF as the overlord of sovereign debt relief. Establishing the sole mandate for the Fund it would end the long turf war with the International Bank for Reconstruction and Development (IBRD).

A class of Funds known as "vulture funds" have served as the argument why enshrining the SDRM into the Articles of Agreement should be necessary. Its rules should have the force of law universally. Rather than getting every country to amend its domestic bankruptcy law, amending the IMF's Articles was recommended in order to oblige all member states to change their domestic laws in a way that opposition of creditor minorities can be overruled. This argument in favour of the statutory approach is altogether flawed. Not all countries and territories are IMF members. The Cayman Islands, for example, are not a member of the IMF but enjoy enough autonomy to offer themselves as a place for creditors shopping for jurisdictions where unanimity is not required. They have routinely been used as an argument against the Tobin Tax vehemently opposed by the IMF. However, if this tax cannot be introduced because entities such as the Cayman Islands would preclude universal acceptance and thus implementation, the same argument holds logically for the SDRM.

The present *de facto* preferential creditor status of international financial institutions (IFIs) would be legalised. The Fund and multilateral institutions would remain exempt from financial accountability for their own decisions. Even if their staff causes damages because of grave negligence or disregard to minimum professional standards, IFIs insist on full repayment with interest, gaining financially from their own errors and negligence: "IFI-flops create IFI-jobs" (Raffer 1993b, p.158). Prolonged and aggravated crises increase their importance. An institutional self-interest in crises is built into the present system. While private creditors having to reduce claims feel the sting of the market mechanism, IFIs can increase their exposure, knowing that they will be protected. At present, new loans necessary to repair damages done by prior loans increase IFI-income. This perverted economic incentive system – absolutely irreconcilable with the market mechanism – would be perpetuated and reinforced by the SDRM. Recalling that the statutes of all multilateral development banks request them to reduce their claims if necessary – and the EBRD actually recognises losses – this would be a huge step backwards. It would also fall behind the standards of the HIPC Initiatives that broke the taboo of debt reductions by IFIs some years ago.

This attempt to save multilateral claims makes the IMF's assertion that the SDRM would be necessary to "bail-in" the private sector look very peculiar. As quite a few Miyazawa-Brady deals or the demand for parallel treatment by the Paris Club document, the private sector has already reduced claims – 35 per cent off in Mexico or 45 per cent in Ecuador cannot but be called generous. On the other hand, there is definitely a need for bailing in the international public sector – not least for economic reasons – rather than for discriminating private creditors both financially and by such misleading formulations.

Specificities of Chapter 9 based debt arbitration

The elements²⁸ of my model that differ fundamentally from the SDRM are:

Respecting the Rule of Law

It is a sad feature of traditional debt management and the SDRM that some creditors take the important decisions. Public creditors have been judge, jury, experts, bailiff, occasionally even the debtor's lawyer, all in one. This is unfair to debtors and other creditors. As the record shows, it has also been unsuccessful. By contrast, international Chapter 9 procedures would be chaired by neutral *ad hoc* entities, by panels established by creditors and the debtor, as traditional practice in international law. Arbitrators would have to mediate between the parties, chair and support negotiations by advice, provide adequate possibilities to be heard for the affected population, and, if necessary, decide. In a domestic Chapter 9 case the affected population has a right to be heard. Internationally, this would have to be exercised by representation. Trade unions, entrepreneurial associations, religious or non-religious NGOs, or international organisations such as UNICEF could represent the debtor country's population. Depending on the country, for example, Christian organisations in Latin America or Muslim organisations in Muslim countries, should be organisations formally representing the population.

This really neutral entity – neither an organ of any creditor or debtor – would also give a greater say to the parties, creditors (except the IMF) and the debtor, than the SDRM. Neutral

arbitration must, of course, be applied to all insolvent debtors, also to present HIPC's whose debt reductions are still decided by public creditors violating the very fundament of the Rule of Law.

Treating the Problem of Sovereignty

Chapter 9 is the only procedure protecting governmental powers, and thus applicable to sovereigns.

The concept of sovereignty does not contain anything more than what paragraph 904 protects in the case of US municipalities. The court's jurisdiction depends on the municipality's volition, beyond which it cannot be extended, similar to the jurisdiction of international arbitrators. Unlike in other bankruptcy procedures liquidation of the debtor or receivership are not possible. Change of "management" of US municipalities (i.e. removing elected officials) by courts or creditors is not possible – nor should it be in the case of sovereigns. On the other hand, any insolvent debtor is economically under pressure to solve the debt problem and to regain normal access to capital markets. This forces debtors to offer realistic terms to creditors. US courts only confirm plans that are also in the best interest of creditors. So would the arbitration panel in my model.

Fairness

The SDRM is unfair to nearly anyone but the IMF. By contrast three elements of my model make it a fair procedure:

1) *Inter-creditor equity*: All debts, including multilateral claims, must be treated equally. Multilateral development banks should finally obey their own statutes. Other creditors would no longer have to pay for the consequences of wrong or negligent decisions by multilateral institutions. The market mechanism must be brought to IFIs, including the IMF, by subjecting them to financial accountability in the same way consultants already are (cf. Raffer 1993b).

2) *Debtor protection*: insolvency solves a conflict between two fundamental legal principles: the right of creditors to stipulated payments and the human right recognised by all civilised legal systems that one must not be forced to fulfil contracts (regarding loans or others) if that causes inhumane distress, endangers life or health, or violates human dignity. Although claims are recognised as legitimate, insolvency

²⁸ For further details refer to:
<http://mailbox.univie.ac.at/~rafferk5>:

exempts resources from being seized by *bona fide* creditors. Debtors – unless they are developing countries – cannot be forced to starve their children to pay more. Human rights and human dignity enjoy unconditional priority, even though insolvency only deals with claims based on solid and proper legal foundations. *A fortiori* this is valid for less well founded claims. Like with US municipalities, resources necessary to finance minimum standards of basic health, primary education or a fresh economic start must be exempt. Civil society meanwhile participates officially in designing poverty reduction strategies in HIPCs. The principle of participation by affected people is part of present debt management, no longer something totally new. In Argentina, for example, civil society "participated" in the streets by banging pots. Formal representation is a better way than that.

None of the IMF's SDRM-documents so far contains the smallest hint of debtor protection, falling behind the standards HIPC II already established. Private creditors accept that there are politically uncollectable debts, which describes the principle of exempt resources in other words. Unlike the Fund they have repeatedly granted substantial debt reductions. Speaking of "bailing-in" the private sector is misleading and absurd.

A transparently managed fund financed by the debtor in domestic currency and monitored by an international board or advisory council would use exempt resources. Legally an entity of its own, checks and discussions would not concern the government's budget.

3) *Best Interest of Creditors*: as in the US the outcome of any internationalised insolvency procedure must also be in the best interest of creditors. The important point of fairness apart, no biased mechanism would be generally accepted, and rightly so. For a sovereign wishing to have new access to credit markets the way the debt overhang was dealt with is critical. If creditors feel that they have been treated fairly, they are likely to be as willing to provide new loans for economically promising projects in the future as creditors usually are after corporate insolvencies.

Sustainability

It emerges from transparent negotiations. Having all the facts on the table would practically restrict the panel's decisions to breaking

deadlocks affecting minor sums. Unlike sustainability estimates of the IMF in the past (usually based on over optimistic projections), the result – based on all relevant arguments – would be stabler.

Speed

Chapter 9-based debt arbitration adapts functioning national and international procedures. It could be implemented immediately if and when important creditors, for example, the G7 agree. Without or against them neither the SDRM nor Chapter 9 could be implemented. No new institution would be created. Panels would dissolve once they would have served their purpose. They could be asked to reconvene if disagreements should emerge later on. As insolvency procedures should, and hopefully will, remain exceptional in the future a standing institution would soon be severely underemployed.

Stabilising the Financial Architecture

The mere existence of sovereign insolvency would stabilise financial markets because the wrong assumption that countries will eventually always repay, on which the lending spree of the 1970s was based, would no longer be upheld. But the introduction of an international Chapter 9 should also be used as an opportunity for stabilising regulatory changes. Regulatory norms unnecessarily harassing creditors (creating so-called legal risk) should be changed. Most important, globalising the tax-deductibility of loan loss reserves as presently practised in Western-European countries would be a cheap and efficient built-in stabiliser for the financial architecture. The problems money centre banks faced in the early 1980s could be avoided.

Concluding remarks

The rejection of the SDRM during the 2003 Spring Meeting by the US and some emerging markets precluded the introduction of an unfair, self-serving, and inefficient system. But the search for a viable solution is not over. The IMF will go on propagating its model, and the discussion will erupt with the next big crisis if not earlier. Therefore, both creditors and debtors, especially those opposing the SDRM, should study alternatives.

There is a strong and convincing case for one specific type of insolvency appropriate for sovereign debtors, an arbitration process based on the principles of US Chapter 9. Unlike the SDRM it could be implemented quickly and it

would be fair to all concerned, avoiding the unnecessary costs for debtors and the international community, which Krueger rightly decried.

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PART VI

SELECTED ISSUES IN DEBT STATISTICS REPORTING

**Selected issues in debt statistics reporting:
summary of panel discussion**

Moderated by: Mr. Neil Patterson, Statistics Department, International Monetary Fund (IMF)

Panellists: Mr. Rainer Widera, Head of International Financial Statistics, Bank for International Settlements (BIS)
Mr. Bostjan Plesec, Head of Statistics and Analysis, Ministry of Finance, Slovenia
Ms. Punam Chuhan, Lead Economist, Global Monitoring Secretariat, World Bank
Mr. Mark Allen, Audit Manager, United Kingdom National Audit Office
Mr. Fred Ruhakana, Programme Officer, Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI)

Selected issues in debt statistics reporting

The panellists presented the current state of affairs in the domain of debt reporting. The catalyst for revising debt statistics reporting was the Asian financial crisis of 1997, which revealed limitations in the existing debtor data, particularly with regard to short-term external debt. The presentations covered the following issues:

- The origin and coverage of BIS international financial statistics and improvements in data;
- The “accrual principle”: the case of Slovenia;
- Selected issues in World Bank debt statistics reporting;
- The Public Debt Committee of the International Organization of Supreme Audit Institutions (INTOSAI) and its role;
- Debt recording and statistics in highly indebted poor countries (HIPCs).

Selected issues in debt statistics recording

NEIL PATTERSON

The title of this session is “selected issues in debt statistics recording”. The key word in that title is **statistics**; we now move from the discussion of important developments in debt, and possible responses, to aspects of the essential task of measuring and monitoring debt.

In recent years, two publications have been produced that provide internationally agreed guidelines for the compilation of debt statistics. The first, which focuses on external debt, is the inter-agency *External Debt Statistics: A Guide for Compilers and Users (External Debt Guide)*. This book was published in final hardcopy form only a few months ago, although a “final draft” has been available since late 2001. The second is the IMF’s *Government Finance Statistics Manual*, which was published in 2001.

The first of these publications, the *External Debt Guide*, was developed in response to the financial crises of the late 1990s. As you know, these crises highlighted the importance of good economic data, and particularly external debt data. The lack, and uncertainty over the quality, of information on external debt in some instances added to the problems. This led to requests from high-level groups for improved external debt data.

As you also may know, the Inter-Agency Task Force on Finance Statistics, was set up to see what could be done at the international level. This Task Force, chaired by the IMF, included eight other agencies with an interest in coordinating their activities in external debt statistics. As well as the IMF, the Task Force participants included the Bank for International Settlements, the Commonwealth Secretariat, the European Central Bank, the Statistical Office of the European Communities (Eurostat), the Organisation for Economic Co-operation and Development, the Paris Club Secretariat, UNCTAD and the World Bank. These agencies saw a need to update the international standards for the measurement of external debt statistics. The previous standards, the old Grey Book, were written in 1988 and are now not as relevant as they were then not least because new international standards have been developed for balance of payments and national accounts statistics, while pri-

vate sector flows have increased enormously, and new financial instruments are being used. So, by means of a superb collaborative effort among the agencies, and widespread international consultation of the various drafts, the Task Force prepared the new *External Debt Guide*.

One feature of the new *External Debt Guide* is that it recognizes the need for statisticians and debt compilers to be as efficient and cost effective as possible. So while seeking to address policy needs, it derives its standards from the system of national accounts and balance-of-payments methodology. Adopting such an approach means that the burden can be reduced upon the providers and compilers of data because each series needs to be collected only once. Cooperation between domestic agencies – the debt management office, the central bank, and the national statistical agency – can be maximized.

Another aspect of the new *External Debt Guide* is the substantial program of training that the various agencies have set in place to help countries to implement its recommendations.

First, the IMF has organized, with assistance from the inter-agency partners, seminars to promote and train national statisticians and debt managers about the new *Guide*. The IMF started in 2000 through early 2002 with seven regional seminars mainly aimed at the more senior staff – in all cases it invited a representative group of statisticians from central banks and national statistical agencies, and staff from finance ministries and national debt offices. UNCTAD was invariably involved to present the debt management perspective. And then, again in collaboration with UNCTAD and other agencies, the IMF commenced in 2002 on longer, more technical courses for statisticians and debt managers. We have conducted these more technical courses on a regional basis in Eastern Europe, Asia, Latin America, and Africa and another course in Eastern Europe is imminent. Regrettably a promised course for Middle Eastern compilers was rejected by the potential host agency, so we need to work on that one. Similarly, the IMF has participated in various UNCTAD seminars and conferences, including this one. And, as a major

consequence, 52 of the 53 industrialized and developing country subscribers to the Special Data Dissemination Standard had commenced, by end September 2003, disseminating quarterly external debt data in the new format of the *External Debt Guide*.

Moreover, with the Monterey Consensus we learned what we already knew, but it was good to have the matter reinforced at a high level, that debt data generally, including domestic debt data, were critically important. We have heard more in the last two days. The international focus is turning now more and more to public sector debt, both domestic and external. A recent issue of the Fund's World Economic Outlook, recognizing this interest, discussed the need to also enhance data on public sector debt.

The second of the new publications, the IMF's *Government Finance Statistics Manual*, includes, among other information, guidelines on the compilation of balance sheet data for the government. These guidelines include advice on the compilation of government debt items. The guidelines on government debt are generally consistent with the *External Debt Guide*. But, for purposes of debt analysis, these guidelines are less developed than those of the *External Debt Guide*.

Now, to turn to the title of the panel discussion, I will mention the advice provided in these publications on selected issues in debt recording. It was suggested that I might touch on the following:

- Valuation of debt
- Inclusion of interest costs as they accrue
- Treatment of financial leases
- The concept of net external debt
- Contingencies

I will describe, very briefly, what the guidelines for each of these issues are:

Valuation of debt (*External Debt Guide*, paragraphs 2.31–2.49)

The *External Debt Guide* recommends that debt instruments are valued at the reference date at nominal value, and for traded debt instrument (i.e. mainly securities) at market value as well.

The **nominal value** is a measure of the amount, at any moment in time, the debtor actually owes to the creditor. It is typically established with reference to the terms of a contract between the debtor and creditor. Conceptually, it can be calculated by discounting future interest and principal payments at the existing contractual interest rate.

The **market value** of a traded debt instrument is determined by the prevailing market price, which, as the best indication of the value that economic agents currently attribute to specific economic claims, provides a measure of the opportunity cost of both the debtor and creditor. For the debtor, it is the amount at which the debt could be repurchased.

In various ratios of external sustainability – for example, reserves to external debt – nominal value is regarded as the desirable measure. The market value of traded instruments is required, *inter alia*, for the calculation of comparable and interrelatable balance of payments, international investment position, and national accounts statistics.

Interest costs that have accrued and are not yet payable (*External Debt Guide*, paragraphs 2.25–2.28)

The *External Debt Guide* recommends that interest costs that have accrued and are not yet payable, at the reference period, be included in the value of the underlying instruments.

This recommendation – that interest costs accrue continuously on debt instruments, thus matching the cost of capital with the provision of capital – is consistent with the approach taken in related international accounting standards and in commercial practice.

Treatment of financial leases (*External Debt Guide*, paragraph 3.33, and appendix 1 (part 2))

The *External Debt Guide* treats financial leases in the same way as the 1988 Grey Book. A debt liability (a loan) is imputed equal to the value of the good being leased, and the loan is repaid through the payment of rentals (which comprise both interest and principal elements) and any residual payment (or return of the good) at the end of the contract.

Net external debt (*External Debt Guide*, paragraphs 1.10, 7.44–7.47)

The *External Debt Guide* advises on additional accounting principles to assist in compiling data series of analytic use in understanding the gross external debt position.

One such series is the net external debt position – gross external debt (the key feature of this *Guide*) less external assets in the form of debt instruments. For economies with substantial external assets, and especially those whose private sector is active in international financial markets, this concept is particularly relevant in assessing the sustainability of the external debt position.

Contingencies (*External Debt Guide*, paragraph 2.10, and chapter 9)

Contingent liabilities are not included in the definitions of external debt. These are arrangements under which one or more conditions must be fulfilled before an actual (or current) liability occurs. Nevertheless, from the viewpoint of long standing debt sustainability, there is considerable interest in the potential impact of contingent liabilities on an economy or on particular sectors. For instance, the amount of external debt liabilities that an economy potentially faces may be greater than is evident from the published external debt data if cross-border

guarantees have been given. The *External Debt Guide* encourages countries to set up and monitor data on contingent liabilities.

Explicit contingent liabilities that are contractual financial arrangements are obviously easier to identify and monitor than implicit contingent liabilities – those that would be recognized after an event takes place. Valuation issues exist. Comprehensive standards are still evolving.

I was very attracted to Mr. Foncerrada's point about debt management being a process. This reminded me of the work of the IMF's Statistics Department on its Data Quality Assessment Framework. This framework, which draws upon statistical best practices in many countries, recognizes that data quality is a multi-faceted process that focuses not just on accuracy and reliability, but on the quality of the institution that produces the data, and on aspects of producing statistics that include how useful the data are to users and how adequate are the dissemination arrangements. The institutional issues – such as the institutional and legal framework, the adequacy of resources, and the transparency of operations – are fundamental.

I understand that UNCTAD sees parallels between the quality of statistics and the quality of debt management, and will incorporate similar elements in its training programs for debt managers.

External debt statistics from the BIS perspective

RAINER WIDERA

Origin and coverage of BIS international financial statistics as an indicator of external debt

The origin of the use of Bank for International Settlements (BIS) financial statistics for monitoring external debt goes back to the Asian financial crisis in 1997. This crisis revealed important deficiencies in the monitoring of external debt, in particular the short-term component of it which is often the most important and also most volatile component of countries' external debt obligations.

At the time of the Asian crisis, comprehensive and timely information on external debt was not readily available from the majority of debtor countries themselves. As a result, four major international organisations, the Bank for International Settlements, the International Monetary Fund, the Organisation for Economic Co-operation and Development and the World Bank teamed up to produce from creditor and market sources a new set of data on major components of external debt for all developing countries. The new statistics were published for the first time in March 1999. To speed up the dissemination of data, it was decided to publish the new statistics on the websites of the four organisations only. As the so-called joint BIS-IMF-OECD-World Bank statistics on external debt are not meant to replace any external debt statistics from the debtor side, it continues to remain the obligation of each individual debtor country to provide a comprehensive and timely measure of all its external obligations itself.

The BIS provides from its international financial statistics three main building blocks for joint external debt statistics: (1) data on cross-border loans and deposits from a quarterly central bank survey of banks in 36 major financial centres (locational banking data); (2) data on short-term international claims from a quarterly central bank survey of 27 major national banking systems (consolidated banking data); and (3) data on the issuance of debt securities targeted to foreign investors that are collected from market sources (international debt securities data).

It should be noted that the collection of BIS international financial statistics goes back to the mid-1960s in the case of data on bank borrowing and the mid-1980s in the case of data on securities issuance and that these statistics were created with objectives not directly related to information on external debt. In the case of banking statistics, the aim was to provide a measure of the role of banks and financial centres in intermediating international capital flows and information on the country risk exposure of national banking systems. In the case of securities statistics, the aim was to assess the relative use of capital markets as opposed to banks in financial intermediation and together with pricing data to assess supply and demand factors in asset markets and potential financial strains.

Recent improvements in BIS data to increase their use for external debt statistics

Since the inception of the joint external debt statistics in March 1999, the BIS has implemented a number of improvements in its international financial statistics to increase their use for external debt monitoring. These improvements mainly relate to BIS international banking statistics and cover the following:

- Increase of countries reporting locational banking data from 24 to 36.
- Increase of countries reporting consolidated banking data from 18 to 27.

As a result, coverage of BIS data on external bank borrowing has increased significantly and can now be considered as nearly complete. In addition, there has been a substantial increase in the number of countries that provide separate data for loans and securities in the BIS international banking statistics. Consequently, the double-counting of external debt in the form of securities issuance as derived from the BIS locational banking statistics and the BIS international debt securities statistics has substantially been reduced.

Main conceptual differences between BIS creditor or market and national debtor data

When using BIS international financial data for measuring external bank borrowing and foreign holdings of debt securities issued by residents, one needs to take into account that the BIS creditor and market data will deviate from national debtor data for a number of conceptual reasons. These mainly comprise differences in coverage, valuation and type of maturity breakdown of the data.

Regarding coverage, BIS creditor data overstating external debt as BIS banking data include local claims of offices of foreign banks in foreign currency that might be locally funded and therefore do not represent external liabilities. In addition, BIS creditor data overstate short-term external debt to the extent that short-term foreign holdings of debt securities issued by residents are indistinguishably included in both the BIS data on short-term external bank borrowing (due to a lack of an instrument breakdown in the consolidated banking statistics and a lack of a maturity breakdown in the locational banking statistics) and BIS data on the issuance of international securities with a remaining short-term maturity.

Furthermore, BIS data collected from market sources overstate external debt to the extent that securities issued by residents in the international markets are counted in full as external debt although part of them might have been purchased by residents of the debtor country. Similarly, BIS market data understate external debt to the extent that securities issued by residents in the domestic market are not at all included in the BIS measure of external debt although part of them might have been purchased by non-residents.

On the other hand, on the debtor side, national compilers of external debt face similar problems in compiling comprehensive data on foreign holdings of securities issued by residents. This is due to the fact that securities are often issued as bearer bonds, which makes it difficult to keep track of the current holder of any security.

Regarding valuation, BIS creditor data are mainly based on market values in case of securities and traded loans while BIS market and na-

tional debtor data are mainly based on nominal or face values of outstanding liabilities.

Regarding maturity breakdown, BIS creditor and market data provide information on remaining maturities, that is original maturities of up to one year plus longer-term debt due within one year, which is the preferred measure for liquidity and solvency analysis. In contrast, national debtor data mostly provide a maturity breakdown of debt based on originally agreed maturities rather than the time left until expiry of a contractual liability.

Prospects for improved creditor and debtor external debt data

The prospects for further improvements to BIS creditor and market data to make them more useful for external debt monitoring are limited. As coverage of the BIS banking statistics is nearly complete, increased country coverage of these statistics will probably add little additional benefits. Adding a maturity breakdown to BIS locational banking data would avoid double-counting of foreign holdings of debt securities issued by residents in creditor and market statistics on short-term external debt. However, such an extension of the statistics is considered to be too costly by BIS reporting central banks. Creditor data from the IMF Coordinated Portfolio Investment Survey could eventually provide a better measure of foreign holdings of debt securities issued by residents than BIS market data. However, IMF data are currently only available on an annual basis with a long time lag.

Debtor countries will therefore have to continue their own efforts to improve external debt data from the debtor side. The requirements of the IMF Special Data Dissemination Standards might in this regard be helpful to provide the necessary encouragement and peer pressure for improved external debt data. Urgent improvements of external debt data from the debtor side are mainly needed in the following three areas: country coverage (in order to increase the coverage far beyond the current approximately 60 SDDS subscribers), frequency (such as a move from annual to quarterly frequency) and timeliness of data (such as shortening of some current time lags of over one year to a maximum of 3-5 months).

INTOSAI guidance on the reporting of public debt

MARK ALLEN

INTOSAI is the International Organisation of Supreme Audit Institutions and the United Kingdom's National Audit Office is a member. The work of INTOSAI is conducted by various committees but the one that I want to draw to the attention of the Conference is the Public Debt Committee (PDC).

The role of the Public Debt Committee is to publish information for use by Supreme Audit Institutions to encourage the proper reporting and sound management of public debt. The Committee has published various documents along these lines, but this presentation will focus on the Committee's "Guidance on the Reporting of Public Debt".

The guidance was published in May 2000, and to try and ensure its applicability to as many countries as possible, it is expressed at the level of broad principles.

It recognises that different circumstances and issues will be present in different countries and consequently it identifies things for countries to take into account when considering the reporting of public debt, rather than providing detailed prescriptive statements about how things should be done.

While the guidance is written from the perspective of Supreme Audit Institutions, and is prepared for use by such bodies, it covers a number of themes that are likely to be of interest to anyone involved in the area of public debt.

The guidance was prepared following a survey of INTOSAI member countries and consultation with a variety of international bodies, including the European Union, the Organisation for Economic Co-operation and Development, the United Nations and the World Bank.

The guidance consists of the following main sections:

- The Role of the SAI in Reporting Public Debt
- Guidance on the Definition of Public Debt

- Identifying and Measuring Public Debt
- Guidance on the disclosure of Public Debt

A number of key messages arise from the guidance.

Firstly, there is a recognition that state audit institutions should do what they can within the limits of their powers and responsibilities to encourage governments to adopt sound and appropriate practices for the financial management and control of public debt. To this end, state audit institutions will need to exercise judgement when considering the nature of their examinations of public debt within their own countries. And these judgements will be informed by the prevailing political and institutional circumstances – for example, the ability of the audit institution to question issues of policy.

There are a number of responsibilities that an audit institution may be required to fulfil – these could include any or all of the following: auditing publicly disclosed debt information, reviewing the basis of measurement used by the reporting entity, or participation in the formulation of accounting standards for the measurement of public debt. Again, the audit institution's precise responsibilities will depend on the circumstances of the individual country.

The reliability of government reports on public debt depends to a large degree on the soundness of the definitions used in preparing them. The PDC guidance identifies five requirements for any definition of public debt: (i) the definition must be precise – to avoid confusion about the inclusion or exclusion of particular elements (ii) it must be clear – to make reports readily understandable by users (iii) the definition needs to be consistent – both from year to year and with other financial statistics or accounting records (iv) it should be appropriate – the criteria for inclusion of particular elements should be based on their relevance to the objectives that the reports are designed to satisfy (v) it needs to be comprehensive – to ensure that all particular elements of debt are brought within the scope of the definition.

The scope of financial reports on public debt and the nature and type of liabilities shown will vary depending on the different purposes for which the reports are prepared – for example, there may be reports to assist in the formulation and monitoring of economic, monetary or fiscal policy; or financial statements might be prepared to demonstrate the accountability of a particular organisation.

In each case, the information presented in the documents, and the definition of public debt used, is likely to vary, depending on the purpose for which the report is prepared.

Where the amount of at least some part of future debt repayments is variable, uncertain or contingent, the measurement of public debt is not clear-cut and will require judgements to be made. For example, where interest rates or exchange rates are involved in the valuation of debt, a choice has to be made about the appropriate rates to use.

Regular disclosure of a country's public debt can reveal whether debt levels have been kept within a country's ability to support them and can help ensure that potential problems become visible. However, a consistent difficulty in public debt disclosure is how to make it understandable and relevant to people. State audit institutions can help in this regard by looking for and encouraging the use of generally accepted ways of bringing sometimes-huge numbers to life for users of the reports.

For example in the United Kingdom, the Treasury, the Debt Management Office and the National Audit Office worked closely to develop agreed disclosures in the Debt Management Account. The account follows UK Generally Accepted Accounting Practice where appropriate and is used to disclose the debt and cash management activities undertaken by the UK Debt Management Office. The account is audited by the National Audit Office and published each year.

Having considered the INTOSAI Public Debt Committee guidance, here are a few thoughts that might warrant further discussion based on the National Audit Office's experiences in the United Kingdom.

Firstly – what information relating to public debt is available in different countries? If we

look at the UK, the information arises from a number of sources. For example, there are the financial accounts of various entities that are audited by the National Audit Office. These include the Debt Management Account and the National Loans Fund and associated Supplementary Statements. The National Loans Fund is essentially the account on which UK government borrowing and lending is recorded. When considering retail debt, there are the accounts produced by National Savings and Investments. National Savings and Investments is a government department that offers some 18-investment products to private investors. This activity is disclosed in a consolidated account showing the transactions and balances for the various investment products available.

Additional, wider information is also available. Primarily this comes from three sources. There is the Office for National Statistics, which publishes data to assist with management of the economy. Then there is the Debt Management Office, which in addition to annual accounts, produces a quarterly review giving details of the government debt portfolio. The Debt Management Office also publishes an Annual Review of its activities each year. Finally there is the HM Treasury which makes a range of information available and in particular, the annual Debt and Reserves Management Report. This provides a comprehensive review of developments in debt management over the past financial year and sets out the details of the Government's borrowing programme for the year ahead.

Another area of interest is that of contingent liabilities and their identification and measurement. In the UK, contingent liabilities are disclosed in the notes of the financial accounts prepared by government bodies in accordance with generally accepted accounting practice. This includes quantification of the likely amounts involved where possible, and narrative disclosures where the amounts cannot be quantified. These items are brought together and summarised in Supplementary Statements showing the contingent liabilities faced by the government. This is an area of particular interest to the INTOSAI Public Debt Committee, and the National Audit Office has been invited to lead a research project on this subject by the Committee.

What areas of potential difficulty are faced by state audit institutions? Two issues spring to

mind immediately. Firstly, there is a skills issue – this is a specialist area that is not encountered in the audit of the vast majority of government accounts in the UK. Consequently, there needs to be investment in additional training to ensure staff are sufficiently skilled to undertake these audits. The other main issue relates to the audit of the IT systems used by debt managers. Such systems can be very complex and a lot of work is needed before the auditor can be confident that the trading and accounting systems are operating as expected to ensure the integrity of the financial statements. These are just two potential areas of difficulty that reflect our own experiences in the UK – no doubt there are many other issues that other entities will have experienced depending on their role and circumstances.

From an auditor's perspective, recent developments in the UK have been very positive. In particular, there are two areas of work ongoing which will see the consolidation and enhanced disclosure of information in relation to public debt. These are the development of accruals-based accounts for the National Loans Fund and the introduction of Whole of Government Accounts. In particular, the publication of audited Whole of Government Accounts from 2005-2006 will bring together information on government assets and liabilities into one overarching document and should provide a ready source of information for people with an interest in this subject.

Debt recording and statistics in Heavily Indebted Poor Countries (HIPCs), experiences in MEFMI-HIPC countries

FRED RUHAKANA

Introduction

In the early 1980s, the main objective of debt management, especially external debt management, was to establish credible debt records so that the borrower countries would be in a position to repay, if they were able to, their creditors on time without undue delay caused by lack of information on when maturities were falling due. At that time debt service payments were made solely on the basis of creditor billing statements and it was not unusual for credible creditors to refund moneys that were overpaid to them in error. Of course non-credible creditors took advantage of the confusion to make wind-falls. There was, therefore, an urgent need to computerise debtors' debt records. The Commonwealth Secretariat and UNCTAD came in at the right time to rectify the situation. At present, all member countries of the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI) use either of these two institution's debt-recording systems: namely, the Commonwealth Secretariat Debt Recording and Management System (CS-DRMS) and UNCTAD's Debt Management and Financial Analysis System (DMFAS).

DEBT DATA NEEDS OF VARIOUS INSTITUTIONS

Debt offices are expected to generate and disseminate periodic and ad-hoc statistics and reports to various domestic and international consumers and stakeholders. They can do this thanks to the CS-DRMS and DMFAS systems, which have been, and continue to be, developed to assist debt offices in the recording of debt information and production of reports. In fact, the DMFAS system has come up with a framework for producing statistical bulletins, which divides debt reporting into two main categories, namely managerial and analytical tables.

For consistency and comparability of debt statistics compiled by international and regional organisations, it is important that reports from all countries are standardised so that data can be aggregated across countries and across debt instruments. To achieve such standardized report-

ing, guidelines such as the publication *External Debt Statistics: Guide for compilers and users*²⁹ (popularly known as the *Guide*) become important and quite handy. Let me take this moment to congratulate the task force/team that was tasked with the responsibility of revising the old grey book for the job well accomplished.

While the new grey book is an enhancement of the old probably in all respects, it does not appear to adequately address some of the statistical compilation questions of HIPCs. Let me give a few examples:

Recording arrears

The Guide recommends that when principle and interest payments are not made when due, arrears should be created or a short-term liability should be created and included in "other debt liabilities". HIPCs that have reached decision or completion points and are receiving interim relief and full HIPC relief respectively are expected to treat all creditors equally, meaning that all those creditors who are not prepared to give equivalent debt relief under HIPC agreed terms should not be paid. Hence the debtor HIPC country may accumulate arrears of two types:

- Normal arrears arising from failure to meet its debt service obligations; or
- Arrears arising due to the equal treatment of all creditors clauses.

MEFMI HIPC countries have advocated for this distinction to be recognised and taken into account in the compilation and reporting of statistics by international organisations.

²⁹ The *Guide* was prepared by an Inter-Agency Task Force on Finance Statistics, chaired by the IMF, and involving representatives from the BIS, the Commonwealth Secretariat, the European Central Bank, Eurostat, the IMF, the OECD, the Paris Club Secretariat, UNCTAD, and the World Bank. The preparation of the *Guide* was based on the broad range of experience of these organizations, in close consultation with national compilers of external debt, balance of payments, and international investment position statistics.

Debt service payments from trust funds, not from government budget

Debt service cash flows (principle and interest) are used in portfolio analysis and in the quantification of risks and costs of sovereign debt portfolios. In HIPC's however, an adjustment need to be made to exclude, or somehow deal with, debt service that is made from trust funds and not from government budgets. If included, the debt burden or even the risks and costs of HIPC liabilities are either over or understated as the case may be.

Recording of restructuring terms of HIPC's

Countries that have benefited from HIPC debt relief are faced with the complexity of recording terms that reflect such debt relief in their debt recording systems. This makes it difficult or cumbersome to generate statistics on future cash flows. The problem arises when debt relief is delivered in different ways, but in the end, leads to achieving comparable debt relief by all creditors. A creditor country participating in this initiative can opt to take any of the following paths:

- Stock of debt reduction, that is outright cancellation of debt stock;
- Debt service reduction through reduced interest rates and extended maturity periods.

As to whether these methods actually yield the same results in terms of financial and social benefits is still debatable. Here are examples of delivery mechanisms of some selected creditors.³⁰

IDA:³¹

- Cancel some loans – This delivery mechanism is straightforward and most preferred by HIPC countries.

- Amounts falling due within a specific future period are serviced from a HIPC trust fund. The challenge here is that these amounts become eligible for payment from the trust fund only when they fall due. In the meantime they form part of the debt stock. Should cash flows used in the computation of cost and risk indicators include or exclude these figures?

IMF:

- In some IMF debt restructuring operations, debt service relief is applied to principle payments only and on a declining balance. Also, interest earned from the HIPC trust fund is used to service IMF obligations. Implementing this scenario in debt recording systems and generating correct statistics is quite tricky or even not possible at present and the question of inclusion or exclusion of such cash flows for cost and risk computation is still relevant.

Japan:

- Forgives debt (sometimes up to 100 per cent) but the relief is realised after the Japanese government has approved and released the funds that would have been paid by the debtor country at maturity. This arrangement is unpredictable, difficult to track and it is difficult to generate good statistics that take into account this relief arrangement.

France:

- Forgives a fraction of debt stock. The debtor country pays the balance at maturity. The French government reimburses the debtor country at a later time. Again this debt relief is difficult to record and to track.

Other creditors offer grants or additional soft loans so that the net effect is equivalent to the agreed debt reduction in net present value terms.

All the above debt relief delivery mechanisms are quite challenging to record and to generate accurate debt statistics and cash flows.

³⁰ These delivery mechanisms do not necessarily apply to all debtors and one creditor could apply different mechanisms to different debtors.

³¹ The International Development Association (IDA) is the part of the World Bank that helps the earth's poorest countries reduce poverty by providing interest-free loans and some grants for programs aimed at boosting economic growth and improving living conditions.

BUT AFTER HIPC, WHAT NEXT?

These challenges will in one way or another be overcome and the now-HIPC countries will move to another stage of debt management that will entail focussing on different objectives of debt management. This means that the scope and scale of debt statistics and portfolio analysis will widen and deepen. As a capacity building institute, MEFMI is working with its member countries to prepare for the “after-HIPC” era. It is running programmes aimed at building capacity to identify, quantify and manage risks associated with sovereign liabilities; so that countries as they contract or issue new debt in various currencies with different interest rates, can manage the risks of the new debt portfolios. As they get out of the HIPC status (thanks to the efforts and support of the international community), MEFMI member countries will be proactive in managing their assets and sovereign liabilities so that they do not fall back in the same trap they found themselves in; or if they do, they will be aware of why and how they went back. Risk management is relevant to developing countries because of their vulnerability to changes in exchange rates, interest rates and commodity prices due to over dependence on primary exports.

Workshops in financial mathematics and statistics as well as in risk modelling have been conducted and are scheduled to continue in the foreseeable future to build the required expertise in risk management in MEFMI member countries. With the support of the World Bank and the African Development Bank, the following risk and cost indicators, among others, have been identified as being relevant to developing countries. The risk models being developed for and with the member countries will therefore be customised to measure risks and costs of MEFMI countries’ liability portfolios.

Cost measures:

- Average interest rates;
- Present value of net cash flows;
- Average growth rate of debt (computed as follows: $\sqrt[n]{\frac{debt_{n+t}}{debt_t} - 1}$)
- Ratios of interest payments to tax revenues;
- Ratio of debt to GDP, and so forth.

Risk measures:

- Standard deviation, maximum deviation, average deviation of various cost measures (such as the Present Value of cash flows);
- At risk measures such as cost-at-risk, budget-at-risk;
- Duration;
- Average time to maturity;
- Average time to refixing interest rates, and so forth.

Currently, we are focussing on deterministic risk indicators, but as capacity improves and policy makers and senior macroeconomic managers start appreciating the need of using risk indicators in managing debt, we shall move to stochastic indicators.

The challenge is on HIPCs and other developing countries as well as international institutions whose mandates are to assist these countries to embrace this approach, so that these countries can avoid future debt servicing difficulties, which is the main cause of poverty in developing countries.

PART VII

BASEL II AND ITS IMPLICATIONS FOR DEVELOPING COUNTRIES

Basel II and its implications for developing countries:

Summary of panel discussion

Moderator: Mr Sergio Edeza, Treasurer of the Philippines

Panellists: Mr Andrew Cornford, Financial Markets Center
Ms Stephany Griffith-Jones, Institute of Development Studies (IDS)
Mr Helmut Reisen, Organisation for Economic Cooperation and Development (OECD)
Mr Herman Mulder, ABN AMRO

Basel II and its implications for developing countries

While the Basel II proposal represents an improvement over the existing Accord, the panel agreed that it raises several problems from a developing-country perspective. These problems include (a) punitive capital requirements for low-grade lenders, leading to higher financing costs for developing countries and effectively shutting them out of lending markets; (b) the reliance of Basel II on credit rating agencies, which were viewed as unsuitable for judging economic conditions in developing countries, especially during crises; (c) the continued bias towards short-term lending; (d) the need to increase representation of developing countries on the Basel Committee; (e) the lack of recognition in Basel II of a diversified developed-/developing-country portfolio rather than one exclusively focused on OECD economies; and (f) the difficulty of implementing Basel II by the 2007 deadline given limited supervisory resources. The points on punitively high capital requirements, credit rating agencies and short-term lending were seen as especially significant given their role in recent emerging-market financial crises, the resulting sharp falls in bank lending to developing countries, and the need to modulate boom-and-bust cycles in the global economy.

How to prevent the New Basel Capital Accord harming developing countries³¹

STEPHANY GRIFFITH-JONES

Introduction

The proposals for Basel II contained in the third consultative package contain a number of important positive features, particularly in the standardised approach.

From the perspective of developing countries, positive features of Basel II refer, for example, to the removal of the OECD/non-OECD distinction and the reduction of the excessive incentive towards short-term lending to lower rated borrowers.

More broadly, the aim of attempting to more accurately align regulatory capital with the risks that international banks face is a highly desirable one.

However, a number of major concerns exist about the proposed Internal Ratings-Based (IRB) approach within Basel II, and its negative impact on developing economies:

1. It would significantly overestimate the risk of international bank lending to developing countries, primarily because it would not appropriately reflect the clear benefits of international diversification which such lending has in terms of reducing risk.³²

A further reason why at present the IRB approach would inappropriately discourage international bank lending to developing countries is because even large international banks lack the data on developing countries required for IRB modelling.

The combination of these factors is likely to cause an excessive increase in regulatory capital requirements on international lending to developing economies, creating a risk that bank lending to developing economies could be sharply reduced and a significant part of remaining lending could see its cost increased. This is contrary to the stated objective of G-10³³ governments to encourage private flows to developing countries, and use them as an engine for stimulating and funding growth. This is particularly the case at present as all capital flows to developing countries – and especially bank lending – have fallen sharply in the past six years, posing a constraint on growth.

2. It would accentuate the pro-cyclicality of bank lending, which is damaging for all economies, but particularly so for fragile developing ones, which are more vulnerable to strong cyclical fluctuations of bank lending, both nationally and internationally.

³¹This paper draws upon a submission made by Griffith-Jones, Spratt and Segoviano to the Basel Committee on Banking Supervision in July 2003 and a paper presented at the IMF-World Bank Annual Meetings at Dubai in September 2003. I would like to thank Professors Charles Goodhart and Avinash Persaud for very valuable inputs and suggestions. I am very grateful to the Basel Committee and the Bank for International Settlements (especially, but not only, to Daniele Nouy) for providing us with insights and data. We are very thankful for the funding of our research to the UK DFID and the US Ford Foundation. I also appreciate the comments and insights received from many senior regulators and policy-makers in both developing and developed countries, from bankers, academic colleagues and journalists.

³² For a more detailed empirical analysis, see below, and “Basel II and Developing Countries; Diversification and Portfolio Effects” Griffith-Jones S, Spratt S and Segoviano M www.ids.ac.uk/intfinance/ For briefer versions see: Basel II and Emerging Markets: The case for incorporating the benefits of international diversification”; Griffith-Jones S, Spratt S and Segoviano M, in *Central Banking*. For a summary see: Griffith-Jones S. *Financial Times* “A capital idea that will hurt poorer countries”. 13 May 2003.

³³ The Group of Ten or G-10 is a group of industrially advanced countries. The central banks of the Group in particular cooperate to regulate international finance. The member countries are Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom and the United States. The ‘ten’ refers to the members of the Group who constitute the members of the International Monetary Fund. Switzerland, which joined the Group in 1984, is the eleventh member.

Both these severe problems have been somewhat reduced by modifications to the Basel II proposals, especially by the flattening of the IRB curve in November 2001; however, they have certainly not been fully addressed.

Key issues for developing and emerging economies

1. Developing countries are not represented on the Basel Committee

The Basel Banking Committee members are from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States (that is basically the G-10 plus Switzerland). Each of these countries is represented by their central bank, and by the authority responsible for banking supervision in that country, where this is not the central bank. The composition reflects the world political order in the middle of the twentieth century. There is **no** representation of emerging market economies and developing countries on the Basel Banking Committee. This is in contrast with other Basel Committees where at least some representation of developing countries has been introduced, and it is in contrast to the Financial Stability Forum that is intended to provide a platform for regulators from systemically important countries to meet. Thus, the Basel Banking Committee is one of the international ad-hoc bodies with the worst problem of representation of a large part of the world – the developing and emerging countries.

It is true that the Basel Banking Committee does liaise with a group of 13 non-G-10 countries, including Russia and China, which meets every two months to review developments and comment on current work. However, this consultative group of developing and transition economies have no clear mechanisms of influence on Committee decisions. **It is useful to be consulted, but it is no substitute to having a seat at the decision-making table.** Indeed, we argue that Basel II appears to be the result of excess influence by the large financial institutions domiciled in the countries represented on the Committee. The new Accord is to their benefit and to the detriment of emerging market borrowers and developing countries not represented on the Committee. It will probably reduce flows to developing economies and make the remain-

In what follows, we first elaborate on the nature of the problems and then propose specific measures that could be fairly easily incorporated into Basel II to address them.

ing flows more expensive and susceptible to sudden stops³⁴.

It may well be that the causes of the potentially negative impacts of the Accord on developing countries that are set out below, have remained integral to the proposals, despite other modifications, precisely because of this lack of representation.

2. The clear benefits of international diversification are not reflected in current proposals

It has long been argued that one of the major benefits of investing in developing and emerging economies is their relatively low correlation with mature markets. We have undertaken detailed empirical research that demonstrates that this is clearly the case.³⁵ Consequently, clear benefits – at the portfolio level – would accrue to banks with well-diversified international portfolios. That is, a bank with a loan portfolio that is distributed widely across a range of relatively uncorrelated markets, is less likely to face simultaneous problems in all of those markets, than a bank with loans concentrated in a smaller number of relatively correlated markets. Therefore, in order to accurately align regulatory capital with the actual risks a bank might face, the Accord should take account of this portfolio level effect: the capital requirements for a bank with a well diversified international loan portfolio should reflect the lower total risk than for a more concentrated portfolio. At present the proposals contain no such considerations, suggesting that, in this area at least, capital requirements will not accurately reflect risk.

We have tested the argument of differential correlations between developed and developing markets, first with specific regard to interna-

³⁴ For an early analysis on capital surges and abrupt stops in emerging markets see French-Davis R and Griffith-Jones S (1995).

³⁵ Griffith-Jones S, Segoviano MA and Spratt S (2002) Basel II and Developing Countries: Diversification and Portfolio Effects, at <http://www.ids.ac.uk/intfinance/>

tional bank lending and profitability and, secondly, in a more general macroeconomic sense (see Table 1 below). **All of our results offer strong support for the validity of this position, and all are statistically significant.** The fact that the tests performed – using a variety of

variables, over a range of time periods – all provide robust and unequivocal evidence in support of the diversification hypothesis, represents a compelling case.

Table 1. Differential correlations between developed and developing markets

Variable	Time-Period	Frequency	Developed/ Developed Mean Correlation Coefficient	Developed/ Developing Mean Correlation Coefficient	Test Statistic (H0: Mx=My) Critical Value of 0.05% one-tailed test in parentheses
Syndicated	1993-2002	Monthly	0.37	0.14	3.33 (3.29)
ROA	1988-2001	Annual	0.10	-0.08	4.40 (3.29)
ROC	1988-2001	Annual	0.14	-0.11	6.92 (3.29)
GDP	1985-2000	Six-monthly	0.44	0.02	9.08 (3.29)
GDP HP	1950-1998	Annual	0.35	0.02	9.41 (3.29)
STIR	1985-2000	Six-monthly	0.72	0.23	11.09 (3.29)
STIRR	1985-2000	Six-monthly	0.66	0.22	10.93 (3.29)
GBI-EMBI	1991-2002	Daily	0.78	0.53	5.45 (3.29)
GBI-EMBI	1991-1997	Daily	0.90	0.74	4.64 (3.29)
GBI-EMBI	1998-2002	Daily	0.42	0.09	5.87 (3.29)
IFCI-COMP	1990-2000	Daily	0.58	-0.15	7.83 (3.29)
IFCG-COMP	1990-2000	Daily	0.58	-0.17	8.06 (3.29)

More recently, we have had the opportunity to have access to the data of one of the largest internationally diversified banks.³⁶ We obtained information on Non-Performing Loans and Provisions amounts. While the variables presented in the table above correspond to publicly available information, the data obtained from this bank is proprietary and has been collected with precise care. Moreover, it is data that reflects in a more precise and concise manner the riskiness of a real internationally diversified portfolio. The results obtained when we analysed the data were the following.

Table 2. Average correlation coefficients and statistical tests for proprietary data form a large internationally diversified bank³⁷

Variable	Time-Period	Frequency	Developed/ Developed Mean Correlation Coefficient	Developed/ Developing Mean Correlation Coefficient	Test Statistic (H0: Mx=My) Critical Value of 5% one-tailed test in parentheses
Non-Performing Loans	1998-2002	Annual	0.71	-.19	3.09 (1.86)
Provisions	1998-2002	Annual	0.55	-.14	2.14 (1.86)

³⁶ We were asked to keep the source of the data confidential.

³⁷ Details of the results are contained in Annex 1.

Let us recall that the null hypothesis to be tested was:

$$H_0: M_x \text{ equals } M_y$$

$$H_1: M_x \text{ different } M_y$$

From the results we observe that the null hypothesis in both cases is rejected at the 5 per cent significance level. These results are consistent with our previous results.

The evidence presented above clearly supports our hypothesis that a bank's loan portfolio

that is diversified internationally between developed *and* developing country borrowers would benefit in terms of lower overall portfolio risk relative to one that focused exclusively on lending to developed countries. In order to test this hypothesis in the specific context of a bank's loan portfolio, we undertook a simulation exercise to assess the potential unexpected loss resulting from a portfolio diversified within developed countries, and one diversified across developed and developing regions.

Table 3. Comparison of non-industrially diversified portfolios

1. Diversified developed/developing			2. Diversified developed			
Total Exposure = 117,625,333.00			Total Exposure = 117,625,333.00			
Per centile	Loss value	Unexpected loss (%)	Per centile	Loss value	Unexpected loss (%)	Per centage difference
99.8	22,595,312	19.21	99.8	27,869,349	23.69	+23.34

As can be seen from table 3, the unexpected losses simulated for the portfolio focused on developed country borrowers are, on average, **almost 23 per cent higher than for the portfolio diversified across developed and developing countries.**

An important issue, which has been raised in this regard, is the fact that correlations are not constant over time. The danger, of course, is that correlations within emerging markets increase dramatically in crises, as contagion spreads the crisis from one country or region to another. In this instance, it is possible that a portfolio diversified across a range of emerging and developing regions, might be hit simultaneously in all of the emerging market areas. However, while this may be the common perception of emerging market behaviour in crises, it only applies to a limited number of cases, which require specific preconditions to be in place; preconditions, which at the current time – and indeed at most times – do not apply. Kaminsky, Reinhart and Vegh (2002)³⁸ examine two hundred years of financial crises, in both developed and develop-

ing countries, for evidence of contagion. They conclude that 'fast and furious' contagion of the type described above, and often viewed as inherent in emerging markets, may occur, but only under certain circumstances. Of the major emerging market crises since 1980, the Mexican default of 1982, the Mexican devaluation of 1994, the devaluation of the Thai baht in 1997 and the Russian default of 1998, were all seen as instances where significant contagion did occur. However, with the exception of the Russian default – which affected all emerging and developing regions, as well as the developed world to a surprising extent (Davis, 1999)³⁹ - the resultant contagion was restricted to the same region. Consequently, a portfolio diversified across *all* emerging and developing regions would not have suffered simultaneous problems to the extent described above.

In order to assess the validity of this argument, we extended our analysis to check what would happen to diversification effects during crises times in three separate periods:

³⁸ Kaminsky, Reinhart and Vegh (2002): *Two Hundred Years of Contagion*. Forthcoming.

³⁹ Davis EP (1999): Russia/LTCM and market liquidity risk", *The Financial Regulator*, 4/2

Table 4: Analysed crises periods

Time Period	Crises Included
94-4 to 99-1	Mexican, Asian and Russian Crises
94-4 to 95-4	Mexican Crisis
97-3 to 98-4	Asian and Russian Crises

Our results are contained in Annex 2, and clearly demonstrate that for each of the analysed variables, the mean Correlation between “Developed” and “Developing” Countries is lower than the mean correlation between “Developed” and “Developed” countries:

$$\text{Corr}(\text{DEVED}/\text{DEVING}) < \text{Corr}(\text{DEVED}/\text{DEVED})$$

This result holds for all periods and all variables. Given this evidence, we can conclude that the diversification benefits obtained through a well-diversified portfolio of developed and emerging markets still hold in crises periods. As would be expected, the magnitude of the diversification benefits is lower in crisis periods than in non-crisis periods. However, these benefits remain positive in all instances, thus demonstrating that our argument in favour of diversification effects holds, and is robust even in crises periods.

3. Potentially large increased cost of international bank lending to developing countries

The sharp increase in regulatory capital requirements for international loans to developing countries (which inappropriately does not reflect the benefits of international diversification) is very likely to significantly increase the costs of such loans. The extent of the increase cannot be precisely estimated *ex-ante*. However, the increase in capital requirements for lower rated borrowers will be very large. Thus, for example, according to the Basel Committee estimates, for B-corporate borrowers, capital requirements would increase from current 8 per cent to 20.8 per cent, an increase of 260 per cent. Lower rated borrowers and unrated Sovereigns would have a substantially larger figure. In contrast, a loan to a borrower rated AA – would require only 1.18 per cent to be set aside as regulatory capital, a sharp reduction in relation to the current 8 per cent.

It is unlikely that this sharp increase in regulatory capital requirements for lower rated

borrowers will be fully reflected in the increased cost, both because capital requirements may not be fully binding and because banks may be able to book marketable bonds in their trading books for some developing countries, which would not affect capital requirements.

However, the fact that the increase in capital requirements is so large for lower rated borrowers implies the risk that an unintended consequence of the new Accord could be very large cost increases for them, even though these would not reach the 2000 basis point maximum potential increase for the lowest rated borrowers by Weder and Wedow (2002)⁴⁰, based on the Basel Committee estimates.

A recent study⁴¹ from a leading international risk management consultancy has also estimated the likely impact on the capital requirements facing domestic banks in developing countries. The study concludes that:

If emerging markets implement the new regulation as it currently stands, we estimate that the Standardised Approach could lead to 20-25 per cent increases in regulatory capital. The more risk-sensitive IRB approaches could produce increases of up to 70-80 per cent for some banks; and even higher changes could be possible in both theory and practice. (p.29)

Clearly regulatory requirements will not be fully binding in practice, with the result that the increase in costs will be lower than these maximum figures. However, it is equally improbable that these large shifts in the pattern of regulatory capital will have only a very small impact on the

⁴⁰ Weder B and Wedow M. (2002) Will Basel II affect international capital flows to emerging markets? OECD Development Centre. Technical Paper No. 199.

⁴¹ Garside T and Pederson C. (2003) *The New Rules of the Game: Implications of the New Basel Capital Accord for the European Banking Industries*. Mercer Oliver Wyman.

pricing of loans. The most often used, but in our view imprecise, argument to support this position is that banks price loans off their own calculation of economic capital, rather than regulatory capital. However, this argument presupposes that the use of economic risk capital is uniform across all major banks that are actively engaged with emerging and developing country borrowers. A recent study by PriceWaterhouse Coopers⁴², surveyed a cross-section of the most sophisticated European banks. They concluded that, far from being uniform, economic capital is only fully integrated into the business practice of less than half of those surveyed. This suggests strongly that, for at least the more than 50 per cent of European banks that have not fully developed the system, pricing cannot be based on calculations of economic capital. **We would therefore expect regulatory capital to have a significant impact on the pricing of loans for these banks, thereby creating a significant impact on average across the system.**

The study cited by the leading international risk management consultancy, Mercer Oliver Wyman, concludes that the new Accord will produce:

An increase in credit spreads for higher risk segments such as mid-market lending, SMEs, low-rated sovereigns, and specialised lending.

4. Reduction of quantity of loans

Strong forces resulting from the implementation of the new Accord will encourage a reduction in the quantity of lending to poorer countries. These forces relate to the changed incentives that will face banks. Clearly, banks will wish to minimise the regulatory capital they are required to hold. If this were not so, there would be little point in the Basel Committee intentionally endowing the Advanced IRB approach with lower capital requirements than the other possible approaches as an ‘incentive’ for banks to move towards its adoption. That is, if, as is often suggested, banks are indifferent to changing regulatory capital requirements when making their lending decisions, then the lower capital requirements under the Advanced IRB approach would **not** provide an incentive towards its

adoption. This ‘incentive’ can only work in practice if banks seek to minimise the regulatory capital they hold. If this is the case, then the reduction in regulatory capital for higher rated borrowers and the increase for lower rated borrowers, must provide a strong incentive over the medium to long-term for banks to refocus their loan portfolios away from lower rated borrowers towards higher rated borrowers – that is, to increase the proportion of developed country borrowers and decrease the proportion of developing country borrowers in the portfolio.

For banks that see their overall regulatory capital increase, there will be three possibilities. First, if they have a sufficient capital buffer, they may be able to absorb the increase. Second, if they are unable to do this, they will have to raise additional capital. However, this second option may not be feasible in certain situations. If it were not possible or desirable to raise additional capital, a third option would have to be considered. For Mercer Oliver Wyman (2003):

The most obvious is to reduce risk-weighted assets by rebalancing business portfolios and exiting high-risk markets. (p.23)

It has been suggested that even if the cost of bank lending to developing countries were to increase and/or the quantity of such lending fall, the countries concerned would be able to access other sources of finance, from the international capital markets, for example. However, the fact that countries without a sovereign rating, as well as those with very low ratings, are also those without access to the international capital markets strongly undermines this point.

5. The growing ‘data divide’

An important issue, that has received relatively little attention, relates to the increasingly sophisticated and quantified approach to credit risk, and the reliance of this process on accurate data of sufficient historical length. It is likely that the process of reforming the Basel Capital Accord will accelerate this process. Indeed, a number of commentators have argued that this acceleration is already well under way, as banks seek to upgrade their internal systems so as to be eligible for the IRB approaches.

Under the Foundation IRB framework a bank is required to provide its own estimates of probability of default (PD), with supervisory

⁴² Presented at the Commonwealth Business Council (CBC) Banking and Financial Services Symposium, London, 25 June 2003.

authorities providing estimates of loss given default (LGD), exposure at default (EAD), and maturity (M). Under the Advanced IRB approach, banks are required to provide estimates of all of these inputs, subject to meeting minimum standards. However, in order for a bank's estimate of PD to be acceptable as an input:

*The length of the underlying historical observation period used must be at least five years for at least one source.*⁴³

For estimates of LGD:

*Estimates of LGD must be based on a minimum data observation period that should ideally cover at least one complete economic cycle but must in any case be no shorter than a period of seven years for at least one source.*⁴⁴

For the most sophisticated internationally active banks that have well-developed systems of this sort, the historical data that underlies their estimates is derived from developed markets. As major banks have told us, the availability of these underlying data inputs in developing countries is far lower than in the developed markets.

In order for the system to be robust – and therefore acceptable to supervisory authorities – it is clear that a given PD in, say, the UK, must be directly comparable with the same PD in any developing country. In order for this to be possible with any degree of accuracy, historical data on the default experience of the various PD bands would need to be gathered in each market. However, this is far from being the case at present.

Consequently, given the fact that a bank wishing to use a statistical default model must:

*Satisfy its supervisor that a model or procedure has good predictive power and that regulatory capital requirements will not be distorted by its use. The variables that are input into the model must form a reasonable set of predictors.*⁴⁵

There will clearly be an incentive to reduce those inputs which exhibit greater uncertainty. Again, therefore, banks will be faced with an incentive to focus their activities on developed markets – markets for which such data is readily available.

Whilst this can be seen as a further force that is likely to reduce the quantity of loans to developing countries, these deficiencies in data can also be expected to adversely impact upon the cost of borrowing in such countries. The third consultative paper “CP3” of the Basel Committee on Banking Supervision concerning Basel II contains a number of pieces of advice for banks faced with data problems of the sort discussed above.

The following is typical of this advice:

*In general, estimates of PDs, LGDs and EADs are likely to involve unpredictable errors. In order to avoid over-optimism, a bank must add to its estimates a margin of conservatism that is related to the likely range of errors. Where methods and data is less satisfactory and the likely range of errors is larger, the margin of conservatism must be larger.*⁴⁶

Thus a bank operating rules under an IRB approach faces two options, in relation to lending to developing countries; 1) withdraw from lending, which would reduce supply of loans or 2) adopt a conservative approach to assigning borrowers to probability-of-default (PD) bands, which would increase cost, as banks will “assume the worst” about those borrowers' creditworthiness. Furthermore, while these factors are likely to reduce the current quantity of lending and/or increase its cost, they will also negatively affect the potential for future lending. Banks that are not currently engaged in lending to developing countries, and choose to adopt the IRB framework, will be effectively precluded from entering these markets in the future by the data limitations we have described.

⁴³ The Basel Committee on Banking Supervision's third consultative paper “CP3” on the new Basel Accord (Basel II), paragraph 425.

⁴⁴ CP3, paragraph 434.

⁴⁵ CP3, paragraph 379.

⁴⁶ CP3, paragraph 413.

Our specific proposals

1. The Composition of the Basel Committee should be altered to include representatives from developing countries.

The outcome of Basel II seems to relate to the composition of the Committee. With this in mind and given that the Basel Capital Accord is a global standard that is likely to have a very large impact on emerging economies, and that emerging markets are critical to the global economy, the composition of the Basel Committee needs to be changed. A more sensible composition would reflect global GDP. The ten largest economies would bring in China, India, Brazil and either Mexico or Russia to the Committee to join the US, Japan, Germany, UK, France and Italy. The new countries are critical to the global economy and to cross-border bank lending. This new composition would have the virtue of powerful economic logic behind it, and would counter-balance the influence of the large international banks domiciled in developed countries. However, it would require some small-developed economies to leave the Basel Committee.

There may be politically more acceptable alternatives. For instance, the current membership could remain and India, China and Brazil could be added. Alternatively, one or two representatives of developing country regions (Asia, Latin America and Africa) could be added for a four-year period. There could then be rotation for different countries to be represented (from each of the three regions). The principle would be similar to the one under which the Executive Boards of the IMF and World Bank operate. Particularly, but not only, if the latter formula is adopted, developing country representatives could be supported by a small permanent technical secretariat, that would contribute both expertise and continuity. In fact, the lack of such a secretariat at present is an important institutional gap.

Whatever the solution, concrete steps need to be taken as soon as possible to start changing the composition of the Basel Banking Committee to increase its legitimacy, especially in the light of the recent serious problems of Basel II. Indeed, we suggest that the Basel Committee start meeting with a representative group from emerging countries (such as its own consultative group or members of the G-24 that represent

developing countries at the IMF) to establish a process whereby emerging countries can quickly become full members of the Basel Banking Committee. This is urgent. The shortcomings of running the 21st century world economy, using the 19th century world order are becoming greater over time. A Basel Committee with appropriate representation from the world economy would not just result in a fairer system, but also in a more stable financial system with welfare enhancing effects for all.

2. International diversification benefits should be explicitly incorporated in the IRB approach

The proposed Basel 2 does not explicitly take account of clear international diversification benefits of lending to developing countries, despite these being widely recognised and confirmed by our research described above. We feel that unless the proposal is amended, capital requirements will – in this respect – not accurately reflect risk, and will unfairly and inappropriately penalise developing countries.

It therefore seems important that in its final revision of the proposed Accord, the Basel Committee incorporate the benefits of international diversification. There is a clear precedent. The Basel Committee, in its previous modifications, has already started to take account of variable asset correlation for lending to corporates, as related to probability of default and as regards size of firm. Following the publication of the Basel Committee's proposal in January 2001, there was widespread concern – especially in Germany, but more recently, in the US – that the increase in capital requirements would sharply reduce bank lending to SMEs. After intensive lobbying, particularly by the German authorities, and based on empirical research (Lopez, 2002)⁴⁷, the Basel Committee lowered capital requirements for lending to SMEs under the IRB approach.

Indeed, the Basel Committee has stated:

“in recognition of the different risks associated with SME borrowers, under the IRB approach for corporate credits, banks will

⁴⁷ J.A. Lopez (2002) The Empirical Relationship between Average Asset Correlation, Firm Probability of Default and Asset Size. Presented at BIS Workshop "Basel II: An Economic Assessment" - May 2002.

*be permitted to separately distinguish loans to SME borrowers (defined as those with less than Euro 50 mn in annual sales) from those to larger firms. Under the proposed treatment, exposures to SMEs will be able to receive a lower capital requirement than exposures to larger firms. The reduction in the required amount of capital will be as high as twenty per cent, depending on the size of the borrower, and should result in an average reduction of approximately ten per cent across the entire set of SME borrowers in the IRB framework for corporate loans.*⁴⁸

Thus, in the case of SME and corporate lending, the Basel Committee has recognised the impact that differential asset correlation can have on portfolio level risk. Our empirical results strongly suggest that a similar modification is justified with respect to internationally diversified lending, especially when one considers the fact that our evidence is as least as strong as that used to support the modification with respect to SMEs.

We recognise the fact that SME lending has “special characteristics”, which justified the modification. However, our argument is precisely that lending to developing and emerging economies also has similar characteristics. Lopez (2002) argues that large firms are more susceptible to systemic risk than are SMEs: the higher weight given to idiosyncratic factors in the latter thus justifies the modification. However, if one defines ‘systemic risk’ in a global sense as associated with global business cycles, then the fact that developing and emerging economies are less correlated with industrialised business cycles – as our results clearly show – demonstrates that these economies are also less susceptible to systemic risk. Consequently, if a modification was justified with respect to SME lending, it is difficult to see why one is not justified in the case of developing and emerging economies.

The results of our simulation show that the unexpected losses for the portfolio focused on developed country borrowers are, on average, almost twenty-three per cent higher than for the portfolio diversified across developed and developing countries. As a specific proposal in this

area, we would suggest an adjusting factor be incorporated into the Accord. This would be applied at the portfolio level, and could function in a tapered fashion. Our empirical results suggest that a fully diversified bank would qualify for a reduction of approximately 20 per cent of required capital. This reduction would then decline as the level of diversification fell, reaching zero for an undiversified bank. Such a modification would be relatively straightforward to introduce, would not add to the complexity of the Accord, but would ensure a more accurate measurement of risk. Alternatively, the modification could be integrated into Pillar 1 of the Accord through the development of a separate developing country curve. This would be similar to the modification produced for SMEs and would be calibrated so as to produce a similarly tapered reduction in capital as in the adjusting factor described above. As well as reducing the required capital for loans to borrowers in developing countries, in the context of an internationally diversified portfolio, such an adjusting factor or separate curve would also provide an incentive for banks to maintain or increase their level of international diversification, in response to an accurate measurement of risk.

3. Overcoming the Data Divide by allowing long transition under standardised approach

The Basel Committee itself has recognised the problem of differential data quality in different jurisdictions. Although it is stated that:

“Once a bank adopts the IRB approach for part of its holdings, it is expected to extend it across the entire banking group”.

This is subsequently qualified:

“Once on IRB, data limitations may mean that banks can meet the standards for the use of own estimates for LGD and EAD for some but not all of their asset classes/business units at the same time”⁴⁹.

As a result, the Basel Committee concedes that:

“Supervisors may allow banks to adopt a phased roll-out of the IRB approach across the banking group.”

⁴⁸ Basel Committee reaches agreement on New Capital Accord issues.

<http://www.bis.org/press/p020710.htm>

⁴⁹ CP3, paragraph 225.

However, this phased rollout must be of a limited duration:

A bank must produce an implementation plan, specifying to what extent and when it intends to roll-out IRB approaches across significant asset classes and business units over time. The plan should be exacting, but realistic, and must be agreed with the supervisor.⁵⁰

It is essential, if the negative impacts linked to data described above are to be avoided, that banks are given the time to accumulate data of sufficient quality and duration in different markets. That is, an internationally active bank should be free to employ the standardised approach in their lending to those developing countries where the data limitations are such to make adoption of the IRB approaches impractical. Furthermore, there should be no arbitrary limit set on the length of this period. Rather, the IRB approaches should not be adopted in lending to developing countries until it can be proved that the underlying data that are inputs into the framework are of sufficient quality and comprehensiveness.

This transition period could also provide the space for more sophisticated full credit risk models to be developed, which could then make effective use of the better data available from developing countries. These models would, among other aspects, explicitly incorporate the benefits of international diversification.

These modifications, if implemented, would encourage a narrowing of the ‘data divide’ described above. In contrast, the proposals as they stand are more likely to encourage a widening and deepening of this divide; an outcome that would be to the benefit of nobody.

4. Dealing with pro-cyclicality

The adoption of a considerably flatter risk-weighted curve and encouragement, in Pillar 2, of banks to take a more forward looking view of their activities may help diminish the potential impact of Basel II on increased pro-cyclicality of bank lending, as may encouragement by regulators to carry out stress tests. However, it is unclear that these measures will be sufficient. It therefore would be highly desirable to introduce **mandatory** counter-cyclical measures, such as forward looking provisions before – or at the same time – as Basel II is implemented; a complementary measure would be to make stress-testing mandatory, with the parameters specified jointly by regulatory authorities and the banks themselves.

Conclusion

We would be happy to collaborate with the Basel Committee, as well as other suitable bodies, in developing these proposals, if this was considered helpful.

⁵⁰ CP3, paragraph 227.

ANNEX 1

Results in figure 1 and 2 offer further support for our hypotheses. They present the Cumulative distribution function test (CDF) computed to complete our analysis. Results were the following:

Figure 1: CDF Test for Non-Performing Loans

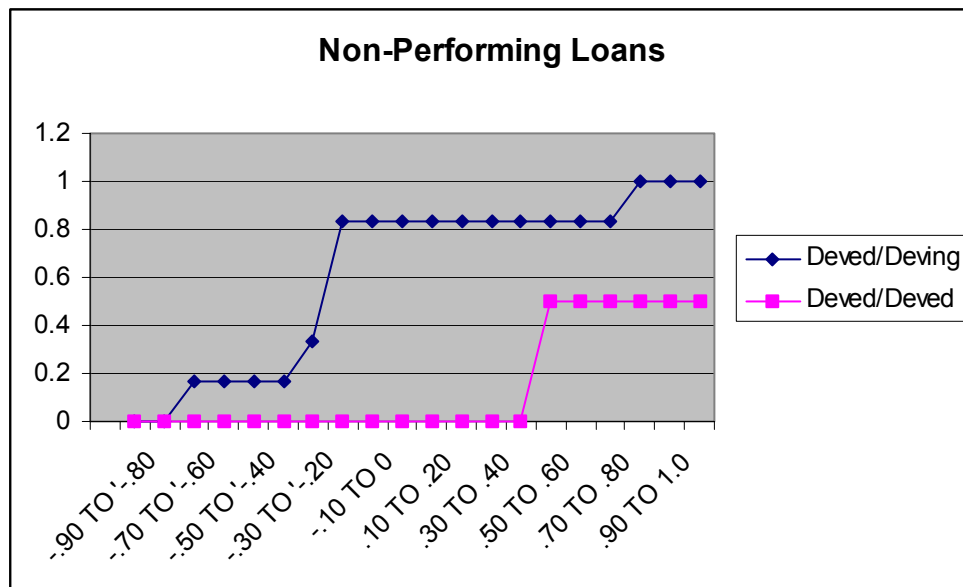
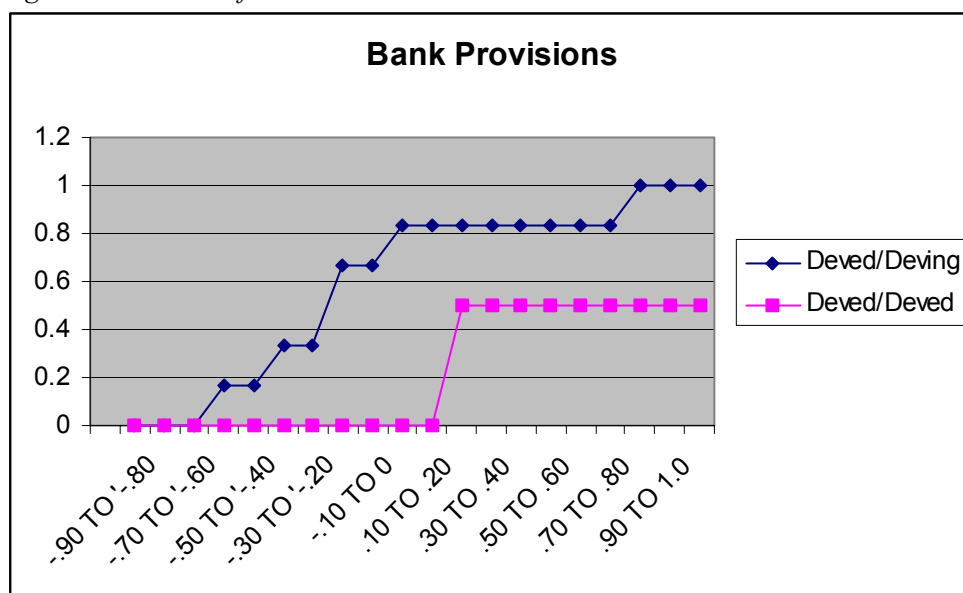


Figure 2: CDF Test for Bank Provisions



The purpose of the tests was to establish, for any given level of correlation, the probabilities that the developed/developed series and the developed/ developing series would have a lower level of correlation. The results of two of these tests are shown in figures 1 and 2 as further evidence of the fact that, in every instance, the developed/developed correlation dominates that of the developed/developing correlation.

That is, for any level of correlation (x), the probability that the actual correlation between developed and developing indicators is lower than x, is higher than the probability that the correlation between developed and developed indicators is lower than x.

ANNEX 2

Correlations in Three Crisis Periods: Developed/Developed & Developed/Developing

Table 5: Syndicated loan spreads under crises periods

Row	SYNDICATED	Total Time Series	94-4 to 99-1	94-4 to 95-4	97-3 to 98-4
1	Mean Correlation (Deved/Deving)	0.141	0.129	0.087	0.229
2	Mean Correlation Deved/Deved	0.375	0.135	0.143	0.479
3	Ratio Mean Correlations	0.375	0.954	0.609	0.477
4	Ratio Volatilities	1.739	2.771	4.300	2.514

Table 6: Global Bond Index-Emerging Market Bond Index under crises periods

Row	GBI-EMBI+	Total Time Series	94-4 to 99-1	94-4 to 95-4
1	Mean Correlation (Deved/Deving)	0.532	0.397	0.698
2	Mean Correlation Deved/Deved	0.783	0.571	0.823
3	Ratio Mean Correlations	0.679	0.694	0.849
4	Ratio Volatilities	1.656	2.400	1.716

Table 7: GDP under crises periods

Row	GDP-HP	Total Time Series	94-4 to 99-1
1	Mean Correlation (Deved/Deving)	0.020	0.114
2	Mean Correlation (Deved/Deved)	0.351	0.409
3	Ratio Mean Correlations	0.056	0.279
4	Ratio Volatilities	1.696	2.256

Tables 5 to 7 demonstrate that for each of the analysed variables, the mean Correlation between “Developed” and “Developing” Countries is lower than the mean correlation between “Developed” and “Developed” countries:

$$\text{Corr}(\text{DEVED/DEVING}) < \text{Corr}(\text{DEVED/DEVED})$$

It is interesting to see from these results that, as would be expected in crises periods, developing countries become relatively riskier in comparison to developed countries. This is illustrated in row 4, which measures the ratio of volatilities given by the Standard deviation of the developing countries divided by the standard deviation of the developed countries. We observe that this ratio increases in crises periods.

$$\text{Ratio: Std}(\text{DEVING})/\text{Std}(\text{DEVED})$$

Finally, we observe that the ratio given by the mean correlation of “Developed” and “Developing” divided by the mean correlation of “Developed” and “Developed” countries:

$$\text{Ratio: Corr}(\text{DEVED/DEVING})/\text{Corr}(\text{DEVED/DEVING})$$

Increases in crises periods. This implies that diversification benefits are in fact aminorated in crises periods however they still remain. This is observed by the fact that the ratio never reaches a value of 1 or greater than 1.

A review of comments of developing countries on the April 2003 consultative documents of the Basel Committee on Banking Supervision (BCBS), the New Basel Capital Accord

ANDREW CORNFORD

The following review is based on comments on the third consultative document on the New Basel Capital Accord of April 2003 (CP3) made by central banks and supervisory authorities of developing countries⁵¹ and by national or regional industry associations of such countries (henceforth “respondents”) and available on the website of the Basel Committee on Banking Supervision (BCBS).⁵²

Scope of application and cross-border implementation

Issues raised under this heading involve the following:

- *The banks to which the New Basel Capital Accord (NBCA) would apply.* Here views expressed indicate that in different countries application would range from being universal to being limited to “internationally active” banks. Several respondents would like the BCBS to provide a definition of the term “internationally active” banks.
- *The structure of banking groups, consolidation, and the levels at which national supervisors should conduct their reviews.* The problem here is that many banking groups have complex structures which may involve different categories of entity – such as branches, subsidiaries and joint ventures – in different locations. The respective responsibilities of the supervisors in a banking group’s home country (parent supervisor) and of the supervisors in the host countries of its foreign entities (the host supervisors) have been addressed by the BCBS in various statements since the 1983 Basel Concordat. However, there is clearly a widespread wish to have the particular ap-

plication of these principles to the NBCA spelled out more explicitly.

- *The closely related question of the respective responsibilities of supervisors in different countries under the NBCA and its consequences in situations where supervisors in different countries prefer banking entities in their jurisdictions to adopt different approaches to capital standards.* Several developing-country supervisors expect most or all local domestic banks to adopt the simpler standardised approach, and many would prefer, and may even impose, this approach owing to limitations on their capacity to carry out the more complex supervision required by the internal ratings-based (IRB) approach. However, the parent entities of internationally active banks can be expected in many cases to choose an IRB approach and, indeed, may be under pressure from their parent supervisor to do so.
- The resulting dilemma has a number of aspects. The host supervisor might reach an agreement with the parent supervisor under which it abdicated many of its responsibilities with respect to the supervision of capital adequacy to the home supervisor, permitting the foreign entity to use the IRB approach. But a consequence of this decision would be a banking regime with two tracks, one for domestic banks and one for foreign banks. Since the IRB approach is expected to lead to lower levels of capital and thus lower costs for banks adopting it, domestic banks could be put at a competitive disadvantage by such a regime. On the other hand, if the host supervisor imposed the standardised approach on entities in its jurisdiction regardless of the approach adopted by the parent bank (which might be the IRB approach), the costs and complexities of supervising the banking group could rise substantially.

⁵¹ The comments are from more than 30 countries of Asia other than Australia and New Zealand, of Africa and the Middle East other than Israel, of Central and Eastern Europe, and of the Americas other than the United States and Canada.

⁵² <http://www.bis.org/bcbs/index.htm>

Timetable for implementation of the NBCA

According to the current timetable implementation of the NBCA is to be achieved by the end of 2006 but several respondents express the view that this deadline is unrealistic and that a longer transition period will be required.

Credit rating agencies and the calibration of credit risk under the standardised approach

Widespread reservations are expressed concerning the dependence of the ratings of credit risk on credit rating agencies under the standardised approach. A major problem here is the absence of credit rating agencies in many developing countries. Moreover typically only a small minority of firms in most developing countries currently have ratings from the major agencies. As a result non-financial firms and insurance companies will receive the undifferentiated rating of 100 per cent assigned to unrated firms. Other misgivings concerning major credit rating agencies are a widely perceived lack of understanding on their part of local conditions in several developing countries and their unregulated status. Some respondents also draw attention to the agencies' failure to adjust their ratings before as opposed to during recent financial crises involving both countries and firms.

Procyclicality of ratings

The failure of the rating agencies as forecasters contains the risk that downwards shifts in their ratings are capable of magnifying economic downturns and financial crises – of having what is described as a procyclical effect. Use of the agencies' ratings for the calibration of credit risk under the standardised approach could easily lead to lower levels of lending and higher borrowing costs for entities adversely affected by shifts in these ratings and thus aggravate the very conditions which led to the shift in the first place. Procyclical effects under the NBCA are not limited to the standardised approach but could also result from unfavourable shifts in banks' internal ratings under the IRB approach. A number of respondents' concerns are directed not only at the procyclicality of the IRB approach in general but also more specifically at that which might result from stress tests carried out to meet part of the supervisory requirements for eligibility for the IRB approach.

Here it is felt that that such tests may lead to a bias towards stressed conditions, and thus towards excessive conservatism, in setting capital levels. Particular concern is directed at paragraph 430 of CP3 where it is stated that "the bank must use LGD (loss given default) estimates that are appropriate for an economic downturn if those are more conservative than the long-run average" and at para. 437 where it is stated "*the bank must use EAD (exposure at default) estimates that are appropriate for an economic downturn, if these are more conservative than the long-run average*".

Risk weights of the standardised approach: interbank and small loans

Interbank lending and some other categories of exposure were singled out for concern regarding their assigned risk weights under the standardised approach.

- Regarding claims on other banks one respondent points out that the risk weight assigned to banks with a certain credit rating under the standardised approach would be substantially higher than, and thus inconsistent with, that assigned under the IRB approach. Several respondents want a relaxation of the rules for the maturity of claims on banks – an original maturity of three months or less – that would qualify them for preferentially low risk weights. And one respondent would prefer the delinking of the preferential risk weight for claims on banks from their maturity and leaving the assignment of their risk weights to national supervisors on the basis of their underlying strength and creditworthiness.
- One respondent wants a further gradation of the risk weights for small loans with an intermediate weight of 50 per cent assigned to consumer loans between those of 35 per cent for residential mortgages and 75 per cent for other retail loans.
- The suggestion is also made that the risk weight of 100 per cent should apply to firms with a wider range of ratings than the NBCA's BBB+ to BB-.

Options as to use of the IRB approach

Under the 2001 consultative paper on the NBCA (CP2) banks were given little latitude in their adoption of the alternative versions – foundation and advanced – of the IRB approach. Once a bank met the requirements for any of the elements of the advanced version of the IRB approach, it could proceed to adoption only on condition that steps were taken to enable it also to adopt other elements of the advanced version in a reasonably short time. CP3 is more flexible and permits “a phased rollout of the IRB approach”, the adopting IRB approach, for example, across asset classes within the same business unit or across business units within the same banking group, or moving from the foundation to the advanced version of the IRB approach only for some inputs to the estimation of risk-weighted assets. The “phased rollout” of CP3 is, however, to be part of a progressive plan in the direction of full implementation. Similar flexibility, it should also be noted, is accorded in CP3 under the Advanced Measurement Approach (AMA) to setting capital requirements for operational risk, adoption of this approach being permitted for some parts of a bank’s operations and simpler approaches for the rest. Several respondents would like further flexibility under which partial adoption of the IRB approach would be permitted for more narrowly defined activities, and one respondent supports national supervisory discretion for approval of permanent but partial adoption of the foundation version of the IRB approach (which would exclude exposures to sovereigns and banks for which, owing to limitations on the availability of data for probability of default (PD), capital requirements may be better treated under the standardised approach).

IRB approach: formulas for risk weights and the treatment of small and medium-sized enterprises (SMEs)

Several respondents express the view that the design of the formulas used to estimate capital requirements under the IRB approach reflects conditions prevailing in G-10 countries and thus takes insufficient account of conditions in developing countries. One point referred to here is the preferentially low risk weight for small and medium-sized enterprises (SMEs), which was a response to representations from within the G-10 that the formulas of CP2 were

capable of imposing punitive interest charges on SMEs and thus compromising their role as the major source of employment in many economies. Some respondents believe that the case for a lower risk weight for SMEs is unproven, exposures in this class being at least as risky as those to larger firms. A more widely expressed concern is that the ceiling on annual sales of 50 million euros defining eligibility for inclusion in the category of SMEs is too high for several developing countries and would result in the inclusion of only a few firms in the exposure class of non-SME corporate entities.

Portfolio diversification and interest rates on developing countries’ international borrowing

It is a long-standing criticism of the capital requirements prescribed by the original 1988 Basel Capital Accord and the proposals so far for the NBCA that they do not take sufficient account of the potential benefits of risk reduction due to diversification of loan portfolios across major exposure classes. *The focus of respondents reviewed here is on the benefits of a portfolio containing exposures to both developed and developing countries as opposed to one containing exposures only to the first group owing to the lower risk of the former which results from lower correlations of major financial and macroeconomic indicators for the combined group than for the first group on its own.* Failure to account for these benefits will, it is believed, lead to large increases in regulatory capital for lending to all but a small minority of developing countries and correspondingly large increases in their cross-border borrowing costs. Two approaches are proposed to dealing with this problem. One, that follows the submission to the BCBS of Griffith-Jones, Spratt and Segoviano to which favourable references are made by several respondents⁵³, would reduce capital for banks which held appropriately diversified portfolios of exposures to both and developing countries. The other, which has more the limited objective of protecting intra-developing country lending from excessive charges linked to the rule of the NBCA, would provide discretion to national supervisors as to the setting of risk weights for exposures to borrowers from within the same region.

⁵³ For a comment on this submission see the note at the end of this paper.

Data requirements for the use of IRB approach

There are several references to the difficulties of meeting the data requirements for eligibility for the IRB approach, and this is an area where there is also a widely perceived need for technical assistance. Two other points are also mentioned by respondents. One concerns the acceptability of using portfolio data for PD where data on individual losses are lacking. And another concerns the need for guidelines in the NBCA for the comparability of the data base for the IRB approach in the case of banking groups operating in several countries.

Credit risk mitigation and collateral

The eligibility and valuation of collateral has proved one of the most contentious issues of the NBCA. This should not be surprising in view of the wide variety of existing practices in this area, which reflect different customs and different degrees of development of the markets where financial instruments, real property and other goods serving as collateral can be bought and sold or valued. The rules in CP3 have been extended in various ways to accommodate representations reflecting this variety. But the new round of comments suggests a widespread belief that the BCBS's response has not yet gone far enough. Real property remains especially important for the collateralisation of loans in Asia, so that – unsurprisingly – submissions supporting greater flexibility in this area are particularly numerous from this region. Particular proposals include more flexible rules for the mortgages secured by commercial property under the standardised approach and a relaxation of the eligibility criteria and lower floors for loss given default (LGD) for commercial and residential real estate under the IRB approach. Proposals from other respondents include more flexible conditions for the valuation of real collateral (difficulties regarding which for several developing countries reflect the lower level of development of markets for this purpose). In the case of guarantees and credit derivatives, proposals include a broadening of the rules as to eligibility for protection providers and, under the latter heading, recognition of other transactions in addition to credit default swaps and total return swaps for the purpose of credit mitigation.

Expected and unexpected losses (EL and UL) and loss provisions

The approach of the BCBS to EL and UL in setting capital requirements has differed from that of the literature on the management of banking risks which treats the former as a cost of doing business to be covered by reserves or provisions, leaving the latter to be covered by capital. Owing partly to the difficulty of achieving international agreement on a definition of loss provisions and reserves, the intention of the BCBS is that capital should cover EL as well as UL, and general loss provisions are included in capital up to a ceiling. *CP3 has taken some cautious steps to permit greater recognition of loss provisions not already included in capital to reduce risk-weighted assets classified as EL. A number of respondents would like the BCBS to go further in this direction or in the recognition of provisions as part of capital.*

Operational risk

Here respondents focus their comments principally on the levels and inconsistency of the proportions of key indicators of a bank's activities used to set capital levels under the two simpler approaches, the Basic Indicator Approach and the Standardised Approach, and the restriction of the recognition of insurance for operational risk mitigation to the third more sophisticated approach, the Advanced Measurement Approach. However, there is also still some scepticism concerning the case for quantified capital requirements for operational risk under Pillar 1 as opposed to handling the subject under supervisory review (Pillar 2). Many respondents view the proportion (alpha) of 15 per cent applied to the bank's average gross income under the Basic Indicator Approach as leading to excessive capital for operational risks since in developing countries interest margins are often higher than in developed ones since owing to their fulfilment of a more important role in off-setting credit risk. It is even pointed out here that, if income resulting from these margins is used to increase reserves, the same risks may be covered by capital under two different headings. Moreover the proportions (betas) applied to the income of business lines under the Standardised Approach are widely viewed as too high to provide the desired incentive for its adoption in preference to the BIA. Several respondents expressed support for recognition of the risk mitigating effect on operational risk of insurance in

the form of a reduction of the capital charge under all three approaches to operational risk.

Pillar 2/supervisory review

Support for national supervisory discretion by some respondents is balanced by the concerns of others that insufficient or inadequate supervisory guidelines under Pillar 2 may compromise attainment of the objective of a level playing field for banks internationally. Several respondents emphasise the shortage of supervisory resources in their countries for implementing NBCA, particularly its more advanced and sophisticated options – a shortage likely to be aggravated by competition for the limited supply of people with supervisory training from the private sector.

NBCA and IMF surveillance

*There is some opposition to any rapid inclusion of implementation of the NBCA in the IMF-World Bank Financial Sector Assessment Programme (FSAP) and in IMF surveillance of countries' financial sectors. This opposition is due to the complexity of such implementation and to the closely related matter of the shortage of supervisory resources just mentioned. The need is thus emphasised by some respondents to limit surveillance of capital adequacy and associated risk management by banks to the relevant parts of the BCBS's **Core Principles for Effective Banking Supervision** at a general level.*

Pillar 3/transparency and market discipline

There is scepticism on the part of some respondents as to the value of disclosure on as detailed scale as prescribed under Pillar 3. Amongst the points made here is that the disclosures of CP3 are designed to enable investors to exercise market discipline. However, in many developing countries depositors are likely to have a more important role under this heading, and some respondents want greater national supervisory discretion for this area. Several respondents also emphasised the need for increased cooperation between the BCBS and the IASB regarding banks' disclosures.

Representativeness of the drafting and implementation of the NBCA

Despite the scale of the consultation exercise undertaken in connection with the NBCA, reservations have still been expressed as to the representativeness of the process involved. Specifically there is a reference to the inadequacy of the attention paid to the problems of small open developing economies. One respondent has suggested that coherent implementation of the NBCA in the large and diverse number of jurisdictions concerned would be facilitated by an enlargement of the membership of the Basel Accord Implementation Group to make it more representative of non-G-10 countries.

Miscellaneous

Several other specific points are covered in the comments of respondents, including the following:

- Inconsistencies between related parts of the text of CP3 and lack of clarity concerning some subjects;
- The increased capital requirements indicated by the third Quantitative Impact Study (QIS) for banks using the standardised approach;
- Cross-holdings of bank capital, a subject on which one respondent feels that the rules of the NBCA prescribing deduction of such holdings from capital are too restrictive;
- Incentives to regulatory arbitrage between banks' banking and trading books;
- The rules as to when domestic- or foreign-currency ratings should apply when unrated borrowers are assigned a rating under the standardised approach which is based on the rating of an equivalent exposure.

Supervisory rules versus supervisory principles

One respondent would like to see a shift in emphasis in the NBCA from "rigid, prescriptive risk management methodologies towards a more principles-based approach" (a point of great enough general importance to warrant naming the respondent – Hong Kong). This leads easily to the question (not elaborated by Hong Kong

itself) of whether the BCBS's task would not have been easier if it had chosen the path of a shorter, more principles-based NBCA, which would be annexed or supplemented by more detailed and technical supervisory guidelines such as are now included in the NBCA itself. A possible objection to this approach is that it would not achieve the objective of a level playing field for banks internationally. Honest judgements may differ here. While detailed rules are capable of promoting competitive equality, they also usually furnish new opportunities for regulatory arbitrage and may be associated – as recent corporate scandals amply illustrate – with compliance with the letter rather than the spirit of regulation.

A note on the submission to the BCBS of Griffith-Jones, Spratt and Segoviano⁵⁴

In view of the frequency of references to this submission in the comments of respondents a few observations seem worth annexing to the review of developing countries' above. The basic argument of the authors as to the benefits in terms of reduced credit risk of a loan portfolio appropriately diversified across borrowers from developed and developing countries seems incontrovertible. They make two alternative suggestions for recognition of the benefits of such diversification. Under the first "an adjusting factor [would] be incorporated into the Accord. This would be applied at the portfolio at the portfolio level, and could function in a tapered fashion...a fully diversified bank would qualify for a reduction of approximately 20 per cent of required capital. This reduction would then decline as the level of diversification fell, reaching zero for an undiversified bank. Such a modification would be relatively straightforward to introduce, would not add to the complexity of the Accord, but would ensure a more accurate measurement of risk". Under the alternative "the modification could be integrated in to Pillar 1 of the Accord through the development of a separate developing country curve. This would be similar to the modification produced for SMEs and would be calibrated so as to produce a similarly tapered reduction in capital as in the adjusting factor described above".

Both of these suggestions may be more difficult to translate into operational rules than the authors think. The level of diversification to be undertaken by the bank to qualify for a reduction in capital requirements would presumably be reflected in an expression for the correlation of risks of a type similar to those specified for the different classes of exposure, corporate, sovereign, bank and retail, under the IRB Approach. Under the first alternative this correlation expression would vary with (presumably as some kind of step function of) the proportions of the portfolio's exposure to developed and developing countries. Such an expression could presumably be determined on the basis of data similar to those used to derive other parameters in the formulas for estimating capital requirements under the IRB approach. However, the exercise might not be straightforward and probably would add to the complexity of the NBCA. This is not an argument for not including such an option if the calibration of credit risk could be reliably improved thereby, and if the techniques of credit risk mitigation in the NBCA would not be effective in bringing levels of financing costs to developing countries down to acceptable levels. Regarding the second alternative, the adjustment factor in the IRB Approach to take account of the lower risk of exposures to SMEs included in CP3 may not provide a good analogue for a method to recognise the benefits of diversification involving the two classes of developed- and developing-country borrowers since the reduction in capital requirements for SMEs under the IRB Approach is due to a lower correlation factor for exposures within the exposure group and thus does not reflect the effects of diversification across groups. As in the case of the first alternative an exercise along the lines proposed would require prior specification of a portfolio containing developed- and developing-country exposures in proportions which significantly reduced the portfolio's credit risk.

⁵⁴ Griffith-Jones S, Spratt S and Segoviano M. Submission to the Basel Committee on Banking Supervision: CP3 and the developing world. July 2003.

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