UNOFFICIAL AND UNEDITED COMPILATION OF PRESENTATIONS MADE DURING UNCTAD'S SIXTH DEBT MANAGEMENT CONFERENCE

Geneva, 19—21 November 2007

UNITED NATIONS

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CONFERENCE ON TRADE
AND DEVELOPMENT

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UNCTAD/WEB/GDS/DMFAS/2009/1

August 2009

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This document is not an official UNCTAD document. It is an unedited compilation of material presented during the sixth Debt Management Conference of UNCTAD, in November 2007. It includes not only available papers and PowerPoint presentations prepared by speakers but also summaries of panel discussions and some transcripts. All papers and PowerPoint presentations are in their original language.

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Executive summary

This document is a compilation of summaries of panel discussions and available papers including Powerpoint presentations on themes deliberated by debt management experts and professionals at UNCTAD's sixth Debt Management Conference, held in Geneva in November 2007. The Conference was organized by UNCTAD's Debt and Development Finance Branch, in particular by the Debt Management and Financial Analysis System (DMFAS) Programme, with the aim of helping countries with developing and transitional economies build their capacity in debt management.

The Conference covered the following main themes: responsible lending and responsible borrowing; debt relief and sustainability and debt strategy formulation and implementation, with a day dedicated to discussions on each of these themes. Panel discussions covered the following sub-themes: odious debt, concessional lending, orderly debt settlements, the case for further debt relief, vulture funds, contingent liabilities, emerging capital markets, formulation of strategies for entering domestic and international capital markets, the use of capital market financing (country case studies) and international support for debt strategy formulation and implementation.

Contents

Abbreviations

AfDB	African Development Bank
AFRODAD	African Forum and Network on Debt and Development
BIS	Bank for International Settlements
CL	contingent liabilities
DeMPA	Debt Management Performance Assessment
DMFAS	Debt Management and Financial Analysis System (UNCTAD)
DMO	debt management office
DOD	disbursed and outstanding debt
DSA	debt sustainability analysis
DSR	debt service ratio
DSF	Debt Sustainability Framework
ECA	export credit agency
EURODAD	European Network on Debt and Development
FDI	foreign direct investment
FfD	Financing for Development
FX	Foreign Exchange
G-7/G-8	Group of Seven/Eight countries
GDP	gross domestic product
GDDS	General Data Dissemination Sytem
HIPC	heavily indebted poor country
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association (World Bank)
IDI	INTOSAI Development Initiative
IFI	international financial institution
IMF	International Monetary Fund
INTOSAI	International Organization of Supreme Audit Institutions
LDC	least developed country
LIC	low-income country
MDB	multilateral development bank
MDGs	Millennium Development Goals
MEFMI	Macroeconomic and Financial Management Institute of Eastern and Southern Africa
MDRI	Multilateral Debt Relief Initiative
MTDS	Medium-term Debt Management Strategy
NGO	non-governmental organization
NPV	net present value
ODA	official development assistance
OECD	Organization for Economic Cooperation and Development
PRGF	Poverty Reduction and Growth Facility
SAI	supreme audit institution
SDDS	Special Data Dissemination Standard
SOEs	state-owned enterprises
TFFS	Inter-agency Task Force on Finance Statistics

UNCTAD	United Nations Conference on Trade and Development
UNITAR	United Nations Institute for Training and Research

Opening statement

Supachai Panitchpakdi
Secretary-General of UNCTAD

It is my pleasure to welcome you to the Sixth UNCTAD Interregional Debt Management Conference, to be followed by the meeting of the Advisory Board of UNCTAD's Debt Management Programme (DMFAS).

As you know, UNCTAD has worked on debt issues since the 1970s. As the debt situation of developing countries has evolved over the past three decades, UNCTAD has provided up-to-date analysis of the most important developments and emerging issues in international debt, and has adapted its technical assistance to the changing needs of developing countries.

In the 1980s, UNCTAD played an important role in helping to build a consensus on debt restructuring that was later consolidated within the Paris Club. It has since retained an advisory role for developing countries involved in debt restructuring with Paris Club creditors. Indeed, it was through UNCTAD's role in the context of the Paris Club negotiations that the idea of our Debt Management Programme was born. UNCTAD recognized that countries often lacked reliable information on their external debt situation. The need to help them produce reliable data for the purposes of negotiations on debt rescheduling and improved strategy formulation and implementation became increasingly evident.

It was for this reason that UNCTAD developed the DMFAS system, a computer-based debt management system. That was over 25 years ago, and of course the needs of debt managers have greatly evolved since then – as has our system, the Programme and the assistance we provide. The Debt Management-DMFAS Programme today is the largest provider of technical cooperation and advisory services in debt management in the world, and has so far provided technical assistance at the country level to 66 countries. This includes activities to strengthen policy-making and managerial capacities in developing countries in order to enable them to attain and preserve a level and structure of debt that is sustainable in the long term.

Indeed, UNCTAD is especially proud of its capacity-building efforts to support the consolidation and development of debt management institutions in a large number of developing countries. We are thus delighted to see so many of them represented here in Geneva today.

Ladies and Gentlemen,

As part of its original and ongoing mandate, UNCTAD retains an acknowledged role as the focal point within the UN system for the integrated treatment of trade and development and interrelated issues. This has naturally entailed continuous examination of the role of finance in trade and development at both the systemic and national development policy levels.

UNCTAD has been a major force behind the initiative that established the ODA target of 0.7% of GNI, which today lies at the heart of the development finance process. This organization was also associated with promoting debt relief and sustainability before either concept was mainstreamed into the work of international financial institutions.

UNCTAD's unique vantage point has taught us that just as debt management cannot be seen except as a part of debt sustainability, so is the external debt *problématique* part of the broader issue of successfully financing development and ensuring coherence between development strategies and macroeconomic policies. In this regard, allow me to refer to some of the key findings of the 2007 report on recent developments in external debt we prepared for the General Assembly. The report highlights many positive trends in the external debt situation of developing countries while also acknowledging that crises may still erupt.

Indeed, we should recognize that external debt remains an important tool in development finance for achieving poverty reduction and the MDGs. It is true that in recent years, many developing countries have been able to reduce their debt ratios to a large extent through debt relief programmes and a favourable external economic environment. Some countries have even been able to pay back their external debt entirely. Nevertheless, the total nominal external debt of developing countries increased to $2,851 billion in 2006, and remains a critical issue for most low-income and some lower-middle-income countries. Moreover, there has been a recent trend towards short-term debt instruments, which now account for about 22% of total external debt.

While it is difficult to judge whether the recent favourable development in the external debt situation is due to external factors or domestic policy, it is clear that several developing countries have used the last few years to improve their debt management strategies. As a result, many developing countries are now better prepared for reversals in the external economic environment.

This is particularly crucial, as it is increasingly uncertain whether the pro-growth economic climate will persist. Long-term interest rates in most of the major developed economies remain high, and 2007 witnessed localized turmoil in some emerging market countries, not to mention in advanced financial markets. Several developing and transition countries are still characterized by large current account deficits and overvaluation of their exchange rates. Furthermore, the persistence in global imbalances continues to be a concern, as a disordered unwinding of these imbalances is still possible, which would have a major impact on developing countries. UNCTAD's *Trade and Development Report* has regularly highlighted these risks, and a recent note by the secretariat on developments in the financial markets outlines some of the related systemic and policy questions of importance to many developed and developing countries.

UNCTAD has also signalled that an excessive focus on external debt could distract policy makers from the fact that in many ways, the composition of a debt portfolio is as important for debt sustainability as the amount of total debt. The recent shift towards domestic debt, which now stands at more than 50 per cent of total debt in developing countries, is thus an important development to be monitored. While domestic debt reduces vulnerability to external shocks, we need to look carefully at the risks arising from this shift. Debt managers also need to analyse potential mismatches in maturity and currency compositions, as these are the largest sources of short-run vulnerabilities, which can easily lead to unsustainable debt positions.

Let me also say a few words about the recent shift towards new forms of financing and new debt instruments. Undoubtedly, the use of such instruments could help reduce the probability of debt crises. It is, however, important to recognize that the likelihood remains low of developing countries raising sizeable sums through such instruments in the near future. Meanwhile, the importance of corporate borrowing has also grown, accounting for 41% of developing countries' long-term external debt. This raises the issue of governments' contingent liabilities arising from such private borrowing. Hence, prudence in issuing new debt, and policies aimed at avoiding over-borrowing by both the public and the private sectors, will remain essential for avoiding debt and financial crises.

Our conference this week will look at a wide array of issues related to debt management, debt relief and debt sustainability. I wish to highlight three areas that continue to be high on the global political agenda and that are part of UNCTAD's research and technical assistance.

First, there is the notion of sound debt management. This concept is often rather blurred. Clearly, debt management requires a public debt strategy consistent with the broad macroeconomic policy stance. It also requires a wide range of debt management tools, such as:

- accurate records of all public and publicly guaranteed external and domestic debt instruments;
- schedules on debt-servicing obligations, including contingent liabilities;
- the capacity to estimate the impact of borrowing decisions of various domestic entities on the country's overall debt profile, budget and balance-of-payments; and
- the capacity to benefit from innovations and instruments available in financial markets to reduce costs and risks to the debtor.

A second issue is that of debt sustainability analysis. While this has not been singled out in a particular session here, it remains the overall framework for any deliberations about debt management. There is still no agreement on the definition of debt sustainability, and two approaches are chiefly used. The IMF approach focuses on solvency and debt- servicing capacity. The UN, by contrast, has proposed that debt sustainability be defined as the level of debt that would allow a country to achieve the MDGs by 2015 without an increase in debt ratios. It is now amply clear that goals and intermediate targets for achieving debt sustainability need to be analysed in domestic policy terms before applying generic criteria or frameworks that are not necessarily relevant. At this week's conference, the importance of contingent liabilities, the use of capital market financing, and responsible lending are just a few of the issues to be addressed, all of them of direct relevance to the question of debt sustainability.

Another hotly debated issue is the concept of odious debt, which is not a new idea in international law. It regained topicality this year when Ecuador established its debt-audit commission, which is trying to advance on a formal investigation of the country's loan agreements. However, legal experts, politicians and civil society organizations disagree about the concept of odious or "illegitimate" debt. The UNCTAD discussion paper prepared on this concept, with the support of the Government of Norway, by Prof. Robert Howse – and here let me extend a warm welcome to both him and our other expert speakers – is one focused contribution to the growing literature on the legal notion of odious debt. We look forward to a vivid discussion of this and other aspects of the important issue of responsible borrowing and lending.

Efficient and effective debt management remains a core task of finance ministries and central banks in developing countries. For this reason, strengthening the capacity of developing countries to manage their debt must be an integral part of national economic and financial policies. Improving debt management capacities is also important to ensure a long-lasting impact of debt relief initiatives. UNCTAD remains committed to its mission to assist developing countries in effectively integrating debt management into their long-term development strategies.

Building debt management capacity is a long-term undertaking, which must be geared to the various country situations. Each situation will depend on the type of financing to which a country has access; on the quality of its macroeconomic and regulatory policies; and on its overall institutional capacity, credit standing and debt management objectives. But for all countries, public debt management is an area that requires constantly updating capacities. The donor community should stand ready to further support capacity-building in debt management, while remaining aware that leadership and ownership at the national level is essential. In this context, I would like to acknowledge the crucial role that the donors of UNCTAD's Debt Management-DMFAS Programme have so far played in helping the Programme achieve its objectives, and to thank them for their sustained commitment and generosity.

The Programme's products and services are available to all countries and belong to all countries. It is in this spirit that I invite you to also attend the DMFAS Advisory Group meeting on Thursday, in order to help us help you achieve your development goals through an improved and efficient debt management. I am happy to also welcome here the numerous representatives of other institutions involved in providing technical assistance in debt. It is only through collaboration with all entities involved in debt issues that we can best comprehend and help countries to manage their debt effectively for the purposes of development and poverty reduction.

Keynote speakers

Debt relief and beyond: debt sustainability and the Millennium Development Goals

Ambassador Dr. Reinhard Schweppe
Permanent Representative of Germany to the United Nations Office at Geneva

I. Introduction

- "Misery is the bedfellow of debt." (Pliny)
- That in a nutshell is the connection between debt and poverty. It is a topic that will always be of relevance for the Millennium Development Goals.
- I am happy to be here addressing this Conference. The important thing for me is that much has happened and much has been achieved in the past decade – but there is still a great deal to be done. What exactly?

II. Taking responsibility – debt cancellation as a contribution to justice

Many of what are today heavily indebted poor countries (HIPCs) found themselves at the start of the 1980s slipping into a situation of unsustainable debt. In the early 1990s, the HIPCs' debt ratios rose to values of up to 800% of exports or 160% of gross national income.

How did that happen?

Loans are an important instrument for making investments for the future. Investments in infrastructure, in education and in health. – Provided that more money is generated by the investments than is needed to repay the loans.

The problem is that the loans did not have the impact on growth that had been hoped for.

If these countries had really experienced economic growth of 5%, then the debt to gross national income ratio would have been 60% maximum. – But the assumptions for the rate of growth were totally exaggerated! Borrowers and lenders often took too rosy a view. In fact the debt ratio was often more than 100%!

Reasons for low growth:

- natural disasters such as droughts;
- resources being wasted due to technology deficits; and
- something that we can hardly conceive today – falling prices for raw materials over a period of many years, with the result for many least developed countries (LDCs) those revenues from exports were lost; the foreign currency revenues urgently needed for debt servicing sank.

Low growth was exacerbated by other factors:

- Weak institutions, poor governance and a lack of debt management.
- External shocks: When first of all oil prices shot up in the 1970s and then interest rates soared in the 1980s, so too did debts.
- Political instability, violent conflicts: For example, the outbreak of civil war in Liberia at the end of the 1980s set the country back decades and led to a totally unsustainable level of debt.

→ More and more new loans are needed to meet repayment obligations. The result is spiralling debt.

- The international financial system failed to draw the necessary conclusions. The right range of instruments, such as changing to grants or writing off certain claims, was simply not yet in place then.
- Thus lenders played quite a major part in triggering the debt crisis. Loans were often provided without sufficient thought.
- The situation that followed was simply intolerable: countries were bankrupt, not one, not two, but more than forty countries.
- For private individuals or businesses there are processes for declaring bankruptcy. There is nothing like that for countries that want to free themselves from the burden of debt. They have a choice: service their debts and cut public spending on social services or stop servicing their debts.
- It is not acceptable for either debtors or creditors if countries are no longer able to pay their debts.
- The result is that in *debtor countries* the interest rates rise so sharply that private invest-

ments increasingly tail off. If debts continue to be serviced, there is no money left for importing vital capital goods.

- Savings are achieved by cutting spending on education, health and infrastructure projects, which puts an additional brake on economic growth. This makes it impossible to alleviate poverty.

→ It is a question of solidarity and justice that we do something to tackle over-indebtedness.

- Linked to debt cancellation is the right to make a new start, the right to liberation from a hopeless situation.
- Debt forgiveness is thus also a matter of economic rationality: borrowers and lenders are mutually dependent on one another. It is important not to bury potential for ever. Debt cancellation offers a second chance by making it possible to make a new start instead of leaving debtors to sink beneath a mountain of debts.
- At the beginning of October, Federal Chancellor Angela Merkel visited Liberia. This is a sad example. A debt burden of 150% of annual export revenues is considered sustainable. Liberia's debt burden is 3000%! How is this country to develop weighed down by such a burden?

III. The long road to debt cancellation – building the future

a. *HIPC/MDRI Initiative*

The *unbearable* – in the most literal sense of the word – situation was screaming for a solution! Slowly changes began to take place in international policy:

In 1996, the Heavily Indebted Poor Countries or HIPC initiative for short was born. At first progress was slow, far too slow. And the conditions were scarcely to be met.

But time was pressing. New ideas were urgently needed! In 1999, the German G8 Presidency provided a great opportunity to do something.

There are two basic conditions that are crucial to the success of this debt cancellation initiative: achieving multilateral debt cancellation too and linking debt cancellation directly to poverty reduction. That was new.

However, first of all the HIPC debt cancellation proceedings were accelerated and the volume of debt cancellation increased. This gave us the Cologne Debt Cancellation Initiative (or enhanced HIPC Initiative). Comprehensive debt cancellation for the first time ever.

Initially, debts owed to multilateral financial institutions were only partly cancelled. This deficit was remedied at the G8 Gleneagles Summit in 2005. At Gleneagles, the Multilateral Debt Relief Initiative (MDRI) was added to the HIPC Initiative. Since 2007, the Inter-American Development Bank has also been involved.

b. *Interim result*

So far debt cancellation worth more than 105 billion US dollars has been promised. 63 billion US dollars of that total comes from HIPC debt cancellations and 42 billion represents multilateral debt cancellations.

22 countries have already been granted comprehensive debt cancellations. Another 10 countries have qualified for debt forgiveness and are already experiencing debt relief. There are 41 countries that can be considered for comprehensive debt cancellation.

By the end of 2008, Gambia, Burundi, DR Congo, Chad, Guinea and Haiti could have had all their debts cancelled and the cancellation of Liberia's and Togo's debts could begin.

Germany has cancelled bilateral debts worth about 3.6 billion euros under the HIPC Initiative. This figure is likely to reach 4.4 billion euros soon and a total of up to 7 billion euros is possible. In addition, Germany's share in the MDRI will be about 3.5 billion euros.

Figures representing sums of money like that are very abstract – but behind them are individual fates.

And, thank God, the debt situation in the developing countries has improved significantly. The poorest countries are already benefiting from comprehensive debt cancellations, e.g. Bolivia, Mozambique and Mali.

Other countries are benefiting from increased prices for raw materials, e.g. Angola and Peru. Others again are achieving particularly high rates of growth thanks to the international division of labour, for example Vietnam or Cambodia with an average of 7.5% or 8.9% in the period from 2000 to 2005. If the economy is performing better then it is easier for a country to make debt repayments.

Many emerging economies now have high levels of foreign currency reserves, which are frequently higher than their outstanding debts and form a buffer in crisis situations. For example: China and India, but also African countries such as Algeria, Nigeria and South Africa.

That is why hardly any debt relief arrangements are being made outside the HIPC framework. Some countries are more interested in repaying their debts early. This is a sign of a more responsible attitude towards loans.

c. *Future!*

Debt cancellation initiatives are having direct impacts: as a result of the HICP debt cancellations, annual debt servicing payments have been halved. And the Multilateral Debt Relief Initiative can be added to that. In 2007 alone, the 22 countries whose debts have already been cancelled completely have saved 1.3 billion US dollars thanks to the MDRI.

That creates scope for poverty reduction. And today, debt cancellations are combined with poverty reduction. In that way we can be sure that the money thus released benefits the people and is invested in education and health. And the success of this initiative is an affirmation of the idea: the proportion of pro-poor spending has risen from below 7% of GDP in 2000 to 9% in 2006.

In Tanzania, debt cancellation has made it possible to abolish primary school fees. The number of children in primary school has gone from 800,000 before the debt cancellation to 1.6 million today: double what it was.

We must not rest on our laurels! Further innovative instruments are needed. A good example is: Debt2Health. At the replenishment conference for the Global Fund in Berlin this September, the German government launched the D2H initiative – under which debts are turned into health! That is an innovation! I am proud of this initiative!

IV. Challenges

In some cases progress under the HIPC Initiative has been slower than we had hoped.

Mostly the reason for that is political instability or violent conflicts: Sudan, Somalia, and Togo.

When countries have reached the point that they are ready to take that step and the general conditions in the country are good, then we need to act quickly! We must not allow a repeat of the situation with Liberia. The German government had lobbied hard for a quick solution. Now, at last, we have a breakthrough at the IMF!

It is good that the World Bank and the African Development Bank are working on mechanisms for situations involving payment arrears like that.

So far, the level of HIPC participation by commercial creditors has not been very satisfactory.

→ We must do more lobbying! We must create incentives to participate! Measures with a strong PR impact can make a big difference. A good first step is publishing scorecards on the World Bank and IMF websites.

The World Bank's Debt Reduction Facility is a useful instrument. It has made it possible to buy back outstanding debts worth 8 billion US dollars for 640 million US dollars. The Facility is helping to increase the participation of commercial creditors in debt cancellation. Private creditors should also participate in HIPC debt cancellations and thus fulfil their social responsibilities.

a. *Litigating creditors / vulture funds*

Litigating creditors, also known as vulture funds, are a source of problems.

They buy up debts cheaply with the aim of taking advantage of a country's improved liquidity following debt cancellation in order to enforce their claims for repayment through the courts, often for sums that are higher than the original debt.

We must not allow such funds to suck up the liquidity that has been created through debt cancellation, thus endangering the achievement of the MDGs. It is important therefore that:

- we prevent the sale of debts;
- all creditors act in a responsible fashion;
- we get private creditors to participate in debt cancellation measures. We need a constructive dialogue!

If debts have fallen into the hands of such funds and court proceedings are threatened, the countries concerned must be able to get support in the shape of the necessary legal expertise. Legal aid funds have an important function in this regard!

Our message must be clear: we will not tolerate private funds profiting from debt cancellation and sucking up the money urgently needed for achieving the MDGs so as to maximise their own profits.

b. *Debt sustainability*

How in times when high levels of funding are needed to achieve the MDGs can we avoid a new debt crisis?

The solution would appear to be simple: give funds solely and completely as grants. However, there are good reasons for not doing that.

Projects are generally chosen and appraised more carefully when the money spent on them must be paid back. That is why loan funding produces better results than grant funding.

In addition, there is the danger that grants create more dependency than loans.

And loans produce greater responsibility and thus greater ownership.

It is also easier to substitute market funds for concessional loan funding than for grants.

→ Loans are still important for financing development.

But, certain conditions are important so that loans can bear fruit: loans are only suitable when a sufficient share of the money is used on investments and the quality of the measures is in order. That is more likely to be true of areas like infrastructure than of others.

Instead, the problems arise when spending on recurrent costs is covered by loans.

Debts must remain sustainable and should not exceed a certain level (in order that countries can survive exogenous shocks).

To ensure that a high demand for funding for the Millennium Development Goals does not lead to renewed over-indebtedness, the World Bank and IMF analyses on debt sustainability are important.

Today far more caution is being exercised. The elaboration of alternative scenarios based on low rates of growth, analyses of the impacts of exogenous shocks and the inclusion of domestic debts in the calculations mean that today we have more reliable forecasts of the risks.

The World Bank and the African Development Bank have drawn conclusions from this for their lending policies: if there is a danger of over-indebtedness, countries receive grants instead of loans or at least a mixture of loans and grants.

The World Bank and IMF analyses also provide important guidance for other lenders and of course borrowers, enabling timely changes in course. Right now the search is on to find the best measures – I am eager to know what the outcome will be. What is important is that all lenders are involved.

The responsibility of creditors?

- We should urge that lenders make a commitment to apply the principles of responsible lending!
- New players must also pay attention to sustainability!
- Measures in the field of South-South co-operation must be designed responsibly.
- There was an open dialogue on that topic last week in Berlin. Experts from borrowing countries, new and traditional lenders, and representatives of international organisations and civil society discussed debt sustainability and prudent borrowing and lending.

c. *Debt management*

All these debt cancellations make no sense unless lessons are learnt: what is the best way to manage debt?

UNCTAD has been doing valuable work in the field of debt management for years. We finally have greater attention being given to this topic.

Ultimately it is borrowers who are responsible for debt sustainability. We should therefore enable countries to meet their responsibilities and develop debt strategies. The key term is capacity building.

I am pleased that this year, for the first time ever, Germany is supporting UNCTAD's work in the field of debt management. We are providing 450,000 euros for UNCTAD's DMFAS Programme from 2007 to 2009. In addition, Germany is lobbying hard at the World Bank to get this area strengthened.

V. Dare more transparency

Borrowing countries are responsible for managing their debts, for debt strategies. To the representatives of borrowing countries I say: set out what responsible borrowing means for you. Without your ownership, securing long-term debt sustainability is not possible.

However, lending countries must also act responsibly. There is therefore an urgent need for common minimum standards for lending to low-income countries. That is the only way to prevent another debt crisis.

Information about levels of indebtedness is essential in order to be able to calculate debt sustainability. The risk of over-indebtedness can only be recognised if those concerned have access to information about the volume and conditions of borrowing and lending transactions. We must therefore increase transparency and improve as a matter of urgency the availability of information about credit transactions.

Dealing with odious debt while developing principles for sustainable lending

Henrik Harboe
Deputy Director General, Multilateral Bank and Finance Section, Ministry of Foreign Affairs, Norway

Odious debt and sustainable lending

- Other contributors today:
  - Academic perspective
  - NGO perspective
- My approach and contribution:
  - Why is this important? Both the past and the future, interlinked.
  - Policy implications, what can and should be done.
  - Norwegian development and debt policy:
    - Policy statements: ambitious debt policy, explicitly on illegitimate debt: stimulate international debate, consider international mechanism or court.
    - What we have done: cancellation + studies
  - Dilemmas and challenges moving forward

Audio transcript:
The original title "responsible lending": the concepts are constantly evolving. We have now moved towards the title of "sustainable lending" which is more objective as a criterion than the concept of "responsible" or not. I will also talk about odious debt.

My approach today, after having said something about why these issues are important, is to look more at policy implications and what we do as policy makers and in the development agencies.

Regarding what is important, I will look at the past and at the future. This is important as in the debate on odious, illegitimate debt and responsible lending there is a kind of difference between the backward looking and the forward looking perspective. Of course, it is important to look forward and to try to define principles of more responsible lending to avoid the debt problems of the past but at the same time it is very important to look at the history and look at the case of doing something about the old debt which some would claim is illegitimate or odious. And of course the link between the two is important. I think that some of the last part that I heard from my German colleague was that we have to learn from experience. Then the policy implications; what can be done and what should be done. As you can see from my title, I represent the Norwegian Ministry of Foreign Affairs and the multilateral bank division which I chair (?) which is responsible both for our debt policy and the Paris Club. Our Paris Club delegate is in my section and he is also dealing with the World Bank. So we are covering many of these areas. I will spend some time describing our development and debt policy. We had a new Government, two years ago, which had a very ambitious debt policy. Actually there is explicit language on illegitimate debt in the political platform of the Government saying that this is an issue that we have to look into. We would like to stimulate an international debate on illegitimate debt and also consider whether there is some kind of international mechanism or court that should be put into place in order to deal with odious debt. So it is very clear language as part of the Norwegian debt and development policy. I will exemplify by describing a bit what Norway has done already in terms of cancelling part of our bilateral debt, and also some important studies on the topic, and then end with dilemmas and challenges moving forward because this is a discussion which is full of old dilemmas.

What is this/why an issue?

- Much dubious debt around, and obstacle to development:
  - Both borrower and lender responsibility
  - Wish to deal with the past and improve future practice
- The issue of illegitimate ("dictator") debt has a moral and intuitive appeal
  - Examples often used: Apartheid debt, Saddam Hussein, "is it fair that the people of Burma shall pay for loans contracted by the generals?"
- Important to deal with odious debt from the past – also lessons to be learned looking forward.
- Odious debt is an evolving concept: contemporary notion less focused on legal aspects than the traditional notion, but more on political and moral aspects
- Odious debt can be decomposed:
  - Ineffective debt: bad project and/or project analysis, bad framework conditions

- Unfair debt: bad conditionality, too expensive loans
- Criminal debt: corruption, kickbacks, illegal capital flight

Audio transcript:
So what is really the issue and why should we care about it? As we all know, there is a lot of dubious debt around. Debt, loans that were given for political reasons, project preparation was very bad, borrowers were irresponsible taking on too much debt, lenders were pushing debt. There are all these stories and I think that we have to admit that there has been a lot of debt with loans that were not given in the best manner. And this is both a borrower and lender responsibility. Any debt contracted is a debt between two parties, meaning that both parties are responsible. That is a very important starting point for the debate.

And we should deal with the past in order to improve future practices. It is very welcome that a lot of countries have a much more comfortable external financing position today than 10 years ago. And that is partly thanks to important debt relief mechanisms but also due to the fact that there is good growth across the world. But we have to then use this opportunity to avoid moving into the same problems as in the past. Then, of course, the discussion on illegitimate debt, or odious debt, or dictator debt has a moral and intuitive appeal. It is very dangerous to quote countries but some of the examples that are often used in this debate, and I think that one of the easiest examples is apartheid debt. Since you then had the regime under UN sanctions and of course for the governments taking over after apartheid, having to repay the debt taken on by the apartheid regime is something that can be seriously questioned. The heated debate about Iraq's debt is a case in point. And also the recent events in Burma I think have also raised the same question. Is it fair that the population in a hopefully democratic Burma should pay the debt of the generals? A lot of political sensitivities. I think that if you call something "dictator debt" it is pretty obvious that asking the population to ask that is morally challenging. And we have to deal with this problem. It pops up from time to time in the discussion. It is a quite active debate in the NGO community and we will hear more on that from Eurodad later. So we have to learn from the past in looking forward.

Then it is important that the concept of odious debt is evolving. This has been an issue under discussion for several hundred years. From time to time debts have been cancelled on this ground. For instance, regimes have changed. So there is a big legal and academic debate on this. I think that Professor Howse will go into more details of the legal aspects of this so I will not touch too much on that. There are a lot of moral and political aspects and my recent examples point to that. As I said, it is morally appealing but at the same time you go into politically sensitive issues when you start meaning something about the debt of Burma or Iraq for instance.

Illegitimate/odious debt is an imprecise issue especially if you try to include more political or moral issues. And one kind of decomposition that has been suggested is that part of this has to do with ineffective debt. The fact that the project that the loan is financing is simply bad: it was badly conceived, badly developed and the analysis that the lender did in preparing the project was actually not done in a good manner. This is the kind of white elephant examples, which are financed by loans, and then you end up with debt stemming from an ineffective – it can be called **ineffective debt** – because it really did not serve the original purpose. Also one reason can be the absence of the necessary framework of conditions in order for a project to be effective and have the desired development effect. That those conditions are not in place so in a sense the loan was given but it was not effective because it was impossible - the project was not able to deliver the intended outcome.

Then you can talk about **unfair debt**. One example is too expensive loans in the sense that the borrower was not really aware of all the costs related to the loans. This could be some interest projections or the interest costs in the contract which were – if you look at it a bit later – were really unfair.

They can also be – and that is very much part of the discussion now with new creditors – active creditors on the block - that we don't really know all the conditions. How much oil??? and in how many years to come is an African country obliged to pay as part of a loan contract. And it can be rather unfair conditions if you add all this up. Then, there is what you can call **criminal debt** where there is corruption linked to lending. We know that it has been true also in many cases, where there can be kickbacks related to big projects or loans. And also that the loans are given to a country but then the money hardly ends up in the country which borrowed the money but it actually ends up in bank accounts in other places. I think that for the debate this is not the perfect decomposition of the issue but in order to understand and to define good policies, decomposing it in different parts is probably appropriate and a good way of doing it.

An issue full of dilemmas

- What criteria to use? When are projects bad enough, borrowers corrupt or illegitimate enough to defend cancellation on illegitimacy grounds?
- Regimes starting out as legitimate borrowers, but deteriorating into dictatorships (Saddam++): how to determine cut-off date?
- Who should make the judgements?

- Moral hazard as in most kinds of debt relief
- Successful projects in illegitimate regimes?
- Unsuccessful projects in legitimate regimes?
- Response from capital markets: risk of credit drought
- Get into a difficult landscape, so better basis for policy needed

Audio transcript:
All this is very complicated and full of dilemmas. If we are to make judgement on some of the variables which I just mentioned, on unfairness, ineffectiveness or illegality, what criteria should you then use in order to deem debt odious or illegitimate? When is a project bad enough in a sense? When is the borrower corrupt enough? Or illegitimate enough to defend cancellation on illegitimate grounds? I mentioned the clear example of apartheid South Africa but if you look at all the cases it becomes very complicated. There are also a lot of examples of regimes starting out as legitimate borrowers. Nobody would actually question it. And if you look at the great number of newly independent countries in the sixties – to say that they were not legitimate borrowers would be a way of stopping their development. But unfortunately some of these countries have deteriorated into dictatorships. An easy example is Iraq. How should we determine the cut off date? At what date did it become illegitimate to deal with Saddam Hussein's regime? It is very difficult but we need to have a view on that if we are to get something operational.

And then who should make these judgements? Should it be a kind of UNish institution, should it be the IMF or the World Bank or should it be some kind of international panel? It is very difficult and like with all kinds of debt relief, there is a moral hazard. And judging what is or isn't illegitimate debt can have severe implications on the capital markets. We have to take that into consideration. We have to be aware of these complicated issues. And then there is the fact that the world is more nuanced than we sometimes hope it is because there are a lot of successful projects in what can be considered illegitimate regimes where you have good growth, good poverty reduction but where you can really question the democratic standing and legitimacy of the regime. On the other hand, a lot of very legitimate regimes have borrowed a lot of money and projects have been very unsuccessful. Now does that merit cancellation on the grounds of odiousness? A big question. (By the way, the examples I used are just examples to illustrate the point).
So we are in a difficult landscape and we need to get a better policy for defining policy, to get a better understanding.

Studies on "illegitimate debt"

- Norway has financed two studies on "illegitimate debt": in UNCTAD and the World Bank
- Studies are proactive and necessary steps. Hope they will contribute to a needed and constructive debate
- However, we must have a realistic and a holistic approach to what we can achieve and the implications it will have on the "bigger picture" (financial architecture and incentives)
- Important that the debate on illegitimate debt does not "drown" the discussion on improvements of existing debt relief mechanism aimed at the poorest countries
- From a pure "cost benefit" point of view, is sustainable lending more important than the backward-looking discussion on odious debt?
- Both is important and the discussion on odious debt can help make future lending more responsible
- Studies important, but action is better...

Audio transcript:
In a difficult landscape, we need better knowledge as the basis for policy. This is why Norway has financed two studies on illegitimate debt recently. One in UNCTAD and one done by the World Bank. We see these research studies as necessary and proactive steps. I hope they will contribute to a constructive debate and stimulate the international debate. It is important when you do studies like that to have a realistic and holistic approach to be both realistic about what can be achieved and also take the bigger picture into consideration. And I just mentioned the moral hazard issue and the response from capital markets. To discuss a delicate issue like odious and illegitimate debt, you have to take this bigger picture into consideration. You can't discuss the issue of odious debt in isolation from the possible consequences. We should also be careful not to drown the already existing mechanism that we have and which has actually delivered a lot of debt relief to the poorest countries. So there is a balance here on focussing on the issue of odious debt but not forgetting the very important mechanisms we already have which deliver debt relief. Because for some countries that is maybe more important than a theoretical and moralistic debate about odious debt. Then I raise this as a question: maybe the discussion about sustainable lending which is forward looking is more important than the background looking discussion about odious debt. I am not concluding this myself, but I think it is important to consider this as a question. I think this is a very important question to have with civil society. Both perspectives are important. We have to continue

the discussion about the difficult issues of odious debt and look forward so that we can learn from past experience and have better lending practices in the future. Studies can teach us something about the past. I think that we cannot just have studies, discussions and meet in seminars; action is important and actually better.

Need to deal with the past and move forward

- All creditors should recognize their responsibility and deal with it.
- Much has happened:
  - Paris Club has gradually moved towards 100% cancellation. This should be continued and followed up by all creditors.
  - We encourage other creditors to follow the example of the Norwegian Shipping Export Campaign.
  - Are dealing with multilateral debt: HIPC 1996, MDRI 2005.
  - But financing of debt cancellation needs to be truly additional.
- The debt campaigners should also take their part of the responsibility. They must continue to push governments, but at the same time be a relevant dialogue partner and have a constructive approach focusing on realistic solutions: the ideal can become the enemy of the good.
  - Example: the chance the debt movement has to comment on the studies. You have been directly challenged; you still have the opportunity to influence this important issue by commenting on the Bank study.

Audio transcript:
I will say something about the Norwegian Ship Export Campaign because it is an example of a country: Norway. We took a critical look at our debt portfolio and found out that some part of the debt that developing countries had to Norway had some of the characteristics of odiousness – or not so good – debt. And this has been a very important matter for Norwegian debt NGOs for many years and they have done a very good job in pushing the government on this and finally two years ago we were able to deliver on that. It goes back to the late 70s we had problems with our ship building industry in Norway and then someone found out that the combination of generous export guarantees would be good both to increase the production of ships in Norway and hopefully these ships could be made of good use in developing countries. So I suggested a win-win situation. But unfortunately as with many projects, many of these ships ended up not being very productive. Some of them even sunk and some of them were not able to be used for the intended purpose so very quickly the guarantees that were issued became operational and the developing countries that had bought ships from Norway ended up with debt to Norway. As there was state guarantee behind the debt, the country would end up having to repay the debt.

This is typical Paris Club type of debt we are talking about. This was critized in Norway and there was a big evaluation a couple of years ago and it was assessed that there was a lot of inadequate analysis related to this project both on the needs side of the developing country, on the actual quality of the project and not least on the risk assessment. To be honest the Export Agency actually did a quite appropriate risk assessment saying that many of these projects should be supported but then political interference changed that and we are going to give that guarantee anyhow.

Norway should look back and take some of the responsibility for this. So in March of this year, the final decision was made about cancelling the remaining debt of this campaign through a unilateral unconditional declaration from Norway. Because we felt that we had to take our part of the responsibility. This was done without reporting the cancellation as ODA. We know that it is possible to do that in the current ODA-DAC rules. We think it is inappropriate. We think that when you cancel debt stemming from export adventures (??) it should not be at the cost of development assistance. So this is why we do not report it as ODA, contrary to a lot of other countries. It is very clear that there is no doubt about the legal or legitimate status of the remaining Norwegian claims on these countries. That is very clear. We have part of the responsibility for that and therefore bear part of the responsibility for the resulting debt. We recognize our co-responsibility for the debt and due consequences. We think this is an important contribution to those countries that have remaining debt to Norway. But we also hope to stimulate other creditors to follow. There are more skeletons in the cupboard without going further into that. But I think that all creditors should take a critical look at their debt portfolio. All creditors should not necessarily do exactly the same but we have to recognize our co-responsibility and deal with it. It is important to do that in parallel to maintaining a discussion about odious debt.

To be fair with the international community, I think we have to recognize and be quite satisfied with how much has happened re debt relief over the last 10 years. In particular for the poorest countries. As you know, the Paris Club has gradually moved towards 100% cancellation. Norway was one of the first countries which topped up the cancellation in Paris Club deals to 100% and more and more countries have come along. And that has been a great achievement and very important contribution. This has not been done after discussions about odious debt but I think as a motivating factor that many of the countries sitting around the table in the Paris Club think that part of this debt, we don't think that we are too proud to collect every cent of it because much of this was done to promote export and that gives us a good reason for cancelling part of it. Maybe not 100% but as a motivating factor. And we encourage others to look into their portfolios to see whether they have part of their portfolios which can be cancelled.

A very important development over the last 10 years is that we are now finally dealing with multilateral debt. Before HIPC, multilateral debt was seen as untouchable. It was impossible to do anything about it. With HIPC it became at least part of the calculation and with MDRI 100% of the debt of the African Bank, the World Bank and the IMF to African countries is cancelled. So there have been very important developments. But as we have seen especially as related to HIPC and MDRI it is important that the financing of this debt cancellation is truly additional otherwise it does not represent any net gain for the poorest countries.

It is not only the creditors who should take responsibility. I think that also the debt campaigners who have played an extremely important role in pushing all these developments I just described and they must continue to push governments. But it is important that this is done, they are a relevant dialogue partner and have a constructive approach focussing on realistic solutions. The ideal can not become the enemy of the good. For example, one big settlement of all illegitimate debt in the world is very unlikely to happen. Too much energy spent on that can be an enemy of building on the mechanisms we have today and moving forward. I refer to the two studies which Norway has financed: UNCTAD (already published) and World Bank study. The WB study is on their site and open for comments. I think that this is a very important document which will be influencing the debate in the coming years. So it is very important that people use the opportunity to comment on that study.

Being forward looking: Responsible/ Sustainable lending

- Analysis of debt sustainable necessary and should constitute basis for borrowing and lending decisions
- For this basis to be effective, must be used by all lenders
- Learn from past experiences and mistakes
- The challenge of policy coherence in creditor countries (debt policy vs. export credit agencies). This will be an even bigger challenge in the future and need to be addressed at the highest political level
- Implications for MDBs and soft window loans or grants: A dilemma, but we need to use soft money where most needed
- Many institutions are taking this seriously and work on the issue: OECD/ECA-group, G8/G20, IDA-replenishment meetings and private creditors. FfD could be an important arena
- New lenders outside of OECD have to be included. This is a key issue, maybe the most important?

Audio transcript:
Re the link of the past history of odious debt and more forward looking approach to more responsible and sustainable lending. Re. The more forward looking aspects. In order to encourage more sustainable lending in the sense that having a view on how much debt can a country take on, I think that was part of the HIPC logic, HIPC initiative, base this on analysis of how much debt can the country live with basically. What is the sustainable level of debt that a country can hold? So some kind of analysis of the debt sustainability must be done and should constitute the basis both for borrowers and lenders. That is a very important point. Not only for the classic lenders e.g. The OECD, we have seen many new actors on the block in particular in Africa but also lending to developing countries and it is very important that they both the private sector and new countries and sovereign funds use this analysis as a basis for what they are doing.

We must learn from past experience and mistakes. Then we have a big challenge in lending countries, in creditor countries when it comes to policy coherence. Clearly our debt policy, and we see this in Norway, and I guess in many other countries, there is a challenge of bringing together the goal of doing something with the debt problem while at the same time taking care of our export interests. And we see this sometimes as a hot issue between my Ministry responsible for Norwegian debt relief policy and the Ministry of Trade and Industry responsible for export credit agency. And I think that this will be an increasing challenge. And we are faced with that in the issue of responsible lending. If we are to be very concrete about saying that we should not lend money to this country, there can be clear conflicts of interest between the export interest and the development policy. And this needs to be dealt with in creditor countries at the highest political level in the government.

Then there is an important discussion about the soft windows of the multilateral development banks. And I think that François Bourguignon will come back to that later today. We are just about to finalize the replenishment of IDA in the World Bank. There is a replenishment discussion of the African Development Fund ongoing and this is very much an issue. In the sense how should you deal with these IDA countries that after debt relief are now in a much more comfortable external position? They get a lot of offers to borrow money and how should IDA respond to that? That is a big issue but I will not answer that but it is on the block. And then it is very encouraging to see that this discussion is very active in many important foras. It tended to start off in the quarters where we were discussing debt relief but of course to be forward looking, the lenders need to discuss it. And it is very encouraging to see the discussion in the process in the OECD's group on export credit agencies have had a very interesting debate for the last year. And also joint meetings between the Paris Club and the export credit agency group in the OECD. And I know that China participated in some of these discussions which is very important. Both in the G8 and the G20 they look into these issues. I mentioned the IDA replenishment. We are now starting up the process for the Financing for Development Conference in Doha a year from now. I think that it is very important that the issue of course of debt but also the forward looking issue of responsible lending is part of that. But very important last point, we need to include lenders outside of the OECD. They play a larger and larger part in global development finance. Maybe this is the most important issue. Not to have the perfect formula or perfect mechanism but really to have as many creditors and lenders around the table is may be as important.

Challenges moving forward

- Some sort of DSA is necessary, but should all creditors automatically follow one analysis?
- Who should make judgement on legitimacy of both historic debt and future lending policy, and based on what criteria?
- How to ensure that we learn from the past
- All must contribute:
  - not only creditors – also debtors through prudent borrowing
  - not only OECD members – but all creditors
  - not only public creditors - also private creditors
- Debate much driven by NGOs and academics. Need the views of borrowing countries:
  - Where should this discussion lead?
  - Hope to get a better picture during this conference

Audio transcript:

Finally I will just sum up what I see as the challenges. I argue that some sort of debt sustainability analysis is necessary and needs to be the base of what we are doing. But, should all creditors automatically follow one analysis? That will never be the case, because we do not live in that kind of world. But it is a dilemma here. If we are serious about respecting debt sustainability analysis, I think all of us have to take it into consideration that the automaticity is problematic of course.

Then who should make the judgement on illegitimacy - both on historic debt and future lending policy and based on what criteria. I am very much looking forward to the civil society response to that because we have to go into those difficult questions. Who should make the judgement and what should be the criteria? And how do we really ensure that we learn from the past? We should not repeat the faults of the past but, then, how do you do that in practice? And then everyone should contribute. There are many actors that are important: not only creditors but also debtors to prudent borrowing. It is extremely important that countries exercise prudence in their new borrowing. As I said also not only OECD members but all creditors. If you only have this perfect kind of solution within the OECD circuit that is not enough because we are actually representing actually less and less the big capital flows in the world. And not only public creditors but also private creditors and this has been a debate much driven by NGOs and academics.

And my final point is that we need the clear views of the borrowing countries. Where do you want this discussion to lead? Do you think that it is important to continue this discussion about odious debt? Or the forward looking responsible lending what should be the balance and what are the most important issues seen from your perspective and that is one of the things I would like to get out of this Conference is a clearer picture on that. Thank you.

Ethics and debt: a view from the international debtor side

Oscar Ugarteche
Senior Research Fellow, Institute of Economic Research,
Universidad Nacional Autónoma de México

Questions of ethics have arisen since the 1980's relating to the debt from developing countries. Now that domestic debt has increased substantially and that Norway has cancelled the debts from its bilateral cooperation programme to eight countries, it is time to evaluate some elements of what can go wrong in the lending and in the borrowing process and especially, how these can be addressed in the future. Co responsibility was invoked in 1983 in the Caracas conference of the Organization of American States on this matter. The word became a label of an empty jar as full responsibility was put on the borrowers for issues that were to do with exogenous shocks. In this presentation I wish to propose two concrete means to do with preventing inequitable and unethical means of credit management and a change in the financial architecture: specifically international loan audits, and real cost sharing and more importantly a discussion on a new international financial code.

During the 1970's the leading economies entered a severe recession as international currencies found their new levels and the bigger economy absorbed the shock of the end of fixed parities. This gave way to a surge of loans. Increased international liquidity affected interest rates and these in turn affected sovereign borrowers who saw that they could borrow for free and purchase the sort of turnkey projects they thought they required for development. The developmentalist state was in full bloom and the critics observed that industrialization policies led to balance of payments bottlenecks whilst backward industrial integration was not happening. Not at least in Latin America. The Asian countries had just started to substitute exports and did not make use of substantial amounts of external loans in this process, with the exception of South Korea. Instead they had very high domestic savings rates which neither Latin America nor Africa had.

I. Interest rate definitions

In the 1970's the inflation rate of the United States was very high and stagnation set in. Stagflation was the name of the phenomenon and interest rates were reduced in order to have the economy recover, but consumers and investors did not make substantial use of this. Instead foreign borrowers increasingly borrowed almost free loans until in the latter part of the 1970's, Fed President Volcker decided to apply a strict monetary policy in order to bring inflation down, which he did. Immediately after Ronald Reagan was elected in December of 1980 and in January 1981 he announced Reaganomics, basically a lax fiscal policy with tax reductions and Government expenditure increases. The combination of both led instantly to a surge in interest rates which jumped from 1.7% to 8.6% in real terms. This has been the highest level of interest rates ever in history in real terms. No one either at the Fed nor at Treasury looked into the rear view mirror to see if other countries might be hurt by this manoeuvre. The consequences were there to be seen immediately as Mexico defaulted and then many other countries.

In a similar circumstance of much lesser importance initially, the rise in US interest rates during the 2005 to 2007 period has led to a rescue package for debtors with mortgage debts of over 417,000 dollars. Internationally then nothing of this sort was devised. Worse, the argument was made that the debt crisis was the result of corruption, mismanagement and unsound policies. Not a word was said of international interest rates nor of the effect of external shocks in developing economies.

Clearly a domestic problem of the US – stagnation and high inflation– was exported via high interest rates derived from the combination of policies mentioned. Given the origin it should have led to some co responsibility but it did not. At least not while burden sharing would have made creditors lose money.

The question in bank lending and interest rate formation is, if an interest rate is defined as the prime rate plus a risk premium, and things go wrong, shouldn't the creditor share the burden? Is this not what the premium is for? Or is it rent seeking, where the highest rents are paid by the poorest countries and the creditor remains always risk free. This is an issue that must be dealt with in order to understand the grievances produced to sovereign debtors by the debt management process from the creditor's point of view.

II. Interest rates redoux: internal rates of return

When projects are evaluated, one system is to calculate the internal rate of return. This is done using the likely interest rate during the life of the project. When reality proves differently and the cost of capital shoots way over the estimated interest rate, those projects become unprofitable. The variations of interest rates are exogenous to the firm or Government that borrowed but the effects are bourn directly by the buyer. This should be a second reason for burden sharing. Nevertheless there has been no burden sharing at the time need: i.e. when sharp interest rate increases occurred reaching the highest levels in history. This generated hardship to the population of those countries whose Governments had borrowed widely at interest rates in the neighbourhood of 0.

III. The loans

Bilateral loans have a vested interest: to promote exports from the countries that generate the guaranteed export loans. In this sense, they might be seen as a covered up export subsidy. During the 1970's and the stagnation that followed the rise in oil prices in the developed world, there was a fever of bilateral loans related to either turnkey projects or military goods on both sides of the ideological spectrum. Developed countries promoted exports of technology mostly on the way of becoming obsolete as technological change was underway. Official borrowers bought technology at cero or near cero interest rates and expected to repay those loans from the profits made by these industries.

During the 1980's, it became evident that some of the technology purchased with these loans were useless. The Bataan nuclear energy plant in the Philippines was scheduled to cost 300 million US dollars and ended up costing 2.5 billion USD. The explanation widely given was that Marcos was corrupt and he took money. We can all agree to that since there is evidence of Marcos being corrupt. Did he take 2.5 billion dollars or where there loans related to the sale of the engineering of the nuclear facility and then loans related to the plant itself. There were also loans related to the supervision of the nuclear plant as it must be certified by the US Atomic Energy Commission and the International Atomic Energy Agency before it goes into operation. It turned out however that there was a crack in the wall and the reactor would never function. It had been built over seismic ground! There was no money back guarantee in case of malfunction (or non-function). The Philippine Government took the case to court in the US and lost. The people of that country are paying for a worthless very expensive asset.

Questions: How could this happen? Was no one responsible? Let's say Marcos was in full knowledge that this plant did not work, are the engineers and lenders not responsible for this. Shouldn't they have known they were operating on seismic grounds? Or was the group of firms, Bechtel and Westinghouse and others involved, just making money at any cost knowing this was going to happen.

In the same 1974 the Government of Bolivia under General Banzer bought a large tin smelter for the project of making Bolivia the leading tin exporter of the world. When the plant arrived in Bolivia, all the studies had been made for it to be placed in one place but someone decided that it was better to relocate it somewhere else. This other location is at over 4,000 metres altitude. What can a smelter melt at that altitude? It turned out it was also oversized. Questions: the German engineers that went along with the place change did not realize what the change meant? The project advisors did not perceive that such a change would harm the project? Didn't anyone realize it was oversized anyhow? It was said then that General Banzer was making money. We can concede this. Nevertheless profits were made by the engineering firms and advisory firms with the support of Hermes of Germany and the financing of KFW in spite of the fact that the project did not function adequately and that Bolivia had many problems. Hermes secured profits to the plant producer and Bolivians owe the monies to this day. It is now probably diluted under both HIPC schemes applied to that country.

The Fish Boat Campaign of Norway in the early 1980's is yet another example. They were sold whether they could sail or not under the navigational conditions of the place they were going to go. In the end, after a 1988 report in Norway of the problems faced with the ships and the SLUG/Jubileo Ecuador study of the Ecuadorian case, the Norwegian Government cancelled those debts.

On the bank level these same cases exist. The lease of the Mantaro and Pachitea steamships by the Peruvian National Shipping Line in 1982 from a Panamanian firm that had bought them from an Italian firm was turned into a long term loan in 1983, at a restructuring agreement but those ships never sailed. One has sunk and the other is corroding in the Peruvian port of Callao while the partners of the Panamanian firm are at large. They were the seller for the Italians and the buyers for the Peruvian National Shipping Line who associated in the firm in Panama and who knew the boats did not sail in the Pacific Ocean and had a structural fault. The debt was converted at 45% into Brady Bonds and they are now other bonds.

Finally, at the multilateral bank level, Cheryl Payer in the 1980's wrote a study on projects financed by the World Bank since the 1960's and on the whole they seemed to be disastrous and some affected the population adversely. Projects like dams and hydroelectric plants have been very harmful to the population and to the environment yet that debt is there or has been reconverted into structural adjustment loans stretching the payback period while wiping out the original loans.

Undoubtedly the quality of the loans might be bad as long as the public is unaware of what is happening. Until now the only case where there has been a loan cancellation by a creditor due to recognition of lending malpractices is the Norwegian Government. There is no doubt that the Norwegian shipbuilders were the ones who profited from that campaign. There is no doubt that without the SLUG/Jubileo campaign that decision would not have been taken.

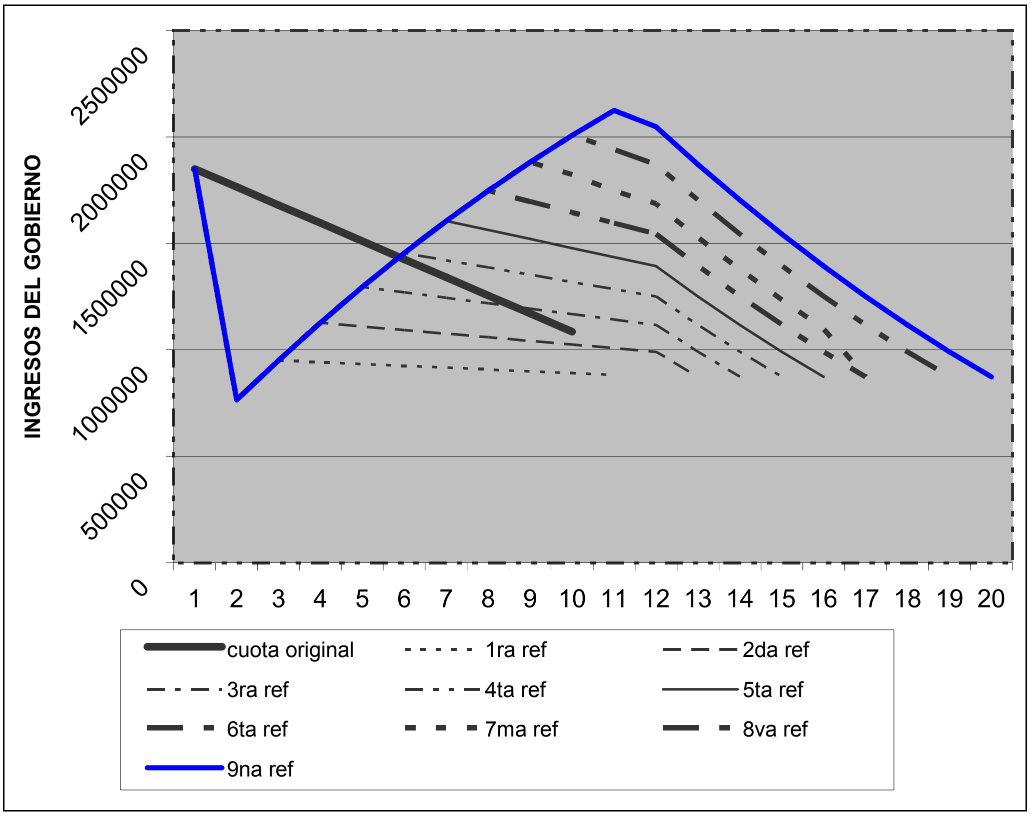
These are all legal loans but they are illegitimate. More than corruption, these are cases of rentism, of the State facilitating profits to their national enterprises at the expense of the debtor Government who bought the goods. In a way they may be considered a fraud if only because they do not do what they are meant to do. <u>But the customer cannot return them to the seller.</u>

IV. Old style debt rescheduling: the ladder effect

The interest rate shock of the early 1980's led to a process of debt rescheduling that was perverse. Unpaid annual capital was stretched out over a ten year payback period on a yearly debt negotiation process added on top of the debt service scheduled for the rest of the debt. Since this was done every year from 1982 to 1990 when the Brady Plan was applied, then the effect looks like a ladder when it is graphed.

In graph 1 there is a thick black line that represents the original payback schedule. Then there is the dotted thin line at the bottom which is the debt payback schedule after the first round of negotiations. Each round is a step higher. By the third round, the cost to the borrower breaks even and it does not matter to reschedule the debt. Thereafter, from round four onwards it just becomes an increasing burden. This is the result of yearly payment rescheduling done year after year during the 1980's. This is a hypothetical exercise. The result shown is that the payback scheme became steeper and steeper in terms of total annual payments. This was how, the debt was paid in full during the 1980's and at the end the amount owed was twice what it had been initially in 1980.

Graph 1: The ladder effect

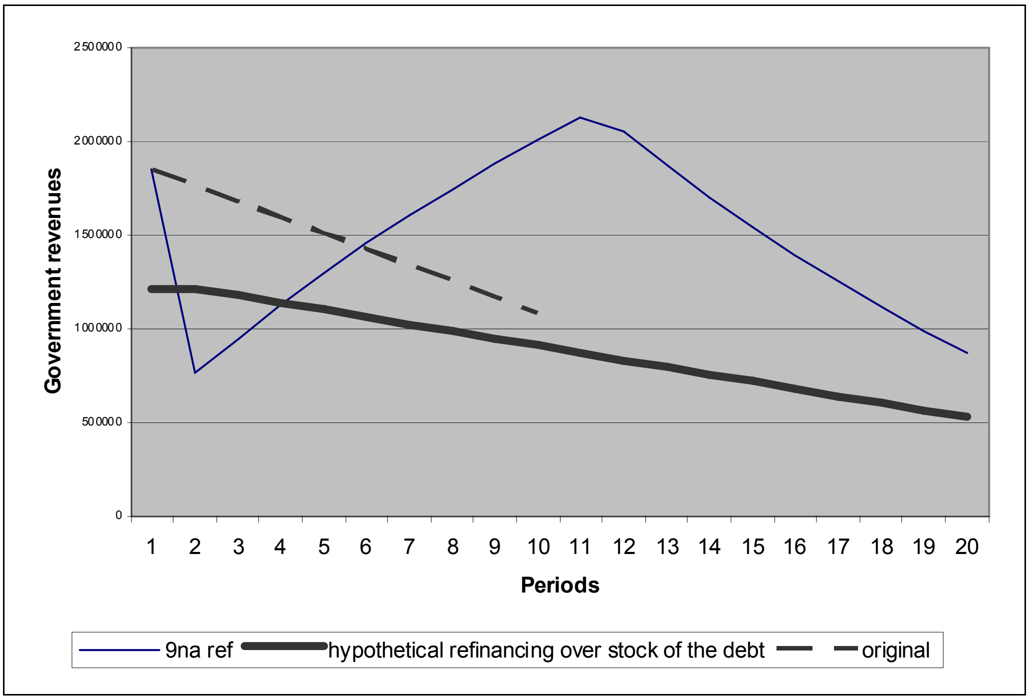


Source: O Ugarteche *Genealogía de la arquitectura financiera internacional*. PhD Thesis, U of Bergen, 2007. at https://bora.uib.no/dspace/bitstream/1956/2319/1/PhD_Thesis_Oscar_Ugarteche.pdf, p. 214

Question: was this a hazard? Or was it done by man?

Graph 2 shows the debt payback schedule if the stock of the debt had been rescheduled in 1982 contrasted with the yearly refinancing of graph 1 and with the original schedule. What is clear is that if the stock of the debt had been rescheduled, shown as the thick line at the bottom, the hardship would have been prevented in the developing economies that had debt problems.

Graph 2: Yearly unpaid principle refinancings, total stock of the debt refinancing and the original calendar



https://bora.uib.no/dspace/bitstream/1956/2319/1/PhD_Thesis_Oscar_Ugarteche.pdf, p. 215

Question: if the rescheduling mechanism was devised by man, could it not have been changed quickly in order to prevent hardship in several continents and the impoverishment of millions of people as well as a depression metaphorically referred to as the "lost decade"? If it could have been changed, why was it not? Where was the principle of equity? Co responsibility?

Finally, the debt accumulated during the 1980's due to this way of handling the external problem caused by the undue and unique rise in interest rates is legal. The question is: How legitimate is it?

This rescheduling mechanism was applied with the technical advice of the IMF who coerced the debtors into taking these schemes while force adjusting the economies to make ends meet. Given the historically unique phenomenon faced with interest rates in the 1981–1983 period, shouldn't the multilateral agency not taken sides with the debtors and assist in changing the rescheduling process? If the rescheduling mechanism was devised by man, it can be changed by man. The consequence of pushing debtor Governments into these agreements and not siding with them against the agreements has been the impoverishment of millions of people. If the object of the Fund was to maintain world economic stability, the result was negative. A depression is not stability, even if most authors do not refer to the contraction of GDP in Latin America and Africa of the 1980's as a depression.

V. On legal and procedural matters

There was a discussion at the end of the XIXth century on whether to apply public international law or private international law to sovereign loans. This discussion was launched as a result of the Suez Canal bonds issued by the Khedive of Egypt but not guaranteed by the Ottoman Empire as such. The decision then was that sovereign loans were to be considered private loans if the lenders were private. When the lenders are public, then public law applies and in multilateral financial institutions again private law is used. None take into account the basic principles of consumer credit: "satisfaction or your money back". Why not? A nuclear reactor cannot be returned like a TV set, but the loan can be wiped out and an apology given with some substitute to compensate for the non-functioning of the project. This is the only possible way to first prevent irresponsible lending, which is not equivalent to unsustainable lending, and second, to stop blaming others for they, the lenders, have done.

As a matter of procedure, when firms reschedule bank debts, they must hand over an audited report of the accounts. This is not a condition for an international rescheduling, and worse, audits are seen as not market friendly, as a Reuters news clip stated recently about Ecuador. It seems that ethics is not perceived as market friendly. Loans audits must be a precondition for any debt swap, refinancing or change of instruments of any sort. We have wiped under the carpet of refinancing and instrument changes cases like the ones named above which were studied in the 1980's.

The principle of "need to know" in banking obliges the lender to know who is doing the operation, how the money is being used and what the outcome is. It obliges the banker to be responsible for his operation, If the banker is not responsible then the 1977 foreign corrupt practices act of the United States can be used as a reference of how to deal with those issues, if the case warrants it. For example, Bank lending to the Nicaragua of Somoza was done through an investment bank called Ultramar Banking Services based in Nassau. Ultramar belonged to Somoza and his cronies. Every loan into the country taken for the reconstruction of the city of Managua after the 1972 earthquake had a 5% commission charged by Ultramar. Somoza and his cronies made several hundred million dollars this way. Did private bankers do anything about this? No. When the negotiation of the debt began in 1979, after the Sandinista revolution, an investigation was made and the report consulted with Washington based lawyers who essentially said that if those loans were not recognised, international reprisals would occur. The loans were never paid but, they were restructured at least twice and secondly they were subject to the IDA facility operation for Nicaragua in 1991. Private commercial banks never again lent to that country. There were no responsibilities from the lawyers view point that would outweigh the political cost of disavowing those loans and suing the bankers for their corrupt practices.

This is similar to the IMF loans given to the Central Bank of Zaire in the 1980's whose president immediately deposited into his bank account in Switzerland. It was well known that this was his practice but the IMF kept on pouring money into Zaire. This is also a case of known corruption but the debt was paid while those responsible were free to follow their international career.

In essence, corrupt practices have at least one legal framework from which to begin but nowhere to refer to unless the operation is done with the United States that has that 1977 act. The facilitation of international financial corrupt practices through tax havens which are also immune to legal requisitions makes it very difficult to chase those responsible or recover the funds.

Cannot this be changed? A new international financial code must be devised to redefine what is public and what is private lending, to incorporate some domestic criteria into international operations and to open up financial havens now the centre of money laundering and ill-gotten monies.

To conclude, ethical issues on debt can be faced using the principle of equity. This may require a new discussion on international financial law and the redefinition of the public and private law application while adding newer elements from domestic consumer credit. This is room for UNCTAD to operate.

International loan audits must be a requirement before a debt restructuring in any of its forms. This is another space for future work for UNCTAD. It is not market unfriendly and this must be made clear to the financial circles.

Finally, illegitimate debt created by worthless sales of goods, projects or services should in principle be subject to the "satisfaction or your money back" principle of domestic credit. This should be applied to all lending institutions.

Odious debts, using the most known principles of Zack should be taken to some court of arbitration for a decision to be taken on their annulment. This board of arbitration, where the lenders would present their case, could be the same one as the one proposed for debt restructurings.

Emerging markets: key trends, selected credit issues

David T. Beers,
Managing Director, Sovereign & International Public Finance Ratings, Standard & Poor's

I. Overview

Substantial growth in Emerging Markets (EM) can be explained by many factors. Among the most important are:

- Changing dynamic of global economic imbalances;
- Improving creditworthiness of many sovereign, corporate issuers;
- Improving liability management by many sovereigns, including introduction of new local currency debt instruments;
- Growing willingness of investors to hold local currency as well as foreign currency debt.

Issues with sovereign local currency debt issuance:

- Liquidity, hedging;
- Behaviour of cross-border investors in market downturns;
- Debt restructuring involving local currency instruments.

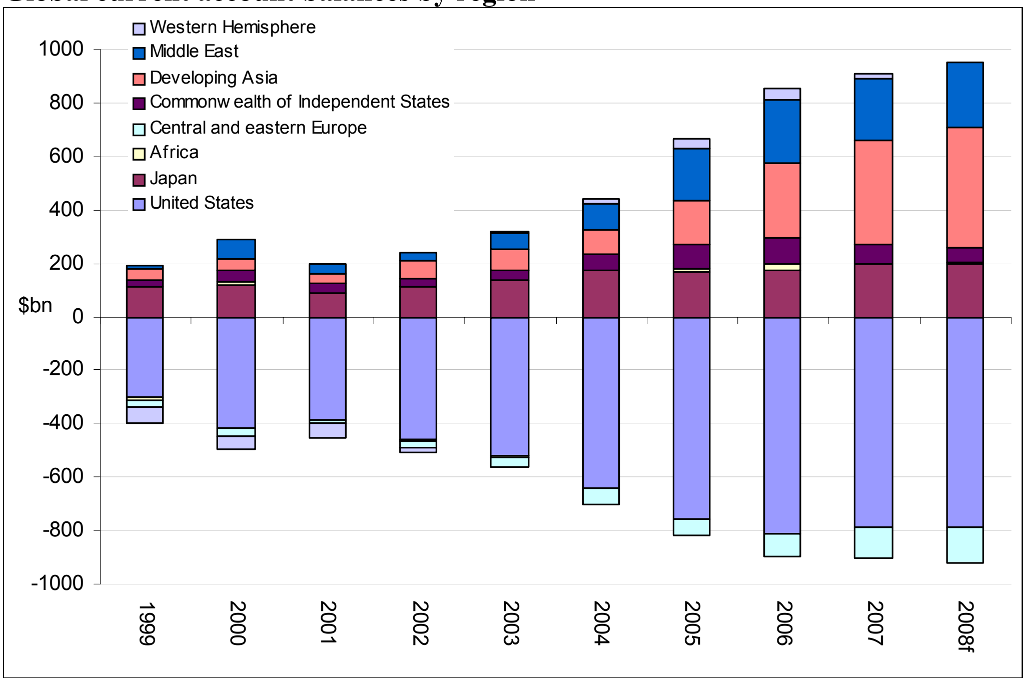
II. Emerging market economic & credit dynamics – A virtuous cycle?

- Improving current account balances for many developing, emerging market sovereigns since the late 1990s.
- In some cases, a deliberate policy response to past financial distress and market turbulence.
- Helped by strong global growth, higher terms of trade, and (until recently) relatively benign financial market conditions.

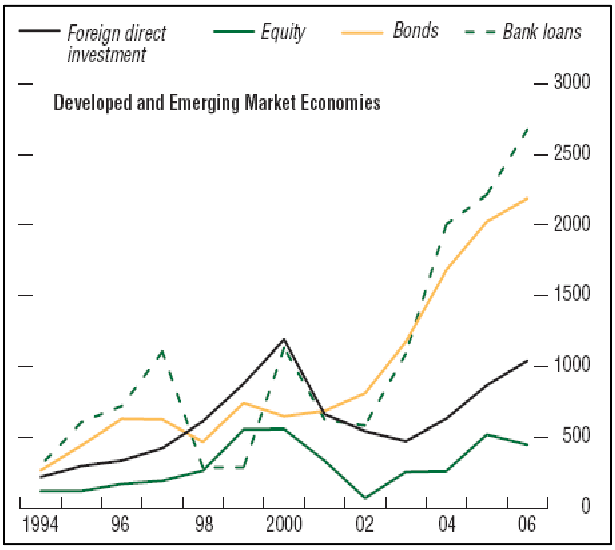
Leading to:

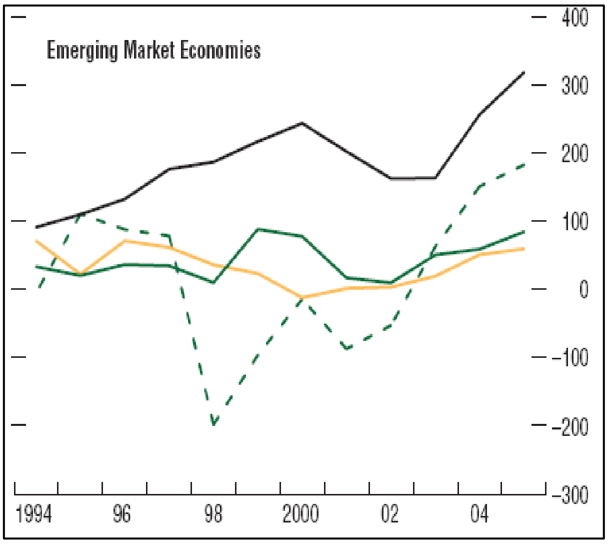
- More diversified capital flows;
- Rising official foreign exchange reserves;
- Falling external debt burdens;
- Deeper local debt markets, increased involvement by cross-border investors;
- Rising sovereign credit ratings.

Global current account balances by region

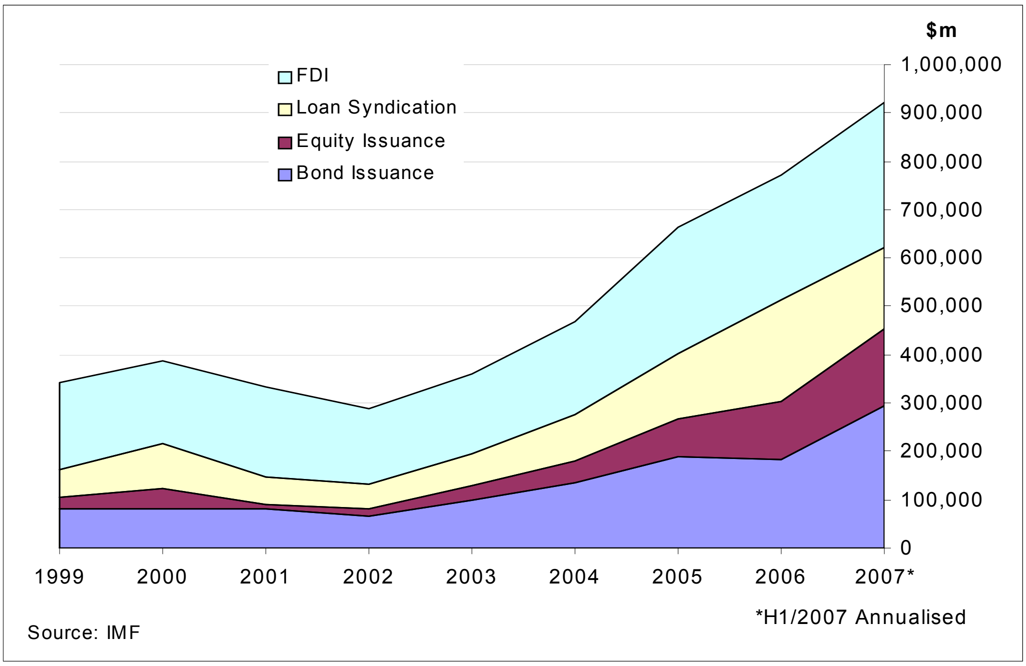


FDI and capital flows to emerging markets

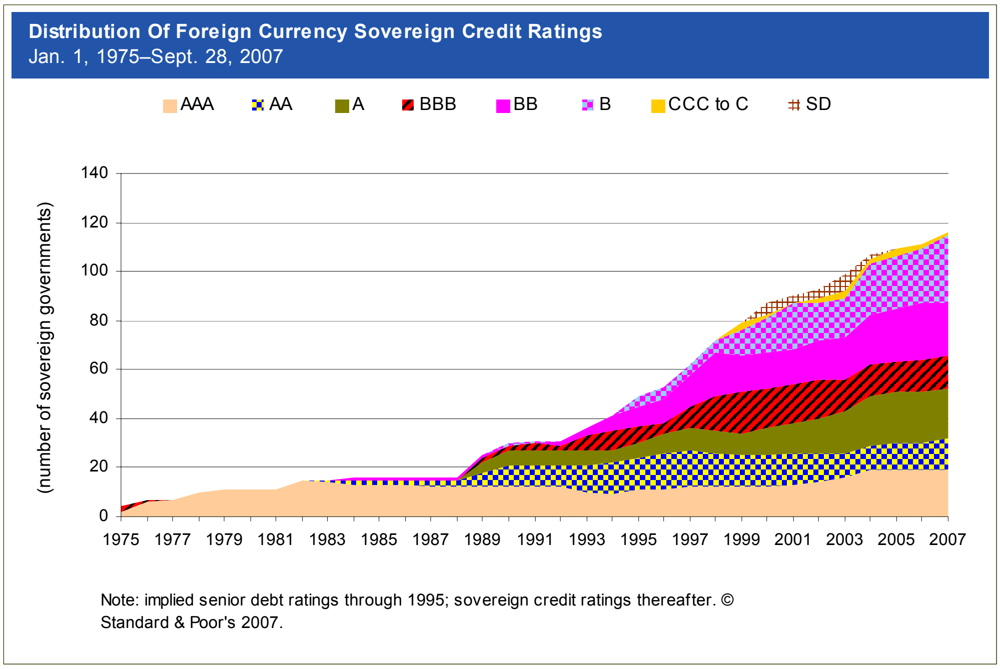




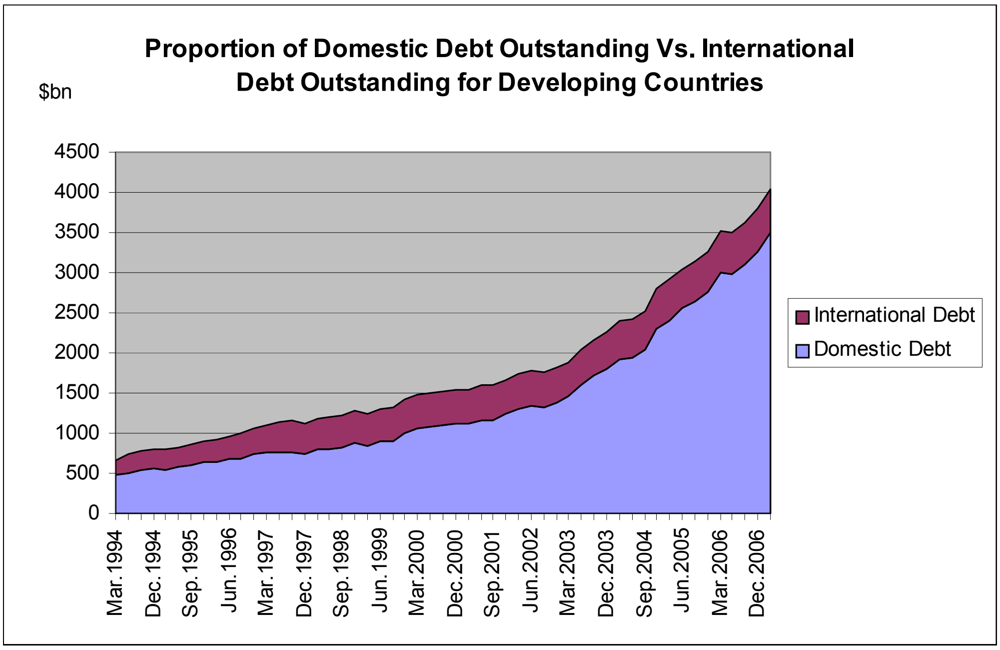
Emerging market gross financial market flows



Foreign currency sovereign credit ratings



International and domestic debt comparative growth



Debt issuance trends

Growth of sovereign local currency debt relative to foreign currency debt issuance.

Growth of corporate debt relative sovereign debt issuance.

Higher cross-border investment in local debt markets triggered by search for yield (carry trade), declining interest rates in domestic markets, improving credit fundamentals, stable or appreciating foreign exchange rates.

Government liability management, including:

- Retirement of Brady bonds;
- Reduced issuance of other foreign currency debt, FX-linked debt;

- Increased issuance of fixed rate local currency debt, including inflation-linked (IL) bonds, local currency (LC) denominated foreign currency (FC) payable debt Emerging market inflation-linked bonds reverse traditional association in these markets with weak credit fundamentals, high, volatile inflation.

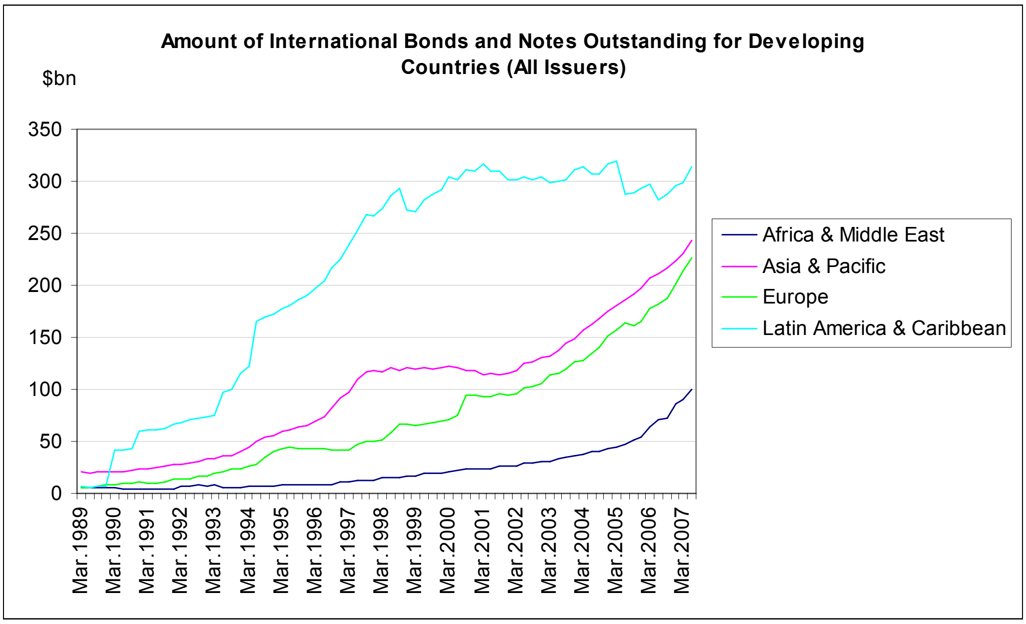
Now, like the UK and other high-grade govts, EM policy makers use local currency debt to demonstrate commitment to disinflation and to support the credibility of inflation targeting.

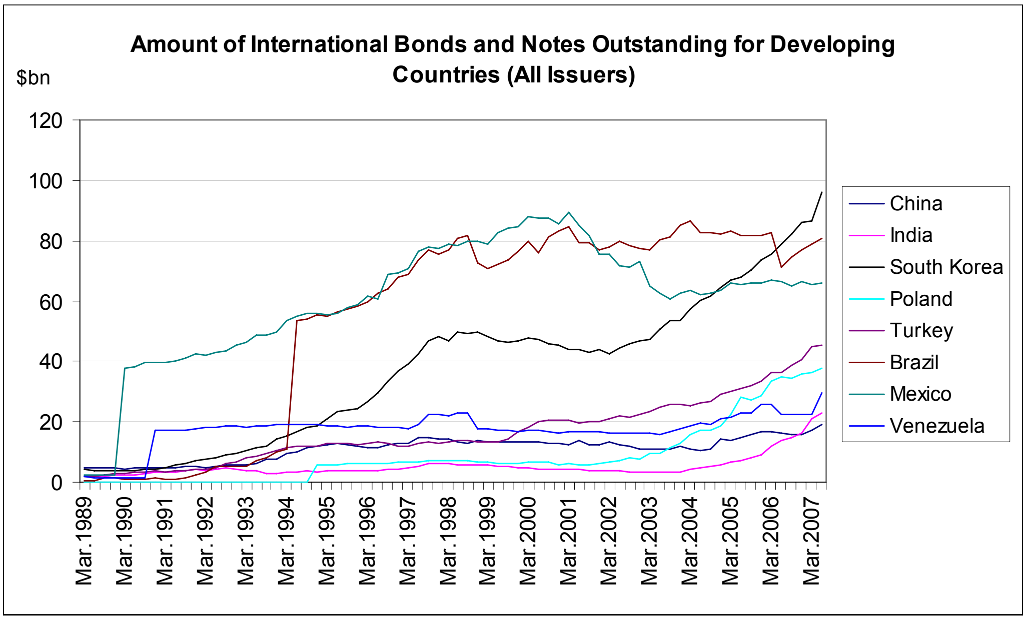
Local currency denominated, denominated foreign currency payable debt partly a market response to continued restrictions on foreign access to domestic debt markets, and/or an effort to issue longer term debt th local currency an currently favored by domestic investors.

Building a local currency debt curve, benchmark issues, liquidity in govt debt markets helps promote local corp debt markets.

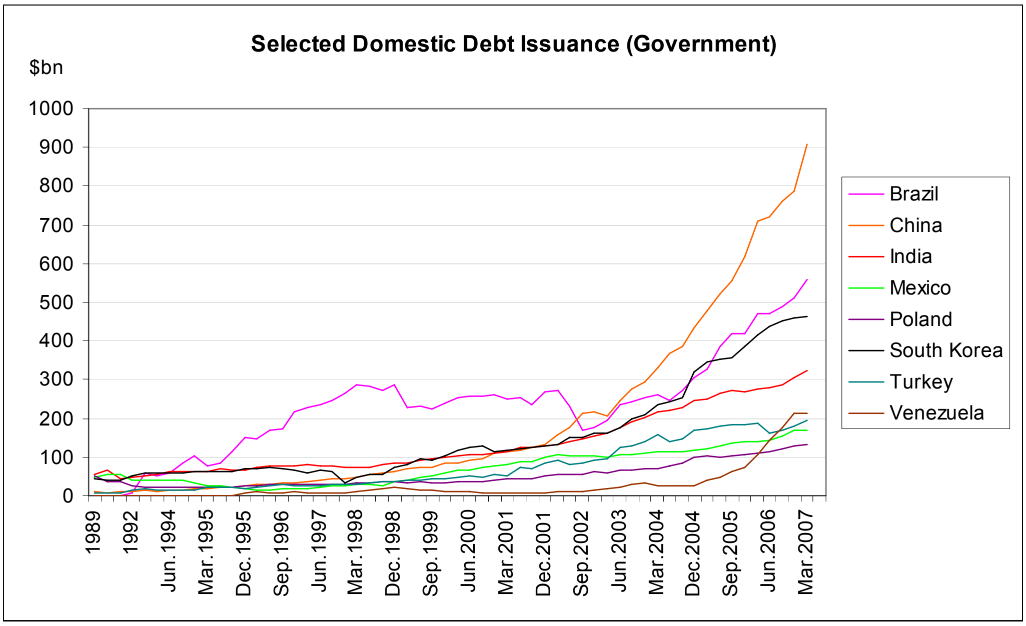
Occasional cross-border investment in non-performing local currency debt that remains unstructured despite domestic investor pressures.

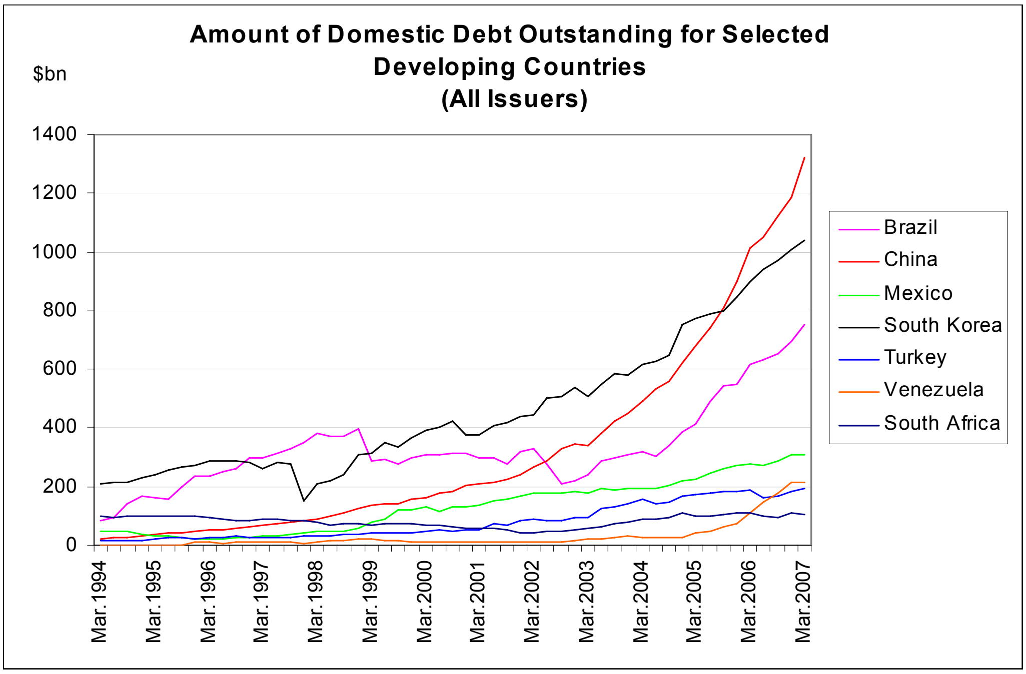
International debt



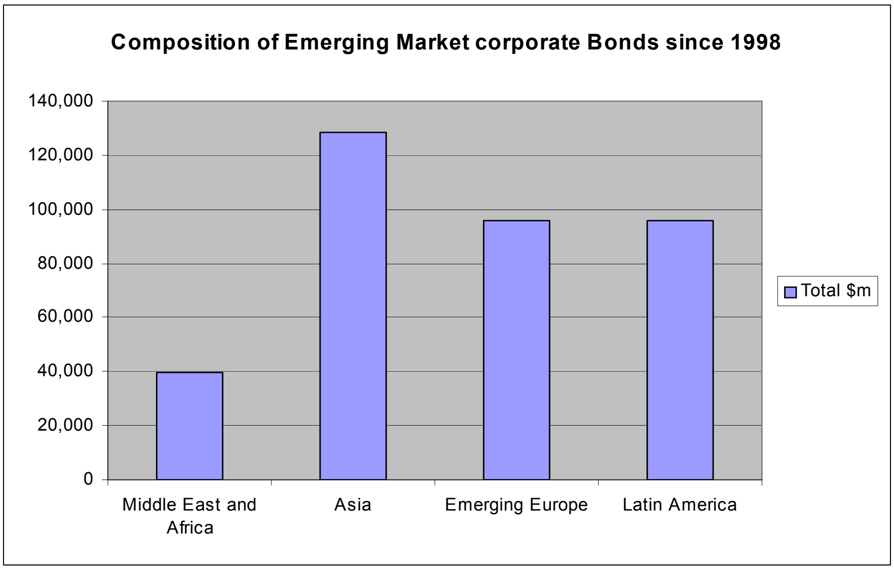


Domestic debt

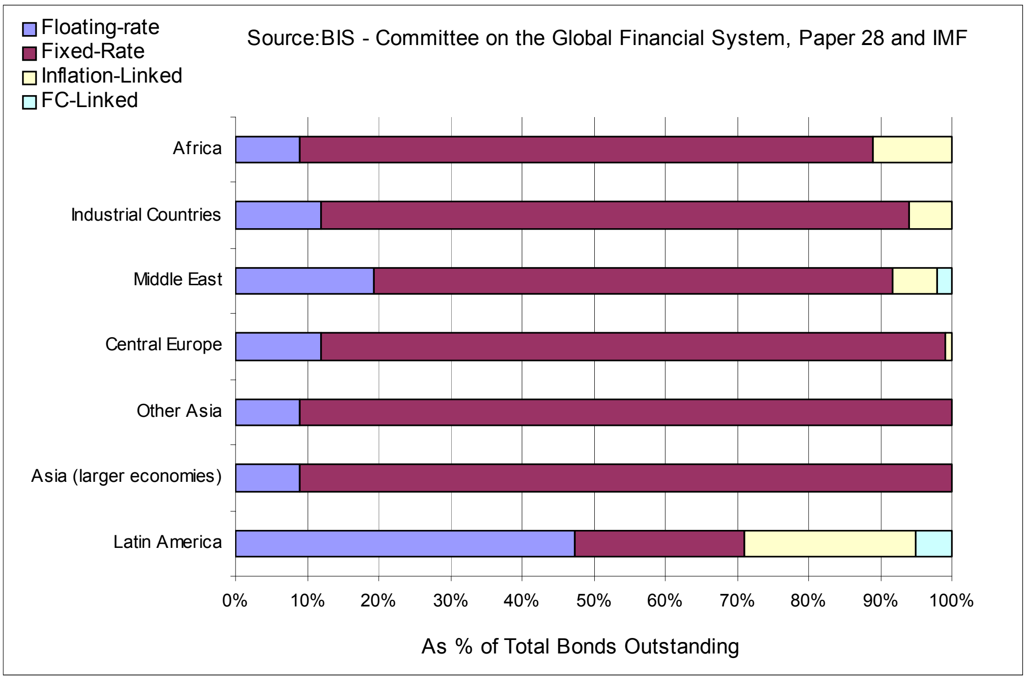




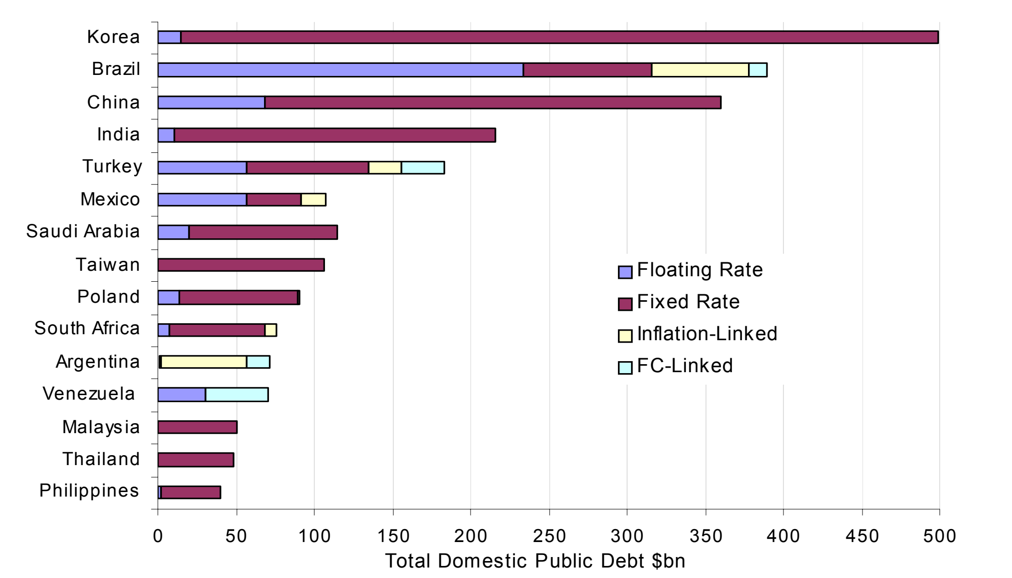
Emerging markets corporate debt



Regional domestic bonds by instrument (2005)



Domestic bonds by instrument by country

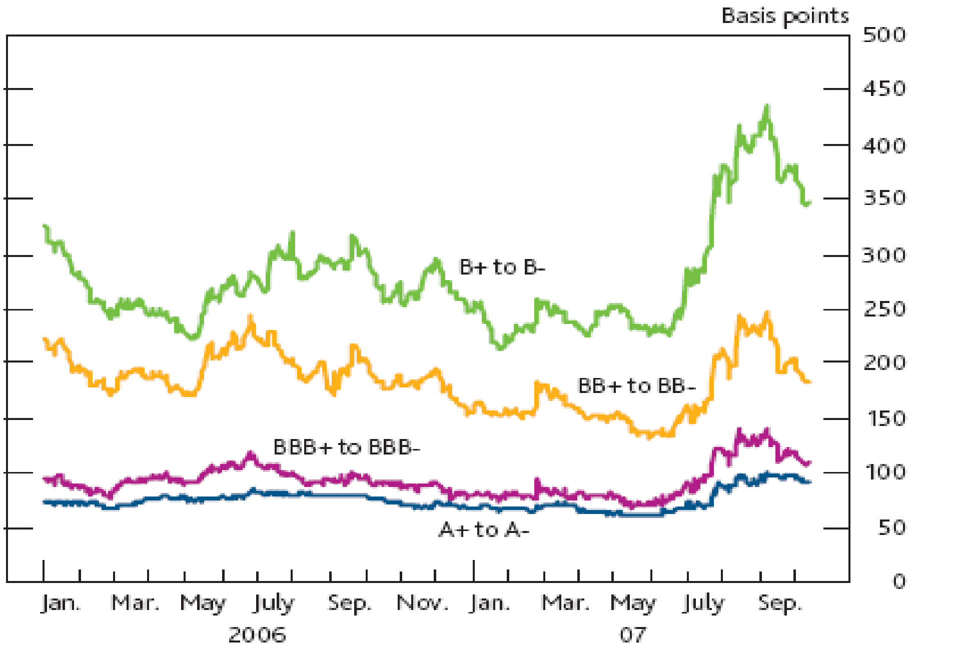


Source: BIS - Committee on the Global financial system, Paper 28

Recent market behaviour

- The global market turbulence since July 2007 has had only a muted impact on the emerging markets sector – thus far.
- More of a problem for emerging market corporates than for emerging market sovereigns.
- More credit differentiation at lower rating levels.
- New sovereign foreign currency debt issuance by Ghana, Sri Lanka, others in Africa, CIS, in the pipeline.
- Market risk appetite still strong; investors still buying the story of "emerging market decoupling" reflecting faith in economic growth and credit fundamentals.
- Standard & Poor's mostly buys the credit story but has reservations about emerging market delinking in a global economic downturn.

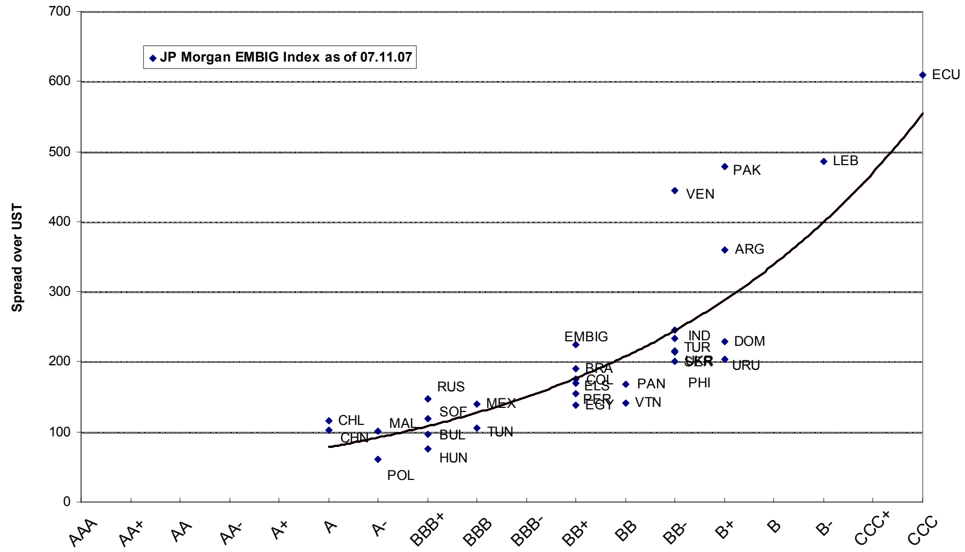
Emerging market sovereign bond spreads by rating



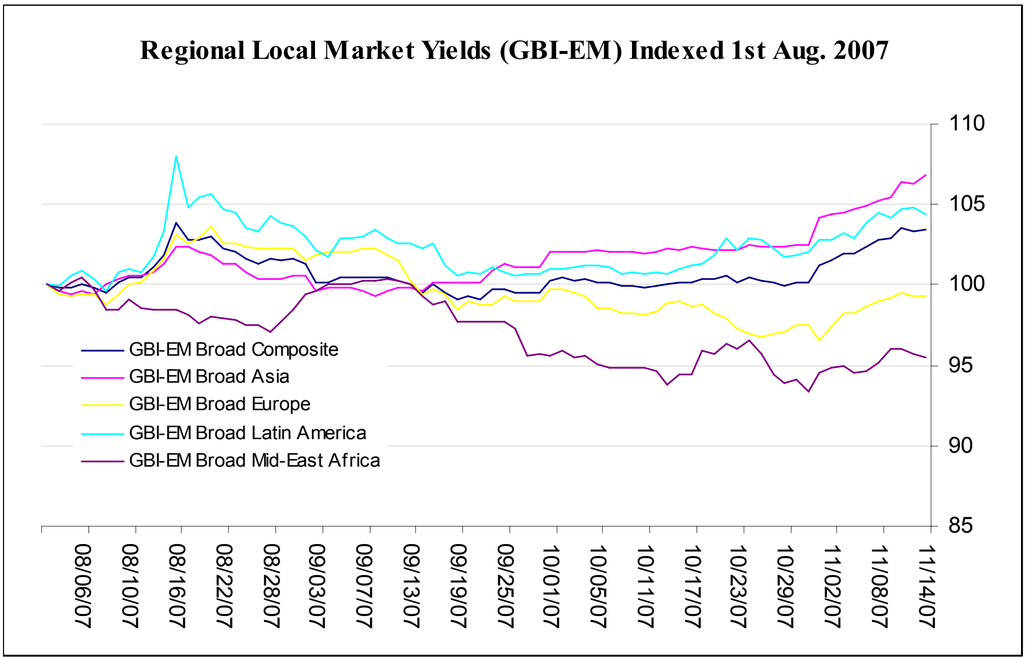
Sources: Bloomberg, JPMorgan Chase & Co., Standard and Poor's and Bank calculations.

(a) Average spread of emerging market sovereign borrowers in the EMBI Global index within a given rating category.

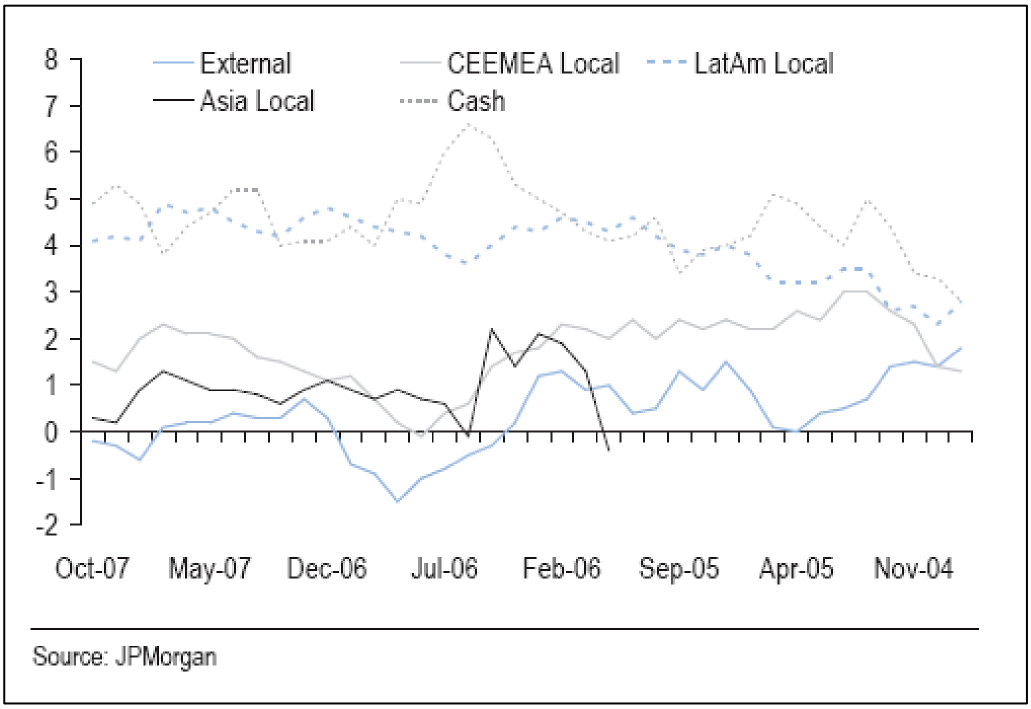
EMBIG spreads



Local market yields



Investor exposure in emerging markets: overweight vs underweight on JP Morgan's 10 point scale



Selected credit issues

- Higher local currency debt, relative to foreign currency debt issuance, making govt balance sheets stronger and boosting creditworthiness.
- Capital controls, home investor bias/inertia still limit foreign investment and can distort markets.
- Liquidity, hedging mechanisms developing but often limited.
- Foreign investor participation rising in benign market conditions, but will that change?
- Foreign participation in local markets can be expected to fall in periods of financial distress – as in Mexico, Russia, Turkey in the past.
- How will local currency denominated, foreign currency payable debt governed under New York or English law fare in future debt restructurings?
- Will selected restructurings of inflation-linked bonds damage cross-border investor interest in this instrument?
- More classes of debt have potential to change issue and investor dynamics in restructurings in ways that are hard to predict.

Summing up

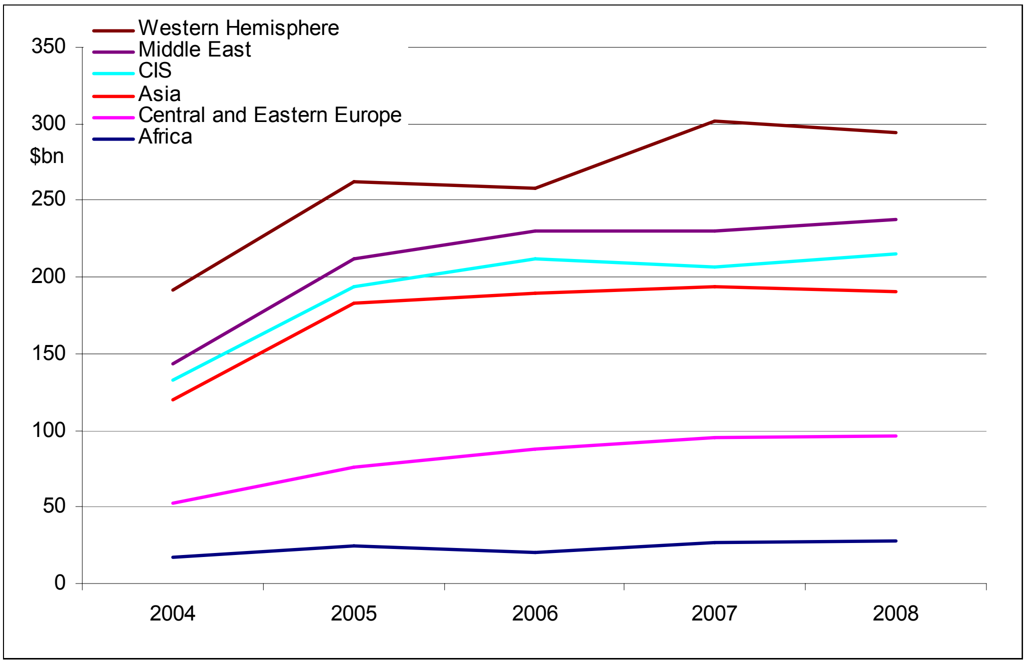
- Despite current market turmoil, Emerging capital market deepening can be sustained, especially where credit fundamentals are stable or continue to improve.
- Local debt markets are closely related to improving credit fundamentals – the two move hand in hand.
- Foreign investor participation in local markets, broadly speaking, helps market deepening.
- Local markets will be tested by exchange rate volatility and depreciation pressure, but where sovereign fundamentals are resilient in most cases the markets can absorb periods of reduced cross-border participation.
- Higher nominal local debt market yields, higher dollar and Euro yields, may swing the pendulum back in favour of foreign currency debt issuance.
- Emerging market foreign currency debt issuance is not yet dead.

Selected recent Standard & Poor's credit research

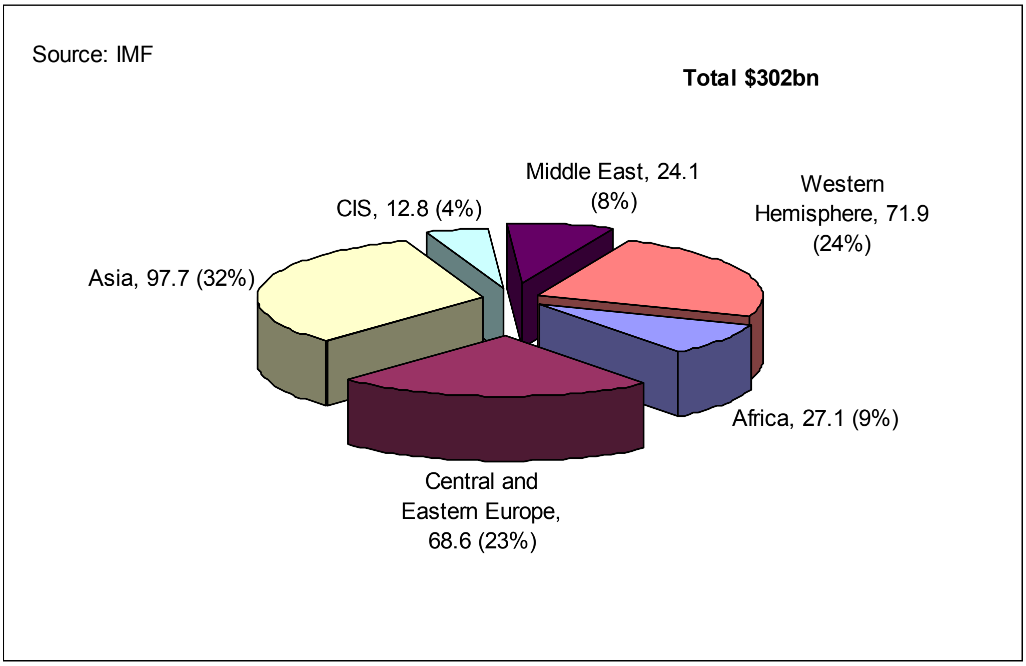
- *Sovereign Debt Management Practice & Policy: Implications for Creditworthiness (16-Nov-07)*
- *Inflation-Linked Bonds and Sovereign Credit Risk (15-Nov-07)*
- *Credit FAQ: The Future of Sovereign Credit Ratings (16-Oct-07)*
- *Report Card: EM Sovereigns Have Deeper Roots to Withstand Today's Gales (10-Oct-07)*

Other selected emerging markets data

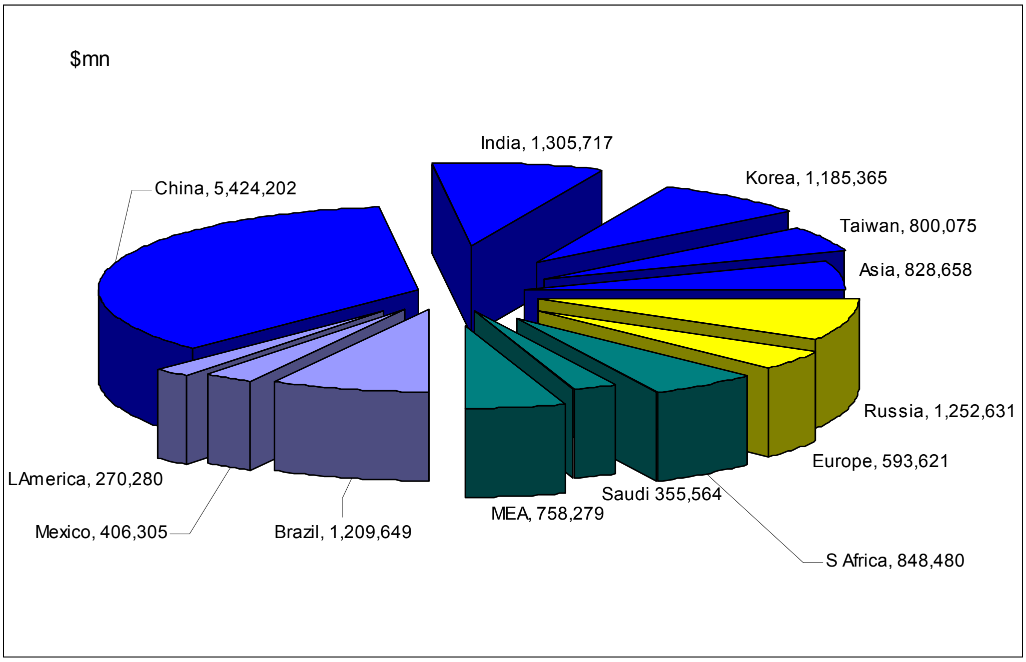
- FDI flows by region



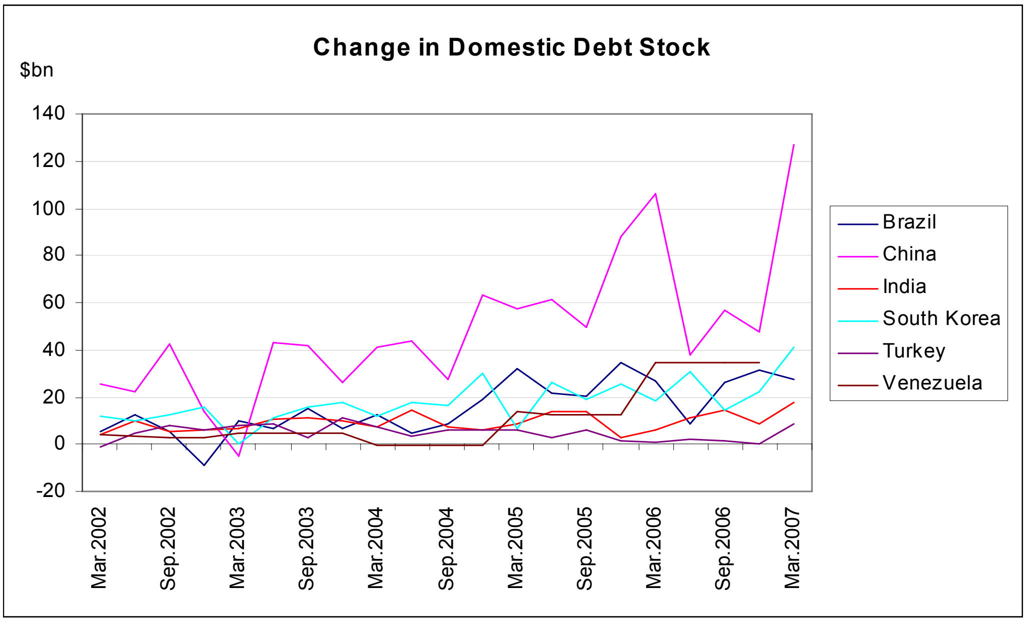
- Net direct investment in emerging markets by region (2007)



Emerging stock market capitalisation breakdown



Domestic debt



Panel 1

Odious debt

Odious debt: summary of panel discussion

Moderator: Mr. Heiner Flassbeck, Director, Division on Globalization and Development Strategies, UNCTAD

Panelists: Mr. Christoph G. Paulus, Professor of Law, Humboldt University, Berlin, Germany
Ms. Gail Hurley, Policy Officer, EURODAD
Mr. Arturo González de Aragón, C.P.A., Auditor General of Mexico
Mr Robert Howse, Professor of Law, University of Michigan Law School, USA

There is a wide disagreement on what "odious" debt really is. The United States first introduced the term "odious" debt as a reason for not honoring the Spanish claims on Cuba in connection with the Paris peace treaty of 1898. The debt, said the Americans, had benefited the Spanish colonizers rather than Cuba. They did not, however, provide a formal definition of the term. A range of proposed definitions have been put forward since Alexander Sack made the first attempt in 1927. In the process, the term "illegitimate" debt has been introduced. The question is therefore; what is "odious" debt and how does it relate to national and international law?

Professor Paulus began the panel discussion by describing some of the historical background to the notion of odious debt and to the difficulties of agreeing on a legal definition of it that would be covered under public international law. So far, he said the concept of odious debt has defied any exact definition and was not a legal concept at all. In many ways, it remains an expression with a somewhat elusive content, bordering on the line between law and politics and between law and morals. For this reason, there are different ways of looking at the concept of odious debt. Making reference to private consumer law as being more developed in dealing with more complicated scenarios including ethical issues, he suggested that international public law should draw on the private law example in order for the international community to better address problematic debt scenarios and protect the more vulnerable.

He referred to the coining of the term "odious" debt by Alexander Sack in the 1920s to describe several case studies for which terms such as war debt, subjugation debts and regime debts had previously been used. Academically, however, he reproached Mr. Sack for having neglected to point out the commonalities of these cases, which would be necessary for legal practicability. For this reason, Sack is never mentioned in legal writings, only non-legal. In fact in legal literature, the only reference to the concept can be found within the context of a draft treaty prepared by the UN International Law Commission in the 1950's on the succession of states. This treaty, however, never became public law, and even within the draft treaty, the two initial sections on odious debt were scrapped.

Looking at the challenges that lie ahead, Paulus pointed out that the issue of co-responsibility of lending would most likely be the key issue with the question being how to help this co-responsibility. He referred to the current period in which we are living as one where international law is moralized and one in which much of private law is actually deducted from global concepts. In this globalisation, he said, some are more adapted to the needs and intricacies of this living together than others. In the case of HIPC countries, for example, these countries can be seen as the equivalent of consumers in private law who might be in desperate need of consumer protection. In line with the concept of co-responsibility, one in cases where contracted debt might be contested, whether the debt be nullified or reduced should be considered on a case by case basis, but a legal mechanism such as the IMF's previously initiated sovereign debt restructuring mechanism should be put in place to deal with such cases.

Ms. Hurley focused her presentation on lender and borrower responsibility from a civil society perspective. Referring to her recent experience as one of the independent auditors of the Ecuadorian debt commission set up by the Government of Ecuador in July 2007, she said that she had been shocked by the grossly unfair terms and conditions of some of the historic bilateral loan agreements that she had come across in this country case example. Not only had she been surprised that such unfair loan contracts as some she had examined could be drawn up by lender countries and be called 'concessional development assistance', she had been equally surprised that a borrower Government would even have agreed to the signing of such contracts when it was clear that the loans would not be to their benefit. In particular, she referred to loans that were 100% tied aid and linked to the purchasing of goods and services from lenders often at vastly inflated prices. In many cases, she added, the money from the loans would not even enter the borrower country, but stay within the creditor nation, with the debtor country merely responsible for servicing the payment of the loan agreement. Whether these were examples of illegitimate debt she said was maybe not clear, but what was evident in her opinion was that they were morally highly questionable and certainly did not in the favour of economic development.

She then referred to the current international policy debate on how to avoid new rounds of unsustainable and irresponsible debt build-up, in the post-HIPC and MDRI initiative era. She warned of confusion regarding the concepts of sustainable lending and responsible lending, which she argued were not the same thing. Sustainable lending she argued was only a part of responsible lending with the latter being more comprehensive. By focusing on sustainable lending only, she said, one misses the point as to why nations can accumulate so much unsustainable and unpayable debt in the first place, which she pointed out was largely due to the poor use of development finance by investors and borrowers. 'Responsible' lending, on the other hand, covers the financial position of the borrower and repayment ability but also such issues as the purpose and viability of the loan itself and the project activities financed, as well as the terms and conditions of the loan, public consent to it being contracted, its social and environmental impact, and so forth.

Referring to the principle of *pacta sunt servanda* – which asserts that if the borrower is a sovereign state, creditor claims are universally valid and upheld – Ms. Hurley argued very strongly that this principle should be challenged. The only way to ensure responsible lending and borrowing, she said, would be to ensure that both creditors and borrowers are held fully accountable and liable for their decisions. Example should be taken from those domestic legal systems where contracts can no longer be enforced (e.g. due to changed circumstances such as bankruptcy or insolvency) if enforced repayment would result in inhumane distress or a violation of human rights, or where it is proven that the lender did not exercise due diligence or where the terms or conditions of the loan were proven unfair.

Referring to the definition of Odious Debt itself, she said that EURODAD would disagree with the argument of Professor Paulus that no universally agreed definition exists. As the recent example of Norway clearly shows (where it took a decision to cancel 80 Million US Dollars of bilateral historic debt in recognition of its shared responsibility of 'odious' lending), if pressure from the civil society on political parties is strong enough, defining Odious Debt in particular contexts is actually possible. She, therefore, urged other governments to take Norway's example in cancelling odious loans. She also encouraged to take Ecuador's example in setting up debt audit commissions.

From the non-governmental side, and in light of the so-far insufficient international response to such issues as odious debt as well as to the general treatment of debts where repayment difficulties or disputes arise, including the absence of an agreed international insolvency procedure, Ms. Hurley said that EURODAD was now involved in developing its own responsible lending charter which will aim at guiding responsible behaviour by both lenders and borrowers, and which proposes a series of contractual changes to loan contracts issued to sovereign states. .

Mr. de Aragón saw the essence of the debate on odious debt as one residing in the encouragement of a culture of better debt management, transparency and accountability, and the promotion among governments of a responsible and committed attitude regarding future generations. Within this context, he also promoted the mission of Supreme Audit Institutions as having a stronger role to play in overseeing and assessing the correct and honest allocation of public debt resources.

Until now, he said audits on public debt management have been limited to verify the compliance with the legal and regulatory dispositions, accounting records and payments revision, balance conciliation, and assessment of internal control mechanisms. However, these revisions have turned out to be insufficient, due to a number of factors including the inadequate disclosure of the debt's structure; in terms of contracting, evolution, sources and financing; scarce and unreliable information regarding amortization and interests payment; discretional decisions regarding debt purposes (expenditure or investment); insufficient regulation and lack of supervision and control, regarding financial institutions; lack of transparency and accountability on public debt, and limited control and auditing, and an historical or short-term approach.

Mr. Howse started his presentation by strongly disagreeing with Professor Paulus in his claim that there existed no clear legal basis for the odious debt doctrine. Referring to the paper he recently wrote for UNCTAD on *The Concept of odious debt in public international law*, he argued that he finds a sound legal basis for the concept of odious debt in public international law. There is no rule or doctrine of public international law to which there is not an exception, he said, and it is in the nature of exceptions or limitations on doctrines that they are contextual. That to apply them one needs to look at individual circumstances and different sets of facts. And therefore even though rules themselves are often stated in fairly straightforward or absolute terms, exceptions or limitations can't be stated in such simple or absolute terms. They are inherently contextual and therefore if one is looking for an odious debt doctrine that is a bright line rule one will not find it. The concept of odious debt is in fact an exception or limitation on a rule of public international law that suggests that the principle of *pacta sunt servanda* applies to state debt obligations. One must interpret this principle, however, in light of broader considerations such as those of human rights and equity. In situations of political transitions, for example, equitable limitations on *pacta sunt servanda* may be of considerable importance in negotiating justice with respect to the crimes of the past.

The concept of "odious debts": a historical survey

Christoph G. Paulus
Humboldt-Universität zu Berlin

Note:
The paper below was not written for the conference and was presented as a background paper. It has been prepared in 2006/2007 for the World Bank in Washington D.C. Nevertheless, the report reflects exclusively the ideas, conclusions and views of the present author and gives, thus, no indication whatsoever as to the respective views of the World Bank's member countries, executive directors or management.

Executive summary

Over the last several years, as throughout its history, the legal concept of odious debts has generated heated debates, but few concrete proposals have emerged for a workable definition of the issue at stake, let alone proposals for its resolution.

There have been cases when a successor state has refused to honor certain debts contracted by its predecessor state. Depending on the reason for the repudiation, such cases have been classified under the labels of "war debts", "subjugation debts" or "regime debts". But all attempts at defining the expression "odious debts" beyond these few categories have met with insurmountable difficulties, so much so that even the International Law Commission (a subsidiary organ of the United Nations General Assembly entrusted with the task of codifying and developing international law), while discussing the issue in its work on state succession, for various reasons ended up not including the concept in the final text of the Convention on succession to property, archives and debts.

Nor have later attempts found any greater success. To the contrary, the very extension of the debate to cases of governmental (rather than state) succession, and the application of the concept to such diverse categories as those of "illegitimate", "criminal", "illegal" and "ineffective" debts, have further confused an already vague concept and diminishing its practical value in answering real problems.

PART 1 INTRODUCTION

The context within which the existence, validity, content and legal consequences of the doctrine of "odious debts" has been (and, for the most part,[1] is still being) discussed is state succession.[2] There is an old[3] and still continuing discussion among public international lawyers whether a successor state is bound to assume the debts of its predecessor state and, if so, whether there are any exceptions to this obligation. The answers to those questions vary depending on several factors, including the "civil law" or "common law" background of the participants in the debate. While generalizing may lead to inaccuracy, it is fair to say that civil lawyers tend to argue that a successor state is bound to comply with the obligations incurred by a predecessor state, while common lawyers embrace a more guarded attitude, if not outright rejection.[4] Within

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[1] Questioning the restriction of the relevance of the doctrine to state succession, see, for instance, Gelpern, p. 411, and Paulus, p. 93.

[2] On state succession, and the limited usefulness of broad conceptual categories in this area, see Brownlie, *Principles of International Law*, 6th ed., 2003, pp. 621 ff. See also Eisemann and Koskenniemi, "Introdution générale – Les Rapports", in Eisemann and Koskenniemi (eds.), *La succession d'Etats: la codification à l'épreuve des faits*, 2000, pp. 3ff. and 65ff.; Buchheit, Gulati and Thompson, p. 3: *"State succession is something of a misnomer".* For the "economic rationale" of the "doctrine of state succession and the rule of maintenance", see Bonilla, pp. 7ff. ("the rule of state succession is efficient because it removes transaction costs from the creation of long term contracts with positive surplus value", p. 10).

[3] Relevant cases reach back into Medieval times. A scholarly discussion developed in the late sixteenth century among some of the most prominent international lawyers of the time, such as Grotius, Gentili, Pufendorf and Brynkershoek. See Hoeflich, pp. 40ff.

[4] On this discussion, see O'Connell, 1967, vol. 1, pp. 369ff.; Id., "Reflections on the State Succession Convention", *Zeitschrift für ausländisches öffentliches Recht und Völkerrecht* 31 (1979), p. 725, at pp. 734ff.; Bedjaoui, pp. 73ff.; Foorman and Jehle, pp. 11ff.; Abrahams, pp. 21ff.; Ebenroth and Wilken, pp. 888ff. For contemporary developments see additionally, however, the draft of the Rapporteur Georg Ress of the 7th Commission of the *Institut de Droit International* about "State Succession in Matters of Property and Debts",

this context, an ongoing discussion exists whether there is one category of debts that is to be excluded from succession in all cases, this category being labelled as "odious debts".[5]

As will become clear from Part C of this note, this expression has gained prominence particularly outside the legal profession. It is seen as a tool to free over-indebted states from the burden of their debts. Hence the issue has been raised within such contexts as the Paris and London Clubs, Sovereign Debt Restructuring Mechanisms, the HIPC Initiative, etc.[6] Despite this renewed interest in the topic, the doctrine of "odious debts" finds little support in the legal literature.[7] The limited objective of this note is to explain the key features of this on-going debate and clarify some of its outstanding issues.

So far, the concept of odious debts has defied any exact definition. It remains an expression with a somewhat elusive content, bordering on the line between law and politics and between law and morals. A few examples will convey a sense of the wide variety of situations to which the concept is applied. Sometimes this expression is used in the context of state succession, sometimes in the context of governmental succession; sometimes debts are designated as "odious" because the lender has followed goals which are seen ex post as immoral, sometimes because the borrowing country – to be more precise: one of its representatives – has done so; sometimes the term "odious" is used when the money lent was stolen by corrupt officials, sometimes because it was not spent for the intended purpose, and sometimes it is used to denote the co-responsibility of lenders that financed failed projects. The only common thread to all these different usages of the expression is that it is applied to state (as opposed to private) debts[8] and the argument that no repayment obligation would ensue from contracting such "odious debts".

It is exactly this argument, namely that debts contracted under such circumstances do not entail a repayment obligation, which has attracted increasing NGOs' interest in the doctrine of "odious debts", as a potential solution to the heavy indebtedness of poor countries. Legal writers, on the other hand, are inclined to concentrate on whether there is a workable definition of odious debt which, while justifying exemption from repayment, does not erode or invalidate the contractual foundations on which the international financial system is built.

However, there seems to be broad agreement, inside and outside the professional legal environment, on the need to strengthen the ethical dimension of the law. Treatises headed "Fairness in International Law"[9] or chapters in books about "Law and Ethics"[10] provide clear evidence to this trend. Whereas some lawyers restrict the notion of equity to allowing a court to achieve a "result [that] is nowhere articulated other than [by] the self-serving description of 'equitable'",[11] others take a broader approach based on ethical considerations:

> *"The justice of which equity is an emanation is not abstract justice but justice according to the rule of law; which is to say that its appli-*

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electronically available at: www.idi-iil.org/idiE/resolutionsE/2001_van_01_en.PDF#search=%22Georg%20Ress%20%22State%20succession%20in%20matters%22%22.

[5] Paradigmatically, Gruber, pp. 37ff.

[6] On these topics, see for instance Manes, *Staatsbankrotte – wirtschaftliche und rechtliche Betrachtungen*, 1922; Reinisch, *State Responsibility*, pp. 12ff.

[7] For criticism, see, for instance, Choi and Posner, *A Critique of the Odious Debt Doctrine* (University of Virginia Law School. Public Law and Legal Theory Working Paper 58, 2007).

[8] This is not necessarily identical with the definition in Art. 33 of the 1983 Vienna Convention on Succession of States in Respect of State Property, Archives and Debts, the text of which is electronically available at http://untreaty.un.org/ilc/texts/instruments/english/conventions/3_3_1983.pdf. See, for instance, Marcelli, *Il debito estero dei paesi in via di sviluppo nel diritto internazionale*, 2004, pp. 9ff. On the other hand, the expression "state debts", as used in the present note, refers to all debts of a state alike, and not just to those contracted with international legal subjects. In other words, for the purposes of the present discussion, the creditor may be a state, a private law person or any other legal entity. As in the case of the use adopted in the aforementioned Convention, though, the debtor is always a state to the exclusion of any its political sub-divisions.

[9] Franck, *Fairness in International Law and Institutions*, 1995.

[10] See Jochnick and Preston, *Sovereign Debt at the Crossroads – Challenges and Proposals for Resolving the Third World Debt Crisis*, 2006 (especially its third chapter), and Stiglitz, "Ethics, Market and Government Failure, and Globalization: Perspectives on Debt and Finance", ibid.

[11] Higgins, "International Law and the Avoidance, Containment and Resolution of Disputes (General Course in Public International Law", *Recueil des cours*, 230 (1991), p. 292.

cation should display consistence and a degree of predictability; even though it looks with particularity to the more peculiar circumstances in an instant case, it also looks beyond it to principles of more general application. This is precisely why courts have, from the beginning, elaborated equitable principles as being, at the same time, means to an equitable result in a particular case, yet also having a more general validity and hence expressible in general terms."[12]

Similar attempts to reach a common understanding of the expression "odious debt", partly on legal and partly on ethical considerations, have met little success, not for lack of effort but for the complexity of the issues involved. To explore these efforts, this note will address the traditional notion of odious debts (Part B) and then examine the concept as it is currently used, at least in some quarters (Part C).

PART 2 THE TRADITIONAL CONCEPT OF "ODIOUS DEBTS"

The expression "traditional concept" is used here to refer primarily (but not exclusively) to the one emerging from the writings of classic authors, from case law,[13] and from treaties. The expression, though, is not meant to convey the wrong impression that there is a unanimously shared "traditional concept" of odious debts. To the contrary, within this "traditional concept", there are disagreements among the writers on practically every detail: classification of debts, delimitation of the concept, and definition of odious debts. In the end, the only common denominator among these divergent views seems to be the use of the same expression ("odious debts"), albeit with different meanings.

I. Classifications

1. War Debts

War debts are those contracted during a war by the previous sovereign to cover the costs of a war. Some restrict this concept to those debts aiming at suppressing a war of independence,[14] while others take a more liberal approach.15 For example, Feilchenfeld writes in his comprehensive monograph:

"Even where debts were distributed after war, treatment of war debts does not appear to have been uniform. The Treaty of Ryswick [1697] did not exclude war debts. It merely provided that the paying capacity should be measured by the revenues of three years before the war. In the treaty between Sweden and Prussia of 1720, Prussia promised expressly to provide for the payment of certain war debts."16

(It will be shown below that this attitude has changed over time, even though there are some counter-examples that seem to be based on obvious political considerations.)[17]

(a) The identification of the underlying theoretical basis justifying the maintenance or repudiation of war debts depends on whether one gives prominent weight to the creditors' acquired rights or instead relies on considerations of natural justice.[18] The expression "acquired rights" means here an implicit reference to the time-honored rule *pacta sunt servanda*,[19] with the consequence that an agreement has to be respected once the parties have entered into it. In principle, subsequent events, or the circumstances under which the agreement was concluded, should not have any influence on the performance of the contractual obligations deriving from the agreement.

As to "natural justice", the argument may be based on fairly pragmatic reasons. This, for example, is what Feilchenfeld wrote:

"The arguments which the English negative school and others have advanced against the maintenance of war debts in case of state succession have, however, little connection with the attempts to restrict war, but are based on a point which is sentimental rather than logical, namely, that an annexing state should not be forced to pay for debts which its

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[12] *Case concerning the Continental Shelf (Libyan Arab Jamahiriya v. Malta), Judgement*, 1985 ICJ Rep. 39, para. 45.

[13] This note deals only with international cases. Cases within, for instance, the United States, which will be ignored here, have been discussed in Khalfan, King and Thomas, pp. 22ff.

[14] See Bedjauoi, p. 141.

[15] See Buchheit, Gulati and Thompson, p. 9.

[16] Feilchenfeld, p. 75, footnote 6.

[17] See the references given by Bedjaoui, p. 153.

[18] See the practical examples discussed below.

[19] See, for instance, Frankenberg and Knieper, pp. 16ff.

enemy has contracted in order to destroy it… Apart from vague sentimental considerations, there is no serious ground why annexing states should not pay debts which are validly owed, even if the proceeds have been used against their interests… Whatever burdens fall upon an annexing state with regard to war debts of an annexed state are not imposed burdens, but are the result of a voluntary act of the conqueror, since they result from annexation, which in all cases is a voluntary act, unless the opinion is advanced that in some cases a state owes it to the cause of civilization to conquer another state. If the feelings of the people of a state are not disturbed by the incorporation into its organization of men who have fought against it, and by the acquisition of assets which have been used for war purposes, there is no reason why they should be disturbed by the maintenance of war liabilities."[20]

With the emergence, in international law, of the prohibition of aggressive war, much of the basis on which Feilchenfeld had grounded his considerations fell. Moreover, practice had already started to neglect the creditors' interests (and, thus, their "acquired rights") even before the time Feilchenfeld had published his treatise. Creditors of war debts had started being compared with gamblers who had set their money on the loosing party.[21]

(b) The emergence of this category of "war debts" is often dated back to a proclamation by Great Britain after the so called Boer War in 1900.[22] The British Government agreed to assume (ex *gratia*, not *ex lege*)[23] the debts of the South African Republic contracted prior to the commencement of the hostilities, but none of those contracted thereafter. The Colonial office asked whether

"even on the assumption that Her Majesty's Government, as the successor of the South African Republic, inherited generally the obligations as well as the rights of the late Republic, the further question arose whether their liability could be held to extend to any obligation between the outbreak of war and annexation... [t]hat it was possible to argue that the outbreak of war created a situation between the continuance of which no obligations could, in the nature of their things, arise which would legally pass from the enemy Government to Her Majesty's Government at the conclusion of hostilities".[24]

To this, Crown Counsel replied:

"We think that obligations incurred during the war, or in contemplation of the war, stand upon a different footing, and we do not know of any principle in international law which would oblige Her Majesty's Government to recognize such obligations."[25]

The emphasis on "such obligations" may be interpreted as an argument based on considerations of justice or balance of power, to the effect that a debtor would not to be held liable for debts previously incurred for financing a war against the ultimately victorious side. Even though the text suggests that Crown Counsel had looked for principles of international law, it becomes quite evident from another case regarding the annexation of the South African Republic that the argument is essentially one based on the power of the winning side. In *West Rand Central Gold Mining Company Ltd. v. The King*, the petitioner, an English registered company, claimed from the conquering state the return of gold which had allegedly been stolen from it by the officials of the predecessor state. Investigating into the question whether Great Britain, as the successor state, was bound by this obligation (the existence of which was not denied against the predecessor state), the judge (Lord Alverstone) reasoned as follows:

"we desire to consider the proposition, that by international law the conquering country is bound to fulfil the obligations of the conquered, upon principle; and upon principle we think it cannot be sustained. When making peace the conquering Sovereign can make any conditions he thinks fit

[20] Feilchenfeld, p. 719ff.

[21] Against this argument see Id., p. 721.

[22] As a matter of fact, the examples reach further back into history. See Bedjaoui, p. 142 (references to, e.g., the Treaty of Campo Formio dated October 17, 1797, between France and the Emperor of Austria; the Treaty of Tilsit dated July 9, 1807, between France and Prussia; and the Treaty of Vienna dated October 30, 1864, between Denmark and Prussia/Austria). See also Menon, p. 162.

[23] See Hoeflich, p. 56.

[24] Quoted in O'Connell, 1956, p. 190. On this case (and other ones), see Lauterpacht, *International Law*, vol. 2 (The Law of Peace, Part I), 1975, pp. 115ff.; Hoeflich, pp. 57ff.

[25] Quoted in Bedjaoui, p. 143.

respecting the financial obligations of the conquered country, and it is entirely at his option to what extent he will adopt them. It is a case in which the only law is that of military force… It is not denied on the suppliants' behalf that the conquering State can make whatever bargain it pleases with the vanquished; and a further concession was made that there may be classes of obligations that it could not be reasonably contended that the conquering State would by annexation take upon itself, as, for instance, obligations to repay money used for the purposes of the war."[26]

(c) Another instance in which war debts were repudiated can be found in an official declaration of the Peoples' Commissar for foreign affairs of the newly formed Soviet Union, dated July 9, 1920. Making reference to consultations with the British Government from June 30 through July 7, 1920, the declaration stated:

"All Russian contracts and obligations regarding British citizens have been annulled – beginning from the date on which the British Government has entered into war and intervention against Soviet Russia and has imposed a blockade in order to force the Russian people through hunger and austerity to reject that very form of government which it had chosen by itself through overthrowing the autocratic tsarist Government."

This happened after a general statement, in 1918, had been interpreted as amounting to outright rejection of liability for any foreign loan debt:

"All foreign loans are hereby annulled without reserve or exception of any kind whatsoever."

This broad statement surprised lenders and scholars alike, who were debating whether the Russian case after the 1917 revolution was one of succession of state or instead mere succession of government.[27]

(d) In 1924, the German Supreme Court in Private Law Matters ("Reichsgericht") decided a case in which a former officer in Deutsch-Ostafrika (nowadays Tanzania, Rwanda and Burundi) had deposited a certain amount into an account at a local bank.[28] At that time this territory was a German colony and became therefore involved in World War I. It was within the context of this war that the officer deposited his money, since the (German) Governor had asked the population to contribute to the strengthening of German warfare power. After Germany lost the war and after it entered into the Treaty of Versailles, which took away all colonies from Germany, the officer sued the German "Reich" for the repayment of his deposit. Upon the objection of the defendant that, not Germany, but Great Britain was to be held liable – because she had received the mandate over this former colony – the Court concluded:

"In no case the liability of a recipient State can be assumed with respect to those debts of the Protectorate which have arisen in the course of warfare or are otherwise connected with the war… In the case at hand the plaintiff had deposited his money at the Governor's request during wartime; given these facts, it is to be assumed that this money was meant to be used for public – i.e. bellicose – purposes. According to the principles of public international law, debts of this kind cannot be pursued against the recipient State. It cannot be said that the Protectorate's obligation was vested in the recipient State".[29]

(e) In the case that has just been mentioned, several references were made to the Treaty of Versailles dated June 28, 1919,[30] which set forth the consequences of World War I for Germany. From Article 254 of the Treaty, it follows *e contrario* that war debts were not regarded as being transferable. Regarding the successor states to the German Empire, the Treaty provided as follows:

"The Powers to which German territory is ceded shall, subject to the qualifications made in Article 255, undertake to pay: (1) A portion of the debt of the German Empire as it stood on August 1, 1914, calculated on the basis of

[26] [1905] 2 KB 391, reprinted in *British International Law Cases*, 1965, vol. 2, p. 283.

[27] On the debate of this thorny issue, see, e.g., Foorman and Jehle, pp. 17ff. See also Hoeflich, pp. 61ff., and Adams, 1991, chapter 17. With respect to the so called "Socialist Revolutionary Rule" ("Sozialistische Revolutionsregel"), see Reinisch and Hafner, pp. 52ff.

[28] RGZ 108, pp. 298ff.

[29] Ibid., pp. 300ff.

[30] The text of the Treaty is electronically available at http://history.acusd.edu/gen/text/versaillestreaty/ver248.html.

the ratio between the average for the three financial years 1911, 1912, 1913, of such revenues of the ceded territory, and the average for the same years of such revenues of the whole German Empire as in the judgment of the Reparation Commission are best calculated to represent the relative ability of the respective territories to make payment…"

It was therefore clear that only debts from the pre-war era (namely those contracted before August 1, 1914, the day of the outbreak of World War I) had to be assumed by the successor states; the later ones were seen as being binding on Germany or as having been extinguished. The aforementioned decision of the German Supreme Court confirmed this conclusion.

The various peace treaties signed at the end of World War I extended the concept of war debts far beyond what might be compared to gamblers' debts. All debts that had been contracted after the beginning of the war were considered to be war debts. Thus, "a loan contracted by Germany in 1917 for the construction of a bridge at Teschen in Upper Silesia was regarded by the German Reparations Commission as a war loan simply because of the date on which it was concluded."[31]

2. Subjugation debts

Bedjaoui describes this category of debts as "debts contracted by a State with a view to attempting to repress an insurrectionary movement or war of liberation in a territory that it dominates or seeks to dominate, or to strengthen its economic colonization of that territory."[32] Instead of calling this type of debts "subjugation debts", some authors call them "hostile debts".[33] This seems to be a difference in name but not in substance.

(a) The main feature of this category of debts is that the creditor must have done something that is seen as sufficient justification for a successor state to repudiate this debt. In contrast, the main feature of war debts is that the debtor has contracted it to wage a war or support a war effort. Bedjaoui[34] has given three examples[35] of subjugation debts.

(b) The Treaty of Peace between the United States and Spain dated December 10, 1898,[36] provides in its Article 1 that "Spain relinquishes all claim of sovereignty over and title to Cuba". There is, in the Treaty, no word about the status of public and private debts, let alone of "odious debts". However, during the drafting of Article 1, both parties to the Treaty argued heavily on what they called the "Cuban Debt" and what the United States, as the stronger party, rejected to be binding on Cuba. The background to this dispute was a debt contracted (at least nominally) by Cuba as a colony of Spain.[37] The United States regarded it as a purely Spanish debt because the money was (according to the US argument) used for the preservation of the Spanish interests in Cuba – i.e. for the reincorporation of San Domingo into the Spanish dominions, the Spanish expedition to Mexico, and the suppression of uprisings in Cuba itself (1868 and 1895). Spain argued that the debts incurred by a country remain its debts irrespective of a change of sovereignty:

"These maxims seem to be observed by all cultured nations that are unwilling to trample upon the eternal principles of justice, including those in which such cessions were made by force of arms and as reward for victories through treaties relating to territorial cessions. Rare is the treaty in which, together with the territory ceded to the new sovereign, there is not conveyed a proportional part of the general obligations of the ceding state, which in the majority of cases have been in the form of a public debt".[38]

The United States responded with the following arguments:

[31] Bedjaoui, p. 150. See also O'Connell, 1956, pp. 190ff.
[32] Bedjaoui, p. 157.
[33] E.g. O'Connell, 1956, p. 188; Khalfan, King and Thomas, p. 17; Buchheit, Gulati and Thompson, pp. 11ff.; Bonilla, p. 12.

[34] Bedjaoui, pp. 159ff.
[35] These are the cases cited below under letters (b), (c), and (e). Another case, relating to a Mexican law dated June 18, 1883, whereby Mexico denied to be liable for debts resulting from "governments allegedly having existed in Mexico" in certain time periods, is discussed by Sack, p. 158, and Tamen, pp. 10ff.
[36] The text of the Treaty is electronically available at www.yale.edu/lawweb/avalon/diplomacy/spain/sp1898.htm. For a discussion of the case examined here, see Hoeflich, pp. 51ff., and Adams, 1991, Chapter 17.
[37] This type of debt is sometimes classified as "localized state debt". See, e.g., Bedjaoui, pp. 14ff.
[38] Reproduced in Moore, *A Digest of International Law*, 1906, I, p. 353.

"From no point of view can the debts above described be considered as local debts of Cuba or as debts incurred for the benefit of Cuba. In no sense are they obligations properly chargeable to that island. They are debts created by the Government of Spain, for its own purposes and through its own agents, in whose creation Cuba had no voice… From the moral point of view, the proposal to impose them upon Cuba is equally untenable. If, as is sometimes asserted, the struggles for Cuban independence have been carried on and supported by a minority of the people of the island, to impose on the inhabitants as a whole the cost of suppressing the insurrections would be to punish the many for the deeds of the few. If, on the other hand, those struggles have, as the American Commissioners maintain, represented the hopes and aspirations of the body of the Cuban people, to crush the inhabitants by a burden created by Spain in the effort to oppose their independence would be even more unjust".[39]

Essentially, the American argument was twofold. Legally, the debt was a debt of Spain, as Cuba could not be held liable for an obligation contracted under force majeure, with no possibility to resist; morally, given the unjust result of any different solution, it was likewise a debt of Spain:[40]

"… that the so-called Cuban debt is not in any sense a debt of Cuba, but that it is in reality a part of the national debt of Spain. The American Commissioners were able to show that the debt was contracted by Spain for national purposes, which in some cases were alien and in others actually adverse to the interests of Cuba; that in reality the greater part of it was contracted for the purpose of supporting a Spanish army in Cuba; and that, while the interest on it has been collected by a Spanish bank from the revenues of Cuba, the bonds bear upon their face, even where those revenues are pledged for their payment, the guarantee of the Spanish nation. As a national debt of the Spain, the American Commissioners have never questioned its validity".[41]

The Spanish counter-argument, to the effect that it was legitimate to suppress a rebellion in its own dominions, was rejected by the United States:

"The American Commissioners have read without offense the reference in the Spanish memorandum to the Indian rebellions which it has been necessary for the United States to suppress, for they are unable to see any parallel between the uprisings of those barbarous and often savage tribes, which have disappeared before the march of civilization because they were unable to submit to it, and for the insurrections against Spanish rule in Cuba, insurrections in which many of the noblest men of Spanish blood in the island have participated. Nor are the American Commissioners offended by the reference of the Spanish memorandum to the attempt of the Southern States to secede. The Spanish Commissioners evidently misconceive the nature and the object of that movement. The war of secession was fought and concluded upon a question of constitutional principle, asserted by one party to the conflict and denied by the other. It was a conflict in no respect to be likened to the uprisings against Spanish rule in Cuba."[42]

In conclusion:

"The American commissioners therefore feel that they are fully justified both in law and in morals in refusing to take upon themselves in addition to the burdens already incurred the obligation of discharging the so-called colonial debts of Spain."43

Such a line of reasoning has not been immune from criticism. However, Bedjaoui, after reporting one classic instance of such criticism (by

[39] Ibid., p. 358.

[40] The inclusion of moral arguments within a legal context was not unprecedented. See, for example, the remark regarding creditors' protection made by the Secretary of State Frelinghuysen on the Chilean guano deposits occupation, cited by Foorman and Jehle, p. 30. See also Hoeflich, p. 54.

[41] Moore, p. 367.

[42] Id., p. 370. Interestingly, no reference was made to para. 4 of the 14th Amendment of the US Constitution, which reads in its second sentence: "But neither the United States nor any State shall assume or pay any debt or obligation incurred in aid of insurrection or rebellion against the United States..." The 14th Amendment was introduced into the US Constitution at the end of the secession war. See Adams, 2004, p. 2.

[43] Moore, p. 376.

Despagnet), rejects it writing: *"The least that can be said is that this point of view is outmoded…"*[44]

To sum up, the argument against holding Cuba liable for repaying the debt was that the debt had been incurred by Spain in the name of Cuba but in fact against its very interest and without Cuba's consent; moreover, it would be contrary to good morals to argue otherwise.

By embracing also a moral argument, the United States seemed to indicate that the legal argument alone would not suffice. And yet, if one may use a private law analogy, the fact is that a transaction in which one and the same person acts on both sides ("In-sich-Geschäft") is considered, in many civil law systems, as void.

(c) The Treaty of Versailles of 1919 has already been mentioned above in the context of war debts. It is relevant, however, with respect also to subjugation debts. In fact, Article 255 provided that Poland was to be freed of all debts related to a program whereby Germany had supported German settlers in Polish territory:

> *"In the case of Poland that portion of the debt which, in the opinion of the Reparation Commission, is attributable to the measures taken by the German and Prussian Governments for the German colonisation of Poland shall be excluded from the apportionment to be made under Article 254."*[45]

(d) Another instance was when Germany, after the "Anschluss" (i.e. the annexation), refused to assume those debts of Austria that had been contracted to impede the annexation. This case will be discussed below.

(e) Yet another example was the so-called "Indonesian debt".[46] This refers to the debts contracted by the colonial power (the Netherlands), which were discussed at a Round Table Conference in The Hague in 1949. Indonesia declared its "readiness to assume certain debts prior to the Netherlands capitulation to the Japanese in Indonesia on 8 March (Java) and 7 April 1942 (Sumatra)." Later debts resulting from military operations against the Indonesian national liberation movement,[47] and in particular those financing guerrilla operations, were rejected. In the course of the Conference, however, a compromise was reached pursuant to which the debts were apportioned between the two states. A few years later, Indonesia refused further payments.[48]

3. Regime debts

Various definitions exist for this category of debts. According to the French international lawyer Charles Rousseau, these are:

> *"Debts contracted by the dismembered State in the temporary interest of a particular form, and the term can include, in peacetime, subjugation debts specifically contracted for the purpose of colonizing or absorbing a particular territory and, in wartime, war debts."*[49]

This definition was quoted by Bedjaoui in one of his reports to the International Law Commission.[50] He explicitly stated that this kind of debts has to be taken into account in any discussion on succession to state debts, with the consequence that regime debts would be regarded as state debts. Moreover, in using this definition, Bedjaoui seemed to imply that the expression "regime debts" is an over-arching expression, which includes war debts and subjugation debts as sub-categories, except that regime debts are themselves a sub-category[51] of the wider category of "odious debts".

However, since Bedjaoui himself stated that in this uncertain area "it is all a matter of terminology or definition",[52] regime debts may be understood as state debts contracted for the sole benefit of a government and/or the persons forming the government.

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44 Bedjaoui, p. 165.

45 For a lengthy discussion of this aspect, see Sack, pp. 159ff., as well as Feilchenfeld, pp. 450ff. See, additionally, O'Connell, 1956, p. 189. For the somewhat parallel argument put forward by Algeria within the context of its war of independence, see Bedjaoui, p. 332.

46 See Bedjaoui, pp. 169ff.

47 This example would also fit in the category of war debts.

48 From then onwards, rejecting to assume the debts contracted by former colonial powers became standard practice, according to Khalfan, King and Thomas, p. 31.

49 *Droit international public*, 1977, vol. III, p. 458.

50 Bedjaoui, p. 47.

51 Bedjaoui is surprisingly imprecise on this point. See pp. 115 and 122ff.

52 Ibid., p. 125.

The classic decision regarding this category of debts is the arbitral award in a case between Great Britain and Costa Rica.[53] The dispute arose between the two countries because the Royal Bank of Canada had demanded repayment from the Banco Internacional de Costa Rica despite the fact that the Costa Rican government had enacted a so-called "law of nullities". This law nullified certain obligations which Costa Rica had entered into under the former government of Tinoco. Tinoco had overthrown the former ruler – not without some popular support – and had established a new constitution. After a couple of years Tinoco "retired" and left the country. A new government was then elected in accordance with the old constitution.

The sole arbitrator (William Taft) had to decide the dispute by "taking into consideration existing agreements, the principles of public and international law, and in view of the allegations, documents and evidence". He considered a complicated bundle of transactions resulting in a loan to Tinoco and his brother, which was clearly a loan for exclusively personal purposes. Accordingly, he decided in favor of Costa Rica stating:

> *"The whole transaction was full of irregularities. There was no authority of law, in the first place for making the Royal Bank the depositary of a revolving credit fund. The law of... authorized only the Banco Internacional to be made such depositary. The thousand dollar colones bills were most informal and did not comply with the requirements of law as to their form, their signature or their registration. The case of the Royal Bank depends not on the mere form of the transaction but upon good faith of the bank in the payment of money for the real use of the Costa Rican Government under the Tinoco regime. It must make out its case of actual furnishing of money to the government for its legitimate use. It has not done so. The bank knew that this money was to be used by the retiring president, F. Tinoco, for his personal support after he had taken refuge in a foreign country. It could not hold his own government for the money paid to him for this purpose."*

[53] 1 Reports of International Arbitral Awards (*RIAA*) 375 (1923).

A few sentences later, the arbitrator referred to a possible counter argument stating:

> *"Whatever it was, it is so closely connected with this payment for obviously personal and unlawful uses of the Tinoco brothers that in the absence of any explanation on behalf of the Royal Bank, it cannot now be made the basis of a claim that it was for any legitimate governmental use of the Tinoco government."*

In any event his conclusion, even without resorting to the doctrine of "odious debts", was that the repayment of a loan cannot be requested if the lender has extended the loan under circumstances which allowed the reasonable inference that the money had been lent for the personal use of a government's representative.

It is likely, however, that the formal irregularities of the loan would have caused its invalidity under private – and perhaps even under administrative – law.[54] In other words, the arbitrator invalidated on moral grounds a contract that was already null and void anyway.

4. Conclusive remarks on this section

After examining the cases discussed above, the first conclusion is that, while one may perhaps detect in them some elements akin to those of odious debts, the fact is that the expression "odious debts" was not used.

The second conclusion is that the decisions that have just been briefly examined were often taken on political or moral grounds rather than legal ones. This is evident in some instances of revolutionary uprise.[55] For example, the new French regime refused in 1789 to assume any political and economic obligations entered into by the "disempowered tyrants". Similarly, the newly constituted All-Russian Central Executive Committee declared in a decree dated February 10, 1918, that all loans contracted by the governments of the Russian land-owners and bourgeoisie were void. Finally, after the creation of the Peoples' Republic of China in 1949, the Political Consultative Council of China

[54] The invalidity, under private law, of the relevant contracts settled some of the disputes between Chile and the Peruvian creditors with respect to guano deposits. See Foorman and Jehle, p. 30.

[55] The following examples are taken from the Russian author Korovin, Völkerrecht, 1960, pp. 122ff.

announced on September 29, 1949: "The Central Government of the Peoples' Republic of China will examine the contracts and agreements entered into by the Kuomintang-Government with foreign Governments and then decide depending on their contents to acknowledge, annul, revise them, or to enter into new consultations."

II. The definitions of "odious debts"

1. Introduction

O'Connell observes in his book on state succession: "The doctrine of odious debts is a dangerous one which, as Despagnet says, 'favors most arbitrary and iniquitous solutions'."[56] (This quotation of Despagnet is taken from what Despagnet wrote on subjugation debts, when discussing the Cuban case mentioned above.)[57] The danger flagged by O'Connell is a valid concern, grounded as it is in the fact that the doctrine of "odious debts" may easily be abused. A striking example in this respect is Germany's repudiation of honoring any of the Austrian debts, after the annexation in 1938.[58] The Minister of the Economy asserted in a public speech on June 16, 1938, that:

> *"neither by international law nor in the interests of economic policy, nor morally, is there any obligation on the part of the Reich to acknowledge the legal responsibility for Austria's Federal debts."*[59]

The justification that was given in support of this view was, firstly, that the rule of state succession would not apply to cases of a debtor state's "self-extinction"; secondly, the "political" character of the debts; and, thirdly, the allegedly comparable precedents from the practice of France, Great Britain and the United States. In other words, we have here a typical case in which the claim that certain debts were "odious" was weak,[60] and in which precedents were misinterpreted to achieve a certain goal.

In consideration of this danger of abuse, it is indispensable to identify the defining elements of "odious debts" in such a way that this danger may be limited, if not completely overcome. Some authors, such as Sack, Bedjaoui and others, have tried to provide a precise definition, and their views will now be examined.

2. Alexander N. Sack

(a) Before the October revolution, Alexander Nahum Sack was a lawyer and lecturer in Tsarist Russia; thereafter he became a law professor in Paris.[61] Influenced presumably by his political experience, he wrote two books dealing with succession of states and its impact on public debts.[62] In the first one, he developed his idea of "debts which do not burden all or part of the territory of the State",[63] which he stated "might be called 'odious'" – thereby coining the expression that is still in use today. Sack wrote:

> *"If a despotic power contracts a debt not for the needs and not in the interest of a State but in order to fortify its despotic regime, to suppress the population from its fight, etc., then this debt is odious for the population of the entire State. This debt is not obligatory for the nation; it is (rather) a debt of the regime, a personal debt of the power which has contracted it… The reason why such odious debts cannot be seen as burdening the territory of a State is that these debts do not comply with one of the conditions which determine the regularity of State debts, namely: the debts of a State must be contracted and the funds thereof must be used*

[56] O'Connell, 1956, p. 187. For criticism in the more recent literature, see Choi and Posner, *A Critique of the Odious Debt Doctrine*.
[57] Despagnet, *Cours de droit international public*, 3rd edn., 1905, pp. 111ff.
[58] See also O'Connell, 1967, vol. 1, pp. 380ff.; Foorman and Jehle, pp. 21ff. See also Hoeflich, pp. 63ff.
[59] Quoted in Garner, p. 766.
[60] The loans were partially made for benign purposes such as the purchase of food.

[61] For his biography, see now Ludington/Gulati, A Convenient Untruth: Facts and Fantasy in the Doctrine of Odious Debts, Duke Law School Legal Studies – Research Paper Series (No. 174), October 2007, p. 15ff.
[62] Sack, 1927, and Id., *La succession aux Dettes Publiques d'Etat*, 1929. For a detailed analysis of his understanding of what constitutes State debts see Sack, 1932-1933, passim.
[63] This is the heading of Chapter IV of the book. Sack used a different classification than the one used in the present note (which is in part based on Bedjaoui's research). Writing before 1967 (and therefore before Bedjaoui), O'Connell still used, in his two-volume treatise on state succession in municipal law and international law, Sack's classification.

for the needs and in the interest of the State."[64]

A few lines after this text, he concluded that "the creditors have committed a hostile act against the people." The consequence is that such debts do not bind the nation; they are rather obligations of the particular regime or a personal debt of the power that has contracted the debt. The example given by Sack is the "subjugation debt" mentioned above, namely Mexico's statutory refusal in 1883 to be held liable for debts which had been contracted by "governments which allegedly have existed in Mexico" during certain periods of time.[65] Additionally, Sack alluded to what have been described above as "regime debts".

(b) One of the chapters in Sack's treatise deals with "debts which are odious for the population of a part of the territory of the debtor State". He described them thus:

"When the government has contracted debts in order to subjugate the population of a part of its territory or to colonize these for the citizens of the dominant nationality, etc. then these debts are odious for the indigenous population of this part of the territory of the debtor State."

As he referred to the abovementioned Cuban case and the case of the German colonization program in Poland, it becomes clear that what Sack had in mind was what Bedjaoui would later call "subjugation debts". It is within this context that Sack defines three elements which cumulatively justify calling certain debts "odious" and which are nowadays often quoted by many writers as the defining elements of "odious debts":

"1. The new government must prove and an international tribunal must regard as proven: (a) that the need for the fulfillment of which the former government has contracted the particular debt is 'odious' and evidently contrary to the interests of the population of all or part of the former territory; and (b) that the creditors – at the time of the issuance of the bonds – had knowledge of the said odious purpose. 2. Once these two requirements are established, it is up to the creditors to bear the burden of proof to establish that the funds resulting from such bonds have in fact not been used for odious needs".[66]

In another chapter, Sack dealt with war debts and declared them, too, to belong to the category of "odious debts": "In providing funds for the war-faring needs of one of the belligerents, the creditors have committed a hostile act against the other belligerent."[67]

(c) To sum up, Sack developed his concept of "odious debts" within the context of his analysis of state succession, and restricted the relevance of the concept to this context. He wrote that, if debts burdening the entire population (of the predecessor state) are contracted by a despotic regime for purposes contrary to the interests[68] and needs of the population, these debts are "odious". If, on the contrary, the debts burden only part of the population, the requirements for establishing the debt is "odious" are more complex. As to war debts, they are "odious" and the successor state would therefore be liable for them only if certain requirements are fulfilled, namely that (1) there is identity between the debtor state and the belligerent state,[69] and (2) the creditors have given the loan with the explicit purpose of waging that war, in addition to the effective use of such a loan for that purpose.[70] In any case, Sack did not advocate the view that all the debts contracted by a despotic regime would be invalid; to the contrary, he advocated a case-by-case assessment of any debt on its own merits.

3. *Bedjaoui and the International Law Commission*

(a) The International Law Commission (ILC) undertook quite an extensive discussion of the definition and legal consequences of "odious debts". Established in 1948 as a subsidiary organ of the United Nations General Assembly, the Commission's mandate is to codify and progressively develop international law, in accordance with Article 13(1)(a) of the Charter of the United Nations. In his role as the Commission's Special Rapporteur on the topic of

64 Sack, p. 157, with a reference to pp. 25ff. of the same work. On p. 27, Sack admits that this rule is "very arbitrary and very vague".

65 On this particular case, see also Khalfan, King and Thomas, p. 24.

66 Sack, p. 163.

67 Id., pp. 165ff.

68 According to O'Connell, 1956, p. 189, the test of "contrary to the true interests of the territory" is one in which "politics assume dominance over legal analysis".

69 Sack, p. 166.

70 Id., p. 168.

succession of states in respect of matters other than treaties, Bedjaoui submitted a report in April 1977[71] in which he devoted a long chapter to "odious debts".

Before describing his line of reasoning, it needs to be emphasized that Bedjaoui, like Sack before him, restricted the applicability of the concept of odious debts to a rather small set of situations: there must be a succession of states (not merely a succession of governments),[72] there must be debts contracted or guaranteed by the predecessor state, and these debts must result from a state's financial obligation towards another state.[73] It is only within these limits that, according to Bedjaoui, the concept of odious debts has a role to play.

(b) On the basis of his study of the topic, Bedjaoui proposed the two following draft articles:

> *"Article C. Definition of odious debts*
> *For the purposes of the present articles, 'odious debts' means:*
> *(a) all debts contracted by the predecessor State with a view to attaining objectives contrary to the major interests of the successor State or of the transferred territory;*
> *(b) all debts contracted by the predecessor State with an aim and for a purpose not in conformity with international law and, in particular, the principles of international law embodied in the Charter of the United Nations.*
>
> *Article D. Non-transferability of odious debts*
> *[Except in the case of the merger of States,] odious debts contracted by the predecessor State are not transferable to the successor State."*

The Commission, though, decided not to incorporate these articles into the draft Convention on the succession of states in matters other than treaties:

> *"The Commission, following the recommendation of the Drafting Committee, recognized the importance of the issues raised in connexion with the question of 'odious debts' but was of the opinion that it was best first to examine each particular type of succession of States, because the rules to be formulated for each type might well settle the issues raised by the question and might dispose of the need to draft general provisions on the matter. It was generally agreed that it would not be useful or timely to draft at this stage, for inclusion in the section on general provisions, articles relating to 'odious debts'."*[74]

On this decision by the Commission, Bedjaoui commented a few years later:

> *It was pointed out that the Commission had decided against drafting general provisions on 'odious debts' in the expectation that the rules being drafted would be sufficiently wide to cover that situation. 'Odious debts' were considered to be those imposed upon a country without its consent and contrary to its true interests, and debts intended to finance the preparation for or the prosecution of war against the successor State. In that connection, some representatives deemed the Special Rapporteur's earlier proposals to be quite interesting… One representative disagreed with the Commission's conclusion that there was no point in defining the concept of 'odious debts' and stipulating that such debts could never be transferred. Another representative deemed it particularly important to clarify that point, since the intent behind the draft articles was that succession to State debts*

[71] Doc. A/CN.4/301 and Add. 1, in *Yearbook of the International Law Commission* (YBILC), 1977, vol. II, part 1, pp. 45ff., electronically available at http://untreaty.un.org/ilc/publications/yearbooks/Ybkvolumes(e)/ILC_1977_v2_p1_e.pdf. For the Commission's discussion, see *YBILC* 1971, vol. II, part 1, p. 185; 1977, vol. II, part 1, p. 45; 1977, vol. II, part 2, p. 59; 1978, vol. II, part 1, p. 229; vol. II, part 2, p. 113; 1979, vol. II, part 2, p. 40; 1981, vol. II, part 2, p. 72.

[72] However, Bedjaoui is not entirely clear on this point. (See p. 125 of his report.) On the watering down of this differentiation, see also Foorman and Jehle, p. 10.

[73] See pp. 6ff. in Bedjaoui's report.

[74] See the Report of the International Law Commission on the work of its twenty-ninth session 9 May-29 July 1977, *YBILC* 1977, vol. II, Part 2, p. 67 (at 44), electronically available at http://untreaty.un.org/ilc/publications/yearbooks/Ybkvolumes(e)/ILC_1977_v2_p2_e.pdf. For an example of how debts today tend to be treated within the context of state succession, see Schweisfurth, "Das Recht der Staatensukzession – Die Staatenpraxis der Nachfolge in völkerrechtliche Verträge, Staatsvermögen, Staatsschulden und Archive in den Teilungsfällen Sowjetunion, Tschechoslowakei und Jugoslavien", in *Berichte der Deutschen Gesellschaft für Völkerrecht* 35 (1998), pp. 213ff.

> *should be a general obligation on all States other than newly independent States. He therefore considered that a provision should be included in the draft to cover that point. Some representatives expressed the hope that, in view of the importance of the question, the Commission would review its decision regarding 'odious debts' when it took up the articles on second reading."*[75]

However, the Commission did not change its attitude in its second reading.[76] Even though the concept of odious debts was not embodied in the Convention, Bedjaoui's treatment of the subject is instructive in many ways.

(c) At the beginning of his analysis, Bedjaoui noted that the Convention *"should include one or two provisions relating to what are generally called 'odious debts' or 'regime debts', in connexion with which the literature refers to the case of 'war debts' and 'subjugation debts'."*[77]

Regrettably, Bedjaoui failed to identify the authorities on which he was relying. It is noteworthy, however, that he did not even once quoted Sack's writings in the chapter dealing with definition and concept of "odious debts".[78] This is how he explained his approach:

> *"It is generally recognized that historically the theory relating to these categories of debts has been developed in the writings of Anglo-American jurists, who have excluded them from all possible succession on the basis of moral principles. As will be seen, however, State practice in continental Europe, if not the writings of European jurists, has often stressed the primacy of this 'clean slate' principle as regards these categories of debts, at least in the case of debts contracted between European States in order to make war on other European States. A definition of 'odious debts' must be sought…"*

He therefore began his inquiry with the assumption that the existing definitions "are not very precise" and that the relationship of the various categories of debts to one another is far from clear.[79] The classification that Bedjaoui favored was that "war debts" and "subjugation debts" are sub-categories of "odious debts". There is no need here to discuss these two sub-categories, as they were mentioned earlier in this note. The relationship between "odious debts" and "regime debts", however, is not one of subordination but one of overlapping, at least "to a great extent".[80] With respect to the latter category, Bedjaoui observed that "in the strict sense of the term" regime debts are "invoked much more frequently in succession of governments than in succession of States." He referred to "the Tsarist public debt, for which the new régime resulting from the October Revolution of 1917 originally refused to assume responsibility."[81] He then added:

> *"The difference between odious debts and régime debts is that the former are considered from the standpoint of the predecessor State (whose political 'régime' is involved), whereas the latter are considered from the standpoint of the successor State (for which this category of debts is 'odious'). Régime debts and odious debts could thus be regarded as practically identical."*[82]

(d) Regarding para. (a) of his definition, Bedjaoui remarked:

> *"A thorough examination will, of course, reveal that almost any political, economic or social action by a State may be disadvantageous to another State. A debt contracted by a State for the purpose of carrying out the political, economic or social action in question does not, however, become an 'odious debt' unless the latter's interests are gravely or substantially injured."*

As to para. (b) of his definition, he offered some examples:

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[75] See *YBILC* 1981, vol. II, Part 1, pp. 19ff. (at 135), electronically available at http://untreaty.un.org/ilc/publications/yearbooks/Ybkvolumes(e)/ILC_1981_v2_p1_e.pdf.

[76] See ibid., vol. II, Part 2, p. 79 (at 43), electronically available at http://untreaty.un.org/ilc/publications/yearbooks/Ybkvolumes(e)/ILC_1981_v2_p2_e.pdf.

[77] Bedjaoui, p. 115.

[78] This is all the more noteworthy as the original language of the report is French – i.e. the language in which Sack, too, had published his works.

[79] This might be understood as an indirect criticism of Sack's classification, which has as its decisive criterion the extent to which a territory is affected.

[80] Bedjaoui, p. 126.

[81] Id., p. 124.

[82] Id., p. 126.

> *"A straightforward case is that of a debt contracted with the intention of using funds to violate treaty obligations. However, this problem derives its complexity from another source. The question of 'odious debts' in a case of State succession arises today in terms of contemporary legal ethics, in connexion on the one hand with human rights and the right of peoples to self-determination and, on the other hand, with the unlawfulness of recourse to war."*

Bedjaoui referred to the purchase of arms "that were used to flout human rights through genocide, racial discrimination or apartheid" as well as to "any policy contrary to the right of peoples to self-determination". He continued: "Debts contracted by a State in order to wage a war of aggression are clearly odious debts."[83]

(e) After having explained his definition of "odious debts", Bedjaoui presented numerous examples of "war debts" and "subjugation debts". He did not discuss, however, the Tinoco case, which was mentioned above under the heading of "regime debts". It is unclear whether or not this category of "regime debts" falls outside of Bedjaoui's classification – either because it is a mere government succession issue, or because these debts would fall outside a strict interpretation of "odiousness".

(f) Bedjaoui's treatment of the topic was fairly influential in the international literature. It is particularly noteworthy that in a number of textbooks that touched upon the topic, however briefly, reference was made exclusively to Bedjaoui's report or the ILC work, whereas Sack's writings were almost completely neglected.[84] Two examples will suffice.

In their textbook of international law, Verdross and Simma wrote:

> *"Pursuant to customary international law, the duty to assume debts [from the predecessor State] is generally excluded in cases of 'odious debts'."*[85]

In support of this passage, the authors referred to two cases. The first one was from 1918, when the provisional government of Czechoslovakia declared its readiness to assume part of the general Austrian-Hungarian bond debts, except for specific war-related bonds.[86] The second one was from 1954, when the Italian-French Composition Commission regarding Ethiopia reiterated the same principle.[87] Verdross and Simma then referred to Bedjaoui's definition stating that its first part (i.e. debts contrary to the major interests of the successor State) is consistent with what can be evinced from customary international law. As to the second part of Bedjaoui's definition, these two authors refrained from any comment.

A similar conclusion can be drawn from another widely used textbook in the German-speaking world, namely the textbook by Ipsen and others.[88] They, too, citing Bedjaoui's work, conclude that the non-transferability of "odious debts" is part of customary international law. The fact that no provision on "odious debts" is contained in the Convention on the succession of states regarding matters other than treaties is irrelevant, according to them, because Article 33 of the Convention, which refers to debts that have come into existence in compliance with public international law, is an implicit acknowledgment that "odious debts" are excluded from transferability.[89]

The examples of these two textbooks are representative of the prevailing view. At the same time, however, the use of the expression "odious debts" is often omitted. The preference seems to be for a generic reference to the need that an agreement be consistent with the requirements of public international law.[90]

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83 Id. pp. 134, 135, and 136.

84 O'Connell (p. 187) was the exception, but he wrote before Bedjaoui's report.

85 Verdross and Simma, *Universelles Völkerrecht*, 3rd edn., 1984, p. 629.

86 See Hackworth, *Digest of International Law*, I, p. 543.

87 See *RIAA*, vol. XIII, No. 176, pp. 627ff.

88 Ipsen et al., *Völkerrecht*, 5th edn., 2004, pp. 355ff.

89 For a similar view, see Pöggel and Meißner, *Staatennachfolge im Völkerrecht*, 1986, pp. 138ff.

90 Paradigmatic in this sense is, for instance, Shaw, *International Law*, 5th edn., 2003, pp. 900ff. See also Ress, "State Succession in Matters of Property and Debts" (paper presented in Vancouver), electronically available at: www.idi-iil.org/idiE/resolutionsE/2001_van_01_en.PDF#search=%22Georg%20Ress%20%22State%20succession%20in%20matters%22%22. For practical applications to the cases of Germany's re-unification and Yugoslavia's dismemberment, see Anderson, pp. 418ff.

4. Other authors

Hardly surprising, the discussion of the concept, contents, and definition of what constitutes an "odious debt" has involved a number of authors, well beyond the ones that have just been considered.

(a) For instance, in his treatise on state succession with respect to debts, Menon too discusses the concept of "odious debts". Without quoting from Sack's writings, he follows Bedjaoui in listing as examples of these debts "war debts" and "subjugation debts".[91] However, he goes beyond this descriptive notion and considers further applications, consistent with the second paragraph of Bedjaoui's proposed Article C, quoted above:

> *"Apart from war and subjugation debts, debts contracted for committing acts in violation of fundamental international law principles may also considered odious debts. For example, in the case of a debt contracted by the predecessor State to violate obligations imposed on it under a treaty, the successor state will consider the debt as odious. The same may be the case with regard to debts which enable the predecessor State to breach obligations in respect of human rights or the right to self-determination. For example, if the predecessor State contracted a debt to purchase arms which are used to infringe human rights, commit genocide or institute apartheid, the successor State will have to consider that debt as odious, even if it has not been a victim of the wrongful acts in question, since it does not support an act which is in violation of international law. In brief, debts contracted contrary to the major interest, right of survival, or independence of the successor State, or debts contracted in violation of the peremptory norm of international law would be odious debts, and would thus be repudiated."*[92]

(b) One of the most comprehensive discussions of "odious debts" in recent times was developed by Khalfan and his co-authors. In defining "odious debts", they identify the following characters:

> *"- Absence of Consent: The population must not have consented to the transaction in question. This is so because it is unlikely that the law would forbid a person from willingly entering into a contract that is detrimental to him or her. With dictatorial regimes this requirement presents few problems, while with democratic ones it could pose one.*
>
> *- Absence of Benefit: According to the applicable writings, there must be absence of benefit to the population in two ways: (1) in the purpose of the transaction and (2) in fact. The purpose requirement refers to the fact that creditors should not be punished for good faith loans that were misspent by corrupt governments, and the fact requirement refers to the principle that populations that benefit in fact from bad faith loans are still required to repay them (unjust enrichment).*
>
> *- Creditor Awareness: This requirement stipulates that the creditor must be aware of the absence of consent and benefit. There are several standards that may be employed for measuring 'awareness', and luckily domestic law provides a sufficiently broad definition of 'awareness' to capture those creditors that shut their eyes to the obvious."*[93]

From this premise, the authors conclude that there are three types of "odious debts": in addition to war and hostile (or subjugation) debts, there are also "Third World debts", which "were simply harmful burdens assumed by a state but for which the population received no benefit".[94] If a debt is odious, the agreement through which it was contracted is not null but unenforceable.

This treatment of the subject by Khalfan and his co-authors is designed to support civil society organizations and debtor countries in their effort to articulate reasons for repudiating debts on the ground of their being "odious". Thus, the authors aim not only at proving or establishing the legal nature of the doctrine of odious debts but also at showing the procedural steps to achieve the goal of repudiating such debts. They give very practical advice to courts, arbitration panels or institutions that may be willing to render far-reaching

[91] Menon, p. 162.
[92] Menon, p. 163.

[93] Khalfan, King and Thomas, p. 1 and pp. 14ff. (For a discussion of "unjust enrichment" and "abuse of power" with respect to sovereign debts, see also Lothian, pp. 463ff.)
[94] Khalfan, King and Thomas, pp. 2 and 19. (The authors refer also to the article by Frankenberg and Knieper.)

decisions.[95] Finally, they discuss the implications of the odious debt doctrine.[96]

It is not completely clear, though, whether the authors allege that there is already, in international law, a doctrine of odious debts or instead they are just advocating it through their arguments. The concluding remark by King (one of the contributors to this collective work), in his chapter on the definition of, and evidence for, such a doctrine seems to point in the latter direction:

"If nothing else, it is hoped that this paper has succeeded in establishing that there are legally persuasive arguments in favour of the morally compelling doctrine of odious debts."[97]

(c) Making reference to the Iraqi war (2003) and to the "Argentina case",[98] Fischer-Lescano approaches the subject of odious debts by observing what he calls the "structural corruption in the world society" – i.e. the deficiencies in solving Argentina's over-indebtedness[99] with world political tools and with the help of lawyers. He asks: "Are there really no legal institutions resulting in serious consequences, in particular in the dissolution of contracts?"[100] This question is the starting point for a discussion whether or not "odious debts" are such a legal institution. He defines them thus:

"This norm protects successor states from being held liable for debts of their predecessors if these debts were entered into without being in compliance with the interest of the population of the respective territory – if, for instance, a colonial power's suppression of a liberation movement has been financed."[101]

After a description of the historical development of the concept, he then examines its legal character writing:

"In public international law it is not decisive to formulate understandable analogies but to prove the validity of legal concepts. This, however, is successfully done only when and if the norm the validity of which is asserted can be linked with the legal sources listed in Art. 38 of the ICJ Statute. In this context, customary international law and general principles of public international law are relevant. But one has to say that a general rule like 'odious debts are non-obliging' can hardly be evidenced. Such a rule hardly corresponds to state practice and the evolution of general principles would have to face the difficulty that there might be exceptions to the validity of contracts based on violation of good morals in almost all jurisdictions of the world but that their respective contents differ."[102]

The ground on which he would nevertheless rely in the case of Argentina's debts, without invoking a legal norm on "odious debts", is Article 53 of the Vienna Convention on the Law of Treaties,[103] which reads:

"A treaty is void if, at the time of its conclusion, it conflicts with a peremptory norm of general international law. For the purposes of the present Convention, a peremptory norm of general international law is a norm accepted and recognized by the international community of States as a whole as a norm from which no derogation is permitted and which can be modified only by a subsequent norm of general international law having the same character."

Fischer-Lescano concludes, on the basis of this norm:

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95 Khalfan, King and Thomas, pp. 53ff.

96 Iid., pp. 86ff.

97 Iid., p. 48. (On the idea that the "odious debt doctrine" is morally binding, see also Huber, "The 'odious debt' principle morally justified", electronically available at www.odiousdebts.org/odiousdebts/index.cfm?DSP=content&ContentID=10372.

98 See also the same author's "Sittenwidrige Schulden", in *Blätter für deutsche und internationale Politik*, 2003, pp. 404ff., as well as Olmos Gaona, "The illegal foreign debt: the value and likelihood of a legal ruling", electronically available at www.odiousdebts.org/odiousdebts/index.cfm?DSP=content&ContentID=2101. From an economic perspective, see Stiglitz, 2006, pp. 166ff.

99 On the wider issue of corruption in Latin America, see Oquendo, "Corruption and Legitimation Crises in Latin America", 14 *Conn. J. Int'l. L.* 475ff. (1999).

100 *Kritische Justiz*, 2003, p. 226.

101 Regarding this definition, the author refers neither to Sack nor to the ILC but rather to Menon, *The Succession of States in Respect of Treaties, State Property, Archives and Debts*, 1991, p. 161.

102 *Kritische Justiz*, 2003, p. 234.

103 For further references to Articles 38, 49 and 50 of this Convention as a possible way out of "odious debs", see Khalfan, King and Thomas, pp. 30ff.

"It follows from this text that the relevant norm to the Argentine example is not one that reads: contracts under public international law are null and void when giving rise to odious debts. It rather suffices to have a norm that is violated through the existence of odious debts. The nullity of such a contract then would derive from the application of Art. 53."[104]

In other words, Fischer-Lescano, while referring to all those elements that would give rise to a separate norm on "odious debts" for scholars like Sack or Bedjaoui, does not appeal to the independent operation of this concept, but rather to the concept of jus cogens, which is well-established in international law, even though the exact determination of which norms are peremptory is not immune from difficulties and disagreements.

(d) Whereas the above mentioned author follows the more recent trend of doing away with the concept of "odious debts" and incorporating its contents into other well known legal concepts, Christoph Paulus (the author of the present note) follows a more traditional approach. While preserving the concept, he defines "odious debts" anew, giving a different meaning to this expression. He starts his investigation with examining existing definitions, coming to the conclusion that the doctrine of odious debts does not belong to customary international law:

"To conclude this brief historical outline, it can be said that these lines of thought and argumentation leave too great a vacuum in theory and in practice for us to accept the principle of 'odious debts' as a legal institution recognized under customary law."[105]

Before presenting his own proposal, he weighs the advantages and disadvantages of the doctrine of "odious debts". With respect to the advantages, he observes certain modern trends to the effect that the iron principle[106] *pacta sunt servanda* (contracts or agreements must be respected) is being increasingly eroded; he mentions, as one indicator of this trend, the increasingly wider scope of consumer protection law.[107]

Paulus then demonstrates that the each one of the elements that have been used in previous definitions of odious debts suffer from serious lack of precision. He raises, for example, the following questions:

"[With respect to the requirement of the 'consent of the population',] who should define who is a dictator under the terms of the doctrine of 'odious debts'?... [With respect to the requirement of the 'absence of benefit',] who is to provide the yardstick against which 'benefit' is to be measured?... The question is, to put it succinctly, who are the 'people' and who should represent them?"[108]

His own proposal is aimed at turning the disadvantage of lack of precision into a structural element of a norm which, by definition, is an open norm or a "general clause" (*Generalklausel*). Following the model of similar norms existing in the codified law of continental Europe (such as the prohibition of "immoral contracts"), he writes that, also for a norm on odious debts, several factors (such as the behavior and intentions of the borrower's representative and/or that of the creditors, the purpose of the loan, and the surrounding circumstances) have to be examined before a decision is made:

"The odiousness of a debt is not automatic, provided the said factual elements [i.e. those identified by Sack or Bedjaoui] are met. Instead, a number of diverse facts must be seen in context before a decision is made in each individual case. This procedure, which will initially have to commence by force of circumstances, can be defined with increased precision as more experience is gained by establishing so-called case groups. Once established, these case groups will represent the experience gained in several cases such that, when this level of experience is gained, an individual case can be accorded to an already recognized case group of 'odious debts' and the legal consequences will then become axiomatic."[109]

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[104] *Kritische Justiz*, 2003, p. 235.
[105] Paulus, p. 86.
[106] This principle is the strongest obstacle to the recognition of the doctrine of "odious debts".
[107] Paulus, p. 90.
[108] Id., p. 94.
[109] Id., pp. 96ff. Even though not mentioned in the text, examples for already existing case groups might be "war debts" and "subjugation debts".

(e) Buchheit and his co-authors observe a "rebirth of the odious debt debate":

> *"The concept of odious debts languished in something of a doctrinal backwater for many years… This changed abruptly, however, following the American invasion of Iraq in 2003 to oust the regime of Saddam Hussein."*[110]

In trying to answer the question whether or not there is now a doctrine of odious debts, these authors see the real challenge in the need to sharply define "the characteristics of this odious debt category".[111] They describe the term "odiousness" as "dangerously" inviting "ethnocentrism" and conclude:

> *"We believe that a principle of public international law concerning odious debts does not have, nor is it likely to achieve, the consensus necessary for it to claim the title of 'doctrine', or the degree of clarity necessary for it to be of much use in invalidating purportedly odious loans without simultaneously discouraging many legitimate cross-border financings."*[112]

However, they do not stop at this conclusion. As an alternative to an "odious debt" doctrine, they construe a hypothetical case regarding various loans given to a fictitious country (Ruritania) under the law of the State of New York. They distinguish among a "corrupt loan" ("the lender knows that all or part of the proceeds of the loan will be stolen by members of the ruling regime"), a "suspicious loan" ("the lender suspects, but does not know for sure, that some or all of the proceeds of the loan will be stolen by the members of the ruling regime"), and an "utterly fatuous loan" (the government uses the proceeds of the loan "for the sole purpose of funding a program to count – individually – each grain of sand in the vast desert of Ruritania; the counting to be done by a team composed exclusively of Nobel prize-winning economists. No personal corruption by government officials is involved or suspected").[113]

In examining the possible defenses that the successor regime[114] might raise before a New York court, these authors conclude that the existing arsenal of "legal weapons" is enough to reject re-payment in at least most cases.[115] Thus, bribery is contrary to public policy in the United States; the equity maxim "he who comes to equity must come with clean hands" protects against enforcements of contracts "that are tainted by bribery or other illegal activity";[116] agency law might serve as shield from re-payment when one sees the population of Ruritania as the principal and the government members as its agents; and, from there, it is just a small step towards the well established doctrine of piercing the corporate veil.

In the final chapter of their article, Buchheit and his co-authors discuss practical problems (such as those of proof and "equal fault")[117] but demonstrate that these practical obstacles are surmountable. This is their conclusion:

> *"The attempt over all these years to enshrine a public international law doctrine of odious debts has been fueled by this sense of moral outrage. Strong moral imperatives, however, have a way of embodying themselves in principles of domestic law as well as public international law. We have suggested that the entrenched hostility of American law to bribery, litigants with unclean hands, faithless agents and public officials embezzling state funds under the cover of what we have called 'governmental veil', is adequate to allow a sovereign defendant to defend itself in an American court against the attempted enforcement of*

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[110] Buchheit, Gulati and Thompson, pp. 18ff. In agreement with this observation see, for instance, Stiglitz, 2003. Boyce and Ndikumana have written that Africa may have a case on the basis of the odious debt doctrine: "One side-effect of the American/British occupation of Iraq is that it has sparked public debate on a dark secret of international finance: the debt taken on by odious regimes." (www.odiousdebts.org/odiousdebts/index.cfm?DSP=content&ContentID=7794.)

[111] Buchheit, Gulati and Thompson, p. 26.

[112] Iid., p. 29.

[113] Iid., p. 30.

[114] The authors see the distinction between succession of State and regime succession as artificial and thus irrelevant. (Iid., pp. 3ff.)

[115] The following defenses are discussed on pp. 31ff. Jochnick (p. 145) reaches a similar conclusion and writes: "All of these arguments [i.e. relating to fraud, unconscionability, or odious debts] find support in international and domestic legal systems."

[116] Buchheit, Gulati and Thompson, p. 34. For a similar survey of possible defenses, see Odiadi, "Sub-Saharan Debt: The imperative of contract adjustment", pp. 8ff., electronically available at www.odiousdebts.org/odiousdebts/publications/Sub-saharandebtpaper.pdf.

[117] Buchheit, Gulati and Thompson, pp. 47ff.

what Alexander Sack would have recognized as an odious debt."[118]

(f) Like the authors that have just been mentioned, Mancina is of the view that a legally binding doctrine of "odious debts" neither exists nor would it do any good if it were introduced into public international law. Her focus is the lending policy of such institutions as the World Bank, but her discussion appears to be broad enough to be understood as a general contribution to the discussion of "odious debts".

She starts with several observations about the moral background to the arguments in favor of such a doctrine but distinguishes between motivation and its translation into an operational tool:

"Levinas channels the abstract suffering of other peoples into a tangible, driving force for the mobilization of efforts to alleviate that suffering. Campaigns to decrease the pain and suffering that result from heavy international debt may be grounded in this sort of moral discourse, but the means through which those campaigns seek to reduce these burdens must be considered in the broader scope of international law… While international law significantly regulates arms control, human rights, and free trade, the legal issues implicated by the international debt crisis remain largely ignored. Present calls for debt relief take many forms, including calls for the integration of the odious debt doctrine into international law. When analyzed as a microcosm for struggles embodied in globalization, this doctrine implicates legal and moral considerations that may ultimately undermine the core values of modern international law."[119]

In examining the origin and scope of the odious debt doctrine, she concludes:

"The odious debt doctrine has not been invoked successfully in the international sphere, but it has been refined in the academic community… The odious debt doctrine's scope, most broadly, encompasses both past debts and the present day acquisition of loans."[120]

Her conclusion about the non-legal nature of this doctrine is the result of her investigation of international law. It is noteworthy that, in this context, she writes:

"Focusing on the World Bank is extremely relevant to a discussion of the odious debt doctrine because the Bank is at the forefront of issues involving international public debt. With approximately $ 30 billion in loans each year, the Bank is a key player in the global economy and its actions are often a model for the international community. At the outset, then, it should be instructive that the Bank has never applied the doctrine of odious debt... Both Vienna I and the Bank endorse a system whereby the responsibility for debts incurred by a sovereign power is not generally absolved upon the dissolution of a state, but rather is reapportioned so as to maintain the liabilities and foster security of repayment for international lenders.[121]

She then justifies her objection to a legally binding doctrine of "odious debts" in the following way:

"From a theoretical perspective, debt can be considered one of the primary neo-colonial tools of oppression… There is an 'approval culture' inherent in the Bank. The Bank may make loans throughout the world, but it is not representative of the global community. The Bank potentially functions as a mere tool for advocating Western policies and imperialism… The states that run the Bank would still define 'evil' regimes. The odious debt doctrine would only further enslave many debtor states because lending policies would become a pretext for the legitimization or de-legitimization of a state's form of government at the hands of an international institution… The doctrine inevitably increases the power of financial institutions over the Third World countries."[122]

The way in which Mancina would prefer that the problem be dealt with is the enactment of "a treaty pertaining to international debt and sovereign insolvency issues".[123]

[118] Iid., p. 56.
[119] Mancina, p. 1242.
[120] Ea., pp. 1246ff.
[121] Mancina, pp. 1250ff. (On p. 1252, Mancina asserts that "the World Bank, even when it has cancelled debt, has not invoked the doctrine".)
[122] Ibid.
[123] Ibid. According to Gelpern, p. 407: "I suggest that countries often are able to get the same debt reduction benefit at a lower cost by going outside the doctrine and framing their decision as a financial restructuring, a composition rather than as repudiation."

III. Is there an internationally binding principle or norm on odious debts?

1. *Introduction*

The question of the existence of an internationally binding principle or norm on odious debts is extremely hard to answer. The defense of debts being "odious" was invoked by Iran in an arbitration case about debts to the United States incurred by the former Imperial government in 1948. In 1997, the Iran-U.S. Claims Tribunal ruled that the government of Iran was liable for the debts, but the Tribunal wrote that, in coming to this conclusion, it did not "take any stance in the doctrinal debate on the concept of 'odious debts' in international law."[124]

In any event, any attempt to answer the question has to be guided by a clear understanding of the sources of international law as listed in Article 38 of the Statute of the International Court of Justice, which reads:

"1. The Court, whose function is to decide in accordance with international law such disputes as are submitted to it, shall apply:

a. international conventions, whether general or particular, establishing rules expressly recognized by the contesting states;
b. international custom, as evidence of a general practice accepted as law;
c. the general principles of law recognized by civilized nations;
d. subject to the provisions of Article 59, judicial decisions and the teachings of the most highly qualified publicists of the various nations, as subsidiary means for the determination of rules of law.

2. This provision shall not prejudice the power of the Court to decide a case ex aequo et bono, if the parties agree thereto."

2. *International conventions*

Obviously, no comprehensive analysis of international conventions can be undertaken here. It will be sufficient to recall that, as was mentioned above, the Special Rapporteur Bedjaoui had proposed to include a provision on odious debts in the draft convention on state succession in respect of matters other than treaties. However, the International Law Commission finally decided not to include any such provision in the convention, with the consequence that there is no trace of the odious debts doctrine in its final text.

3. *Customary international law*

On the formation of customary international law, this is what the International Court of Justice (ICJ) stated in the North Sea Continental Shelf cases:

> *"Not only must the acts concerned amount to a settled practice, but they must also be such, or be carried out in such a way, as to be evidence of a belief that this practice is rendered obligatory by the existence of a rule of law requiring it. The need for such a belief, i.e., the existence of a subjective requirement, is implicit in the very notion of the opinio juris sive necessitatis. The States concerned must therefore feel that they are conforming to what amounts to a legal obligation. The frequency, or even habitual character of the acts is not in itself enough. There are many international acts e.g. in the field of ceremonial and protocol, which are performed almost invariably, but which are motivated only by considerations of courtesy, convenience or tradition, and not by any sense of legal duty."*[125]

In a later decision on continental shelf delimitation, the ICJ stated:

> *"Furthermore, the Court would have had proprio motu to take account of the progress made by the Conference even if the Parties had not alluded to it…for it could not ignore any provision of the draft convention if it came to the conclusion that the content of*

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[124] Case No. B36 (Mealey Publications, 1997) – quoted by Kremer and Jayachandran, p. 6, footnote 5, who comment: "In fact, the doctrinal debate is characterized by jurists taking no stance." On this case and on another one before an American municipal court (*Jackson* v. *People's Republic of China*, 550 F.Supp. 869, 872 (N.D.Ala. 1982)), see Mancina, p. 1248; Buchheit, Gulati and Thompson, pp. 18ff.

[125] *North Sea Continental Shelf Cases* (*Federal Republic of Germany* v. *Denmark*; *Federal Republic of Germany* v. *The Netherlands*), ICJ Rep. 1969, p. 44 (para. 77).

such provision is binding upon all members of the international community because it embodies or crystallizes a pre-existing or emergent rule of customary law."[126]

In yet another case regarding continental shelf questions, the Court clarified:

"It is of course axiomatic that the material of customary international law is to be looked for primarily in the actual practice and opinion juris of States, even though multilateral conventions may have an important role to play in recording and defining rules deriving from custom, or indeed in developing them."[127]

Difficult as it may be to identify the objective element (practice) and the subjective element (*opinio juris*) of international custom, in the case of odious debts it is even difficult to tell what the expression actually means.[128] As was indicated above, Bedjaoui had restricted the concept to a few categories of debts without using or even referring to Sack's work. The inherent difficulties in defining odious debts, beyond some generally accepted categories, have thus been expressed:

"There is an exception, acknowledged through customary law, from the general rule of the assumption of debts from the predecessor state – namely the so called 'dettes odieuses' or 'odious debts'. Like in any other case of special obligation categories, here, too, it is hard to define its particular contents. Whereas it is well settled that, for instance, war bonds or loans contracted with a view to combat independence movements or opposing civil war parties form the classical core contents of 'dettes odieuses', do some interpret them as 'all debts which have been contracted contrary to the interests of the population or the specific territory'."[129]

Compared to the approach discussed within the context of the International Law Commission's work on succession to debts,[130] the "Sack approach" is broader and seems to cover also regime debts. The problem is that there is already scant support in actual practice for the restricted category of "regime debts", let alone for proposals going beyond Sack's categories. In consideration of all this, it is somewhat sobering what Anna Gelpern observes:

"As it happens, no national or international tribunal has ever cited Odious Debt as grounds for invalidating a sovereign obligation. Each of the treaties and other examples of state practice cited even by the doctrine's most thorough and principled advocates appears fundamentally flawed—it lacks one or more of the doctrine's essential elements and/or is accompanied by a chorus of specific disavowals of the doctrine by indispensable parties. But even if the examples were on point, the fact that Odious Debt's most fervent proponents to this day must cite an 1898 treaty and a 1923 arbitration as their best authorities suggests that the law-making project is in trouble. Odious Debt's apparent disuse and disarray after a century of Hitler, Stalin, Mobutu, Abacha, Somoza, Marcos and Idi Amin—not to mention the socialist revolutions, capitalist restorations, and the intervening wars of liberation from colonial rule—are more than mildly puzzling. Most recently, the overthrow of Saddam Hussein revived the hopes for resurrecting the Odious Debt Doctrine. But when given the opportunity to invoke it, the new Iraqi authorities demurred: 'Iraq's need for very substantial debt relief derives from the economic realities facing a post-conflict country that has endured dec-

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126 *Continental Shelf Case* (*Tunisia* v. *Libyan Arab Jamahiriya*), ICJ Rep. 1982, p. 38 (para. 24); see also *Congo* v. *Belgium*, ICJ Rep. 2002, p. 21 (para. 58).

127 *Continental Shelf Case* (*Libyan Arab Jamahiriya* v. *Malta*), ICJ Rep. 1985, pp. 29ff. (para. 27); see also the *Nicaragua* case (*Nicaragua* v. *USA*), ICJ Rep. 1986, p. 97 (para. 183).

128 See, for example, Grashoff, *Staatensukzessions-bedingter Schuldnerwechsel*, 1995, pp. 76ff., where the author lists several categories or elements which would constitute the odiousness of a debt: war bonds, political or regime debts, main interests of the successor state, and unacceptability.

129 Reinisch and Hafner, pp. 71ff. See also Grashoff, *Staatensukzessionsbedingter Schuldnerwechsel*, 1995, p. 77.

130 Even assuming the existence of an international customary allowing the repudiation of odious debts, this would be true only with respect to those cases which were listed above under the categories of "war debts" and "subjugation (or hostile) debts". See, for instance, Stern, *La Succesion D'États*, 1996, p. 172; Buchheit, Gulati and Thompson, p. 26, footnote. 86. However, see also Hoeflich's characterization of the treatment of these types of debts, p. 65: "despairing of ever discovering a 'settled' principle of international law".

ades of financial corruption and mismanagement under the Saddam regime. Principles of public international law such as the odious debt doctrine, whatever their legal vitality, are not the reason why Iraq is seeking this relief' (taken from an interview with Adil Abdul Mahdi, minister of Finance in the Interim Governement of Iraq)."[131]

A suggested qualification to Gelpern's statement is that there is actually one decision by an international tribunal in which the "principle of odious debts" was mentioned, at least in a dissenting opinion: Judge Ameli, a member of the Iran-U.S. Tribunal, referred to this principle as one option among others to invalidate a debt.[132]

4. General principles of law

With respect to the general principles of law (itself quite a controversial source of international law), it appears to be hard to find a general principle to the effect that odious debts are void or unenforceable. Even assuming the existence of a general principle of law (in the sense in which this expression is used in Art. 38 of the Statute of the International Court of Justice) to the effect that contracts which are contradictory to good morals are void,[133] it would not follow from this premise that what various authors understand to be "odious debts" would automatically fall into this category.

5. Unilateral declarations

In the *Nuclear Tests* cases,[134] the Court indicated that unilateral acts may give rise, under certain conditions, to binding obligations. This is not the place to examine this difficult issue, also because there does not seem to be any instance in which a country may be regarded as having made an internationally legally binding declaration to renounce credits corresponding to "odious debts".

PART 3 PROPOSALS TO EXPAND THE TRADITIONAL CONCEPT OF "ODIOUS DEBTS"

I. Classifications

In discussing some proposals aimed at expanding the traditional concept of "odious debts", which one encounters in the international literature, it should be noted that many of these proposals are not advanced by lawyers, with the consequence that these proposals often ignore some basic requirements of legal precision. For example, the epithet "odious" has variously been attributed, sometimes within the same writing, to lenders, regimes, leaders and debts.[135] In the ensuing paragraphs, the proposals under such headings as "illegitimate debts" (paragraph 1), "criminal debts" (paragraph 2), "illegal debts" (paragraph 3), "ineffective debts" (paragraph 4), and "other categories" (paragraph 5), will be summarily examined. Despite the use of these different categories, it should be kept in mind, though, that there will be a considerable element of overlapping. Moreover, it is debatable whether the category of "illegitimate debts", at least in some of the proposals, does not end up encompassing all the others.[136]

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[131] Gelpern, p. 406. Anderson states in his article, on p. 408, that the "principle of odious debts" has been invoked numerous times but admits, on p. 437, that a potential declaration of Iraq's debts as odious "would be the first direct application" since 1923.

[132] See *INA Corp*. v. *Iran*, Award No. 184-161-1 (26 Nov. 1986), *Iran-U.S. Claims Tribunal Reports*, vol. 8 (1985-I), p. 403, at pp. 446-447.

[133] Grashoff, Staatensukzessionsbedingter Schuldnerwechsel, 1995, p. 241. Khalfan / King / Thomas, p. 34 seqq. examine the legal institutions of unjust enrichment , abuse of rights, and obligations arising from agency as possible principles in this context.

[134] ICJ Reports 1974, 253, at 269-270; 457, at 474-475; for a discussion of the present question see, for instance, Tomuschat, International Law: Ensuring the Survival of Mankind on the Eve of a New Century, in the privately distributed book on p. 344 seqq. (publicly available in the Collected Courses of the Hague Academy of International Law, Vol. 281 (1999); Krzystov Skubiszewski, Unilateral Acts of State, in: Bedjaoui (ed.), International Law: Achievements and Prospects, 1991, p. 221 seqq.

[135] See "Odious Lending", *New Economics Foundation* ("nef"), pp. 3 and 6. On p. 15, the author refers to "gradations of odiousness".

[136] Ibid, p. 6, where one encounters the "more general term 'illegitimate debt'." See also Kaiser and Queck, p. 8: "The doctrine of odious debt is, on the one hand, a

1. *Illegitimate debts*

An instructive example of the width and breadth of some proposals, coupled with their lack of precision, can be found in an article by Hanlon.[137] Its very title ("Defining 'Illegitimate Debt': When Creditors should be Liable for Improper Loans") clearly announces that, for this author, the concept serves the purpose of shifting liability. In Hanlon's own words:

> *"The concept of 'illegitimate debt' is important because it puts the liability for bad and imprudent lending back where it belongs, with the lender".*[138]

Numerous examples are presented which stand for such bad and imprudent lending:

> *"Campaigners have argued that the concept should be applied not only to countries where the U.S. military has imposed 'regime change' and overthrown dictators opposed to it but also to dictators supported by the United States, such as Mobutu Sese Seko in Zaire (now Congo). Campaign groups in the South have gone further and argued that a substantial part of poor-country debt is 'illegitimate'... International lenders have made improper loans that would not have been acceptable under domestic law on the assumption that the international community would enforce repayment. Lenders should be made liable for their bad lending, both on the grounds that the people of poor countries should not be forced to repay loans that the lenders should never have made and also on grounds of 'moral hazard' – that lenders will only learn to exercise the required caution and prudence if they are penalized for past negligence and if... financial markets learn that it is dangerous to make illegitimate loans".*[139]

Starting from this premise, Hanlon thus delimits what he considers to be "illegitimate debt":

> *"We will argue that a loan is 'illegitimate' if it would be against national law; is unfair, improper, or objectionable; or infringes public policy. We separate the loans themselves from the conditions attached to those loans so that a loan can be legitimate but the conditions, for example usurious interest rates, can be illegitimate. Second, we distinguish between loans and conditions that are 'unacceptable' and those that are 'inappropriate'. We consider a loan or condition to be 'unacceptable' if it is obviously improper. We consider a loan or condition to be 'inappropriate' if it would be acceptable in some circumstances but not those in which it was made".*[140]

In conformity with this understanding, the key question becomes one of legitimacy of the loan:

> *"Entirely an issue of whether a lender should have made a loan. No financial institution should have lent money to Mobutu, and it is the loans themselves that are illegitimate; they are solely the liability of the creditor and should not be repaid, independent of the Congo government and whether or not it 'deserves' debt 'relief'."*[141]

Hanlon distinguishes illegitimate debts from what the Jubilee 2000 campaign calls "unpayable debt" and from a wide category of debts which, according to some Southern NGOs, include debts resulting from failed development projects, debts

very restrictive concept when compared with the broader concept of 'illegitimate debt'".

[137] In Jochnick and Preston, pp. 109ff. See also, by the same author, the article headed "Take the hit", electronically available at www.newint.org/issue312/hit.htm.

[138] In Jochnick and Preston, p. 127. For a discussion of lenders' responsibility under public international law, see Reinisch, *State Responsibility*, pp. 116ff. (concluding that there is – if at all – merely a duty of renegotiating). See also the study prepared by the International Law Commission under the title "'Force majeure' and 'fortuitous event' as circumstances precluding wrongfulness: survey of State practice, international judicial decisions and doctrine", *YBILC* 1978, vol. II. Part 1, pp. 61ff., electronically available at http://untreaty.un.org/ilc/publications/yearbooks/Ybkvolumes(e)/ILC_1978_v2_p1_e.pdf. For a discussion of possible future developments affecting lenders liability, see Lothian, pp. 462ff.

[139] In Jochnick and Preston, pp. 109ff. In the text, there is a reference to a statement by the United States Secretary of the Treasury in April 2003: "Certainly the people of Iraq shouldn't be saddled with those debts incurred through the regime of the dictator who is now gone."

[140] Ibid., p. 110. On p. 125, the author states that "an illegitimate condition makes the entire loan illegitimate".

[141] Ibid., p. 111.

which have funded capital flight, debts which are linked to bad policy advice and bad projects, and private loans which have been converted into public debt under duress to bail out lenders.

Contrary to such a wide notion of "illegitimate debt", Hanlon suggests that "illegitimate debt" is a debt that satisfies one of the following conditions: (1) it is against the law or not sanctioned by law; (2) it is unfair, improper, or objectionable; or (3) it infringes some public policy. Noting that the expression "illegitimate debt" is almost never used in legislation or court judgments, Hanlon remarks that, nevertheless, common law systems (such as those of England and Australia) contain rules to the effect that gambling debts cannot be enforced.[142]

Further clarifying this point, Hanlon describes, under the heading of "Examples of Illegitimacy in the Courts", cases in which the concept of "odious debts", "loans to dictators" and "extortionate debts" have played a role. With respect to odious debts, he refers to the Peace Treaty between the United States and Spain regarding Cuba and to the arbitral award in the Tinoco case. He then lists the three elements of Sack's definition of "odious debt". Hanlon attributes considerable significance, for the concept of odious debts, to a statement by the British House of Commons International Development Committee in 1998, which he quotes as follows:

> *"[T]he bulk of Rwanda's external debt was incurred by the genocidal regime which preceded the current administration… Some argue that loans were used by the genocidal regime to purchase weapons and that the current administration and, ultimately, the people of Rwanda, should not have to repay these 'odious' debts… We further recommend that the [UK] government urge all bilateral creditors, in particular France, to cancel the debt incurred by the previous regime."*

However, the Committee, while referring to the concept of "odious debt", did not do so directly but indirectly, by referring to "some" who have allegedly advanced arguments on the basis of that concept. Moreover, by recommending that the government urge creditors to cancel the debts incurred by the previous regime, the Committee implicitly acknowledged that these debts would not otherwise be void or unenforceable on the basis of the odious debt doctrine.

As to "loans to dictators", Hanlon refers to the *Tinoco* case, while "extortionate debt" is described with the words of Great Britain's Consumer Credit Act of 1974, Article 138 of which provides that "a credit bargain is extortionate if it (a) requires the debtor…. [t]o make payments… which are grossly exorbitant, or (b) otherwise grossly contravenes ordinary principles of fair dealing."

Even though not entirely clear from the text, it is probably fair to assume that these categories – according to Hanlon – form part of "illegitimate debt" and therefore entail the legal consequence that the debt is invalid. This seems to be the case also of usury debts, loan laundering and "fungibility". While the case of usury debts is self-explanatory,143 the two others need some clarification. Henlon calls "loan laundering" what he defines as "illegitimate successor loan":

> *"1. If an institution replaces, rolls over, or pays off an illegitimate debt with a new loan, then the new loan is an illegitimate successor loan.*
> *2. If a bond or new loan is issued for the sole or main purpose of paying off an illegitimate debt, then this is an illegitimate successor loan and the creditor has taken the risk.*
> *3. A government guarantee of an illegitimate successor loan does not make the loan any less illegitimate. Furthermore, it strengthens the illegitimacy if international financial pressure has forced the government to accept responsibility for a private debt".*[144]

The primary example of "fungibility" is money given as a loan, "in particular to aid or loan funds for poor countries".[145] Hanlon continues:

> *"Aid or a loan can be supplied for a specific beneficial purpose – rural credit or an electricity supply line for poor people – but the aid or loan releases funds that the government*

[142] The same is true of German law and the law of numerous other civil law countries. Nevertheless, Hanlon's observation is perhaps the echo of earlier comparisons between war debts and gambling debts, in the sense that whoever supports one side in a war acts like a gambler.

[143] In Jochnick and Preston, pp. 118ff.
[144] Ibid., p. 117.
[145] Ibid. p. 117.

would have used for the rural credit or the electricity line, and those funds can be used for another purpose, such as to buy arms or to put in a foreign bank account… We therefore argue that because of fungibility, all loans to odious regimes and dictators can be classed as odious, even if the ostensible purpose was permissible... Therefore, we are forced to conclude that fungibility means that either all loans to a government are illegitimate, probably due to odiousness, or to be illegitimate, an individual loan must be clearly linked to an illegitimate purpose or conduct. Capital flight is an example of fungibility."

Hanlon then provides examples for the case "Where Lender Misbehavior Makes Loans Illegitimate".[146] Lending to oppressive regimes is described with the example of Argentina: "Argentina is an example of most of the issues related to illegitimate debt: odious debt, corrupt debt, successor loans, nationalization of debt, and policy advice."[147]

In this context, a decision of a Federal Judge, Dr. Jorge Ballesteros, dated July 13, 2000, is quoted:

"The exact co-responsibility and eventual guilt of the international financial institutions (particularly the IMF and the World Bank) must be established, as well as that of the creditors, because during the whole period under examination (1976 to 1982) many technical missions sent by the IMF visited our country… The conclusion is that the creditor banks, the IMF and the World Bank acted with imprudence themselves."

Thereafter, the nullity of "successor debts" is exemplified with loans given to South Africa after Mandela was released from prison: "Therefore, it seems likely that South Africa's current indebtedness is almost entirely successor debt. This debt is illegitimate because the current loans obviously refinanced apartheid debt, which is odious debt".[148]

Gross negligence is exemplified by the case of Zaire/Congo: "There is perhaps no clearer example of odious debt. Money was poured into Zaire when the lenders had already been told there was 'no (repeat no) prospect' of being repaid."

The example of lending to self-enriching regimes is The Philippines; the one for failed projects is Tanzania, Nigeria, and Indonesia. With respect to the latter, Hanlon quotes from a document of the United Nations Institute for Training and Research (Debt and Financial Management (Legal Aspects) Training Package):

"Developing countries rely on external expertise because they lack the technical know-how and assistance to plan infrastructure policies and to implement projects. Consequently, developing countries should not bear the burden of… bad planning and bad implementation performed by external sources… [C]omparative law studies indicate that modern civil and commercial law has broadened contractual obligations in complex business transactions beyond the strict delivery of goods… to include dissemination of professional information, exchange of motivated opinions, discovery of special risks, and instructions and consultations, especially if one party is less knowledgeable than the other and therefore must trust the other's superior skills. Neglecting these accessory obligations may be considered a breach of contract… and should be all the more applicable if the lender is an official donor with the statutory obligation to finance and assist in the execution of development projects."

Finally, Hanlon gives yet another definition of what he means by the concept of "illegitimate debt" and presents quite an exhaustive list of cases falling under this new definition. He classifies them in four groups on the basis of the distinction between loan and condition and the determination of what is unacceptable and inappropriate:

"We propose the following definition: 'Illegitimate debt' is debt that the borrower cannot be required to repay because the original loan or conditions attached to that loan infringed the law or public policy, or because they were unfair, improper, or otherwise objectionable."

To get a sense of the intentional width of this concept, the four categories deserve to be reported in full:

"1. Unacceptable loans would include loans that were odious, were given to known corrupt officials, and were for obviously

[146] Ibid., pp. 118ff.
[147] Ibid., p. 120.
[148] Ibid., p. 123.

bad projects. Examples include: Odious debts, such of the apartheid state in South Africa, and loans to dictators such as Mobutu in Zaire, Duvalier in Haiti, Suharto in Indonesia, and the military in Argentina, which were clearly not in the interest of the people of those countries. They are loans taken by the regime and not the state; loans that involve corruption and kickbacks; loans directly linked to capital flight, as happened in Argentina and Brazil in the 1990s; loans for manifestly bad projects, such as the Bataan nuclear power station in the Philippines, and for environmentally damaging projects, especially ones such as dam projects and Indonesian "transmigration," which would not be funded now; successor loans that are explicitly renewals, exchanges, or rollovers of loans that are independently unacceptable; private loans taken over by the state, nationalized, or guaranteed, and where the lender should have accepted the cost of making a bad loan to a private enterprise.

2. *Unacceptable conditions would include usurious interest rates and policy demands that violate national laws. Examples include: Usury, including the very high interest rates of the 1980s imposed on floating-rate loans. In assessing usury, interest rates can be calculated in the currency in which the loan is denominated or in the prices of the main export commodities; conditions that are illegal under national law, such as the requirement for repayment of Brazilian debt before the audit required by the constitution; conditions that violate public policy, such as cuts in health or education spending or the imposition of poverty wages on civil servants, especially where later statements by the international financial institutions admitted that such conditions were incorrect or unduly harsh; conditions that ultimately increase the cost of the debt, such as dollar convertibility in Argentina, even if they are accepted by the elected government; requiring the government to nationalize or guarantee unacceptable or inappropriate loans made to the private sector.*

3. *Inappropriate loans are consumption loans and loans given where grants would have been more correct. Examples include: Consumption loans made to poor countries that have no chance of repaying without imposing unacceptable privation of their people. These are loans that should have been grants and, as a result of policy changes in the 1990s, often are now grants; loans to formally elected governments that had become dictatorial and were no longer using the funds in the interest of the people, such as Robert Mugabe in Zimbabwe and Alberto Fujimori in Peru.*

4. *Inappropriate conditions are linked to unsuitable policies. Examples include: Restrictions that are inappropriate to the circumstances, such as limits on post-disaster reconstructions."*

Finally, in what is essentially an appendix to his article, Hanlon briefly touches upon three phenomena from which claims of the South against the North might emerge and which would allow some sort of set-off.[149] These three phenomena are (i) odious debts (for which the examples of the debts contracted by Mobutu and the South African apartheid government are given), (ii) capital flight, and (iii) the historical guilt of slave trade, colonialism, damage resulting from recent Cold War proxy wars, and environmental depredations.[150]

From all this, a lawyer is led to conclude that the main thrust of Hanlon's article is to impose a greater measure of liability on creditors. This, after all, is not a unique feature of Hanlon's article but a recurring theme in NGOs' writings. Paradigmatically, for instance, this is what Patricia Adams writes:

> *"When lenders from France, Germany, the United States, Canada, or anywhere else realize that repayment from an Iraq under Saddam, a Syria, a North Korea, a Cuba, depends on the regime staying in power long enough to see the money repaid, they will think twice about making the loans to finance the armies and foreign bank accounts of dictators, and demand higher premium if they do. An odious*

[149] Ibid. pp. 127ff.

[150] The author of the nef-publication has apparently these categories of debt in mind when he refers to what he calls "moral debts"; he classifies into the subcategories of "environmental debts" and "historical debts" (pp. 7ff.). See also Jochnick, pp. 137ff.

debt legal regime would help the United States cut off many sources of funding terrorist states without having to lobby other creditor governments. And that would be profoundly good, not only for Iraqis, but also for world peace and future generations."[151]

In the same direction, Hoeflich writes:

"(C)onservative lenders should examine closely their sovereign debtors and, whenever possible, avoid loans to states which are or could become unstable."[152]

In a somewhat more traditional vein, but nevertheless with the same thrust, Frankenberg and Knieper conclude:

"In the end, therefore, the recognition of 'hostile debts' and 'war debts' as 'odious' results in a distribution of risk between creditors and debtors; whoever makes financial means available for military operations, or other purposes which clearly contradict national interests shall not, under international law, be exempted from the risks of such an investment."[153]

2. *Criminal debts*

This expression is sometimes applied to a wide category of debts which are alleged to be void, and therefore need not be repaid, because the debt was corruptly diverted from its intended use.[154] The recommendations to the Consultative Group of Indonesia (CGI) by INFID in Jakarta on January 21, 2000, are paradigmatic:

"We call on the CGI to support an independent assessment/audit – by the establishment of an international commission – to determine the extent to which foreign loans have been misappropriated through corruption. The portion of the debt that is found to be odious should be cancelled."[155]

It is in particular Winters who has elaborated this category of invalid debts and who sets it in direct contrast to the common understanding of "odious debts":

"A third option [apart from asking for charity or referring to the 'odiousness' of debts] is the right to demand debt reduction based on the illegal behavior of creditors, particularly the multilateral development banks."[156]

He defines this category in this way:

"'Criminal debt' refers to a repayment burden on a society that is unjust either because sovereign loans were made to a country and then were stolen by officials and business cronies, or because debt was incurred to rescue an economy severely damaged by criminal behavior of powerful actors… Criminal debt is public debt on the shoulders of a society that is directly linked to illegal business activities or outright appropriation of external loan funds by individuals for their private enrichment. The public never receives any benefit from these resources."[157]

Winters then describes what is, in his view, the World Bank's role with respect to "criminal debts":

"But only part of all criminal debt originates wholly from within the national context. Another part originates from international sources… It is here that the World Bank enters the discussion. Just as there is a power relationship between a government and its people, there is also one between the World Bank and governments that borrow. Debt accumulated and stolen domestically is a purely domestic concern. But what of debt accumulated through an institution like the World Bank and systematically stolen by client governments?… The share of criminal debts that originates from sources like the World Bank merits separate treatment because the Bank not only has leverage to prevent (or at least greatly diminish) the accumulation of foreign

[151] Adams, 2004, p. 17; Ea., 1991, Chapter 17. See also Jochnick, pp. 134ff. ("Creditor countries and banks share much of the blame for the overindebtedness of countries, having played a critical role in both the international economy and local processes that created the crisis"), and Stiglitz, 2006, pp. 165ff.

[152] Hoeflich, p. 68. See furthermore Hahn in *Encyclopedia of Public International Law*, under "Foreign Debts", with respect particularly to development loans.

[153] Frankenberg and Knieper, p. 34.

[154] For a discussion of the existing patterns of fighting corruption, see Posadas, "Combating Corruption Under International Law", 10 *Duke J. Comp. & Int'l L.* 345 (2000).

[155] The recommendations are electronically available at www.infid.be/statementcgi210100.html.

[156] Winters, p. 5.

[157] Id., pp. 7ff.

> *criminal debt from its own lending, but also the strong legal mandate in its constitution to do so. If it can be shown that the Bank was aware that a share of its resources was systematically being siphoned off as criminal debt, and if it can further be shown that the Bank failed to fulfill its legal mandate to prevent the loss of its loan funds, then according to international law the Bank shares culpability and also must bear some of the fiscal burden for funds transferred and lost."*[158]

The consequences resulting from these considerations are summarized elsewhere by Winters:

> *"They [i.e. the NGOs] are simply pointing out that there is something very wrong about demanding repayment for funds the people never received. The money was delivered from the World Bank and other MDBs, but it was intercepted along the way and 'privatized' illegally. It is easy to demonstrate that officials in the MDBs were aware of these practices for decades and, in violation of legal obligations under the Articles of Agreement, did nothing at all to stop the corruption. On the contrary, in almost every case, flows of funds from the MDBs increased as pressures to lend mounted."*[159]

3. *Illegal debts*

This category embraces all debts resulting from contracts which have been entered into without giving due respect to certain legal requirements. Sometimes it is added that these requirements have to be those of the borrowing country,[160] such as the requirement that a loan be authorized by parliament or the executive.

Under general principles of contract law, these contracts are null and void. For example, from the description of the facts given by the sole arbitrator Taft, it may be inferred that the agreements that were in dispute in the Tinoco case would have fallen under this category.

In this respect, Stephen Mandel (the author of the nef-publication cited above) has observed that creditors have an obligation to ensure that the applicable procedures are followed, failing which the contract would be null and void.

4. *Ineffective debts*

The expression "ineffective debts" is not technical, but describes a category of debts having certain common elements. These are debts resulting from loans contracted with a particular purpose in mind (as evidenced by the provisions of the contract) which, however, has never been served; instead, the funds have been used for other purposes.

While writing about odious debts and citing extensively from Sack's work, Adams extends Sack's original concept to one that would encompass what may be called "ineffective debts". She sees them as belonging to a sub-category of "odious debts":

> *"Even those loans extended for purposes that are broadly governmental – to an electric utility or for balance of payment's support – are subject to challenge. When government officials treat state investments for political favors, graft, and capital flight, and are prepared to turn a blind eye to the technical and economic viability of such projects, foreign bank loans become grease in wheels that turn against state interests. Foreign bankers who fail to recognize or to act upon pricing irregularities, slipshod plans, and suspect contracts soon become parties to hostile acts against a populace."*[161]

Using a different name ("debts incurred by fraud"), but referring essentially to those very cases classified by Adams as "ineffective", Mahmud considers these debts to be illegitimate and therefore unenforceable:

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[158] Id., p. 9.

[159] Winters, "Combating Corruption in the Multilateral Development Banks, Senate Hearing before the Committee on Foreign Relations", May 13, 2004, p. 7, electronically available at: www.senate.gov/~foreign/testimony/2004/WintersTestimony040513.pdf.

[160] See, for example, "Odious Lending" (nef-publication), p. 6. From a legal perspective, it should be recalled that these contracts are often concluded under the law of a third country (e.g., the law of New York), with the consequence that the law of this third country too becomes relevant.

[161] Adams, 1991, Chapter 17.

"Such 'debts' are not payable because they are incurred for fraudulent reasons, or at least for reasons of doubtful nature. For example, a drug dealer cannot take to court his correspondent for failing to keep to terms of an illegal contract. There are cases of debts incurred, for example, for building a road or a power project which either did not materialise at all, or which fell far short of required specifications."[162]

5. *Other categories*

It has already been mentioned that, regrettably, there is no unanimity on the typology of debts, with respect to neither terminology nor contents. The expression "other categories" is therefore used here to capture a wide variety of debts.

(a) The very category of "odious debts", as defined by Sack, lends itself to divergent considerations. As Buchheit and others have written, the very choice of adjectives by Sack has captured the imagination of later writers:

"Alexander Sack did, however, contribute two highly emotive adjectives to the debate: 'despotic' and 'odious'. Had he been less colorful in his choice of adjectives, we believe that this topic would have attracted less public attention than it has in this century."[163]

However, referring to Sack's work does not necessarily imply that one accepts also Sack's criteria for classifying odious debts; and, even when accepting the same criteria, these are often given a completely different meaning from the one originally intended by Sack.

(1) The author of the nef-publication, for example, writes under the heading of "typology of illegitimate debt" and "odious debts":

"Then there is the concept of odious debt… though… it should more accurately [be] defined as odious lending… In essence it is where those taking out the loan do not have the right to impose the obligation of servicing the debt on the population of the country in whose name they ostensibly take out the loan, either because they have no proper power, or because they are seriously corrupt. This is not quite synonymous with dictator debt, since democratically elected leaders could equally be blatantly corrupt, but it includes all dictator debt."[164]

In the same publication, "odious debts" are defined as those where the relevant contract is formally impeccable but still illegitimate because of the absence of consent by, or benefit to, the debtor, with the creditor's knowledge.

The requirements that Sack had treated as cumulative seem to be regarded here as potentially alternative to one another. The author further explains:

"We therefore conclude that for a debt to be odious, it is sufficient to show that those contracting the debt did not have the right to impose the burden of repayment on their successors (because of the absence of legitimacy or gross corruption) and that the creditor was in the position to know that this was the case. Certainly the burden of proof should lie with the creditor (to prove benefit) in the case of an odious regime. Furthermore, it could be argued that the absence of proper consent will exist with any illegitimate regime, which should render the contract a contract with the regime and not with the state… We argue that an undemocratic and illegitimate government has no right to impose costs on the country's population; and that a democratic successor government should not be worse off, in terms of its external indebtedness, than it would have been had no odious debt been incurred."[165]

In dealing with odious debt, four principles are articulated, as follows:

"1. Unrepresentative and undemocratic governments do not have the right to impose external debts on subsequent representative and democratic governments. 2. Creditors act irresponsibly in lending to such governments, thereby promoting their continuation in office, and therefore forfeiting the right either to profit from such loans or to recover the capital so provided. 3. Representative governments should be no worse off, in terms of external indebtedness as a result of such odious debts having been incurred by previous governments than they would have been had such

[162] Mahmud, p. 3 (printed version).
[163] Buchheit, Gulati and Thompson, p. 18.
[164] "Odious Lending", nef-publication, p. 6.
[165] Ibid. pp. 10ff.

debts not been incurred. 4. Arbitration over the extent and treatment of odious debts should be in the hands of an independent international body, which is neither a creditor in its own right, nor controlled by creditors, and which conducts its activities in a transparent fashion."[166]

From these lines and the ones that follow thereafter, it becomes evident that the author intends to restrict the application of the concept of odious debts to the context of a succession of state.

(2) Some authors, on the other hand, take the concept of "odious debts" as a given, without even trying to define it. A good example is provided by several writings of Kremer, Jayachandran and others.167 This is their understanding of "odious debts":

"This paper… examines the case for eliminating illegitimate or odious debt. The argument is that, just as individuals do not have to repay if others illegitimately borrow in their name, the population of a country is not responsible for loans taken out by an illegitimate government that did not have the right to borrow 'in its name'. There is also an analogous principle in corporate law that a corporation is not liable to a third party for a contract that the CEO (or other agent) entered without the authority to bind the corporation. The view that some uses of power by government officials might be illegitimate or criminal is in line with a trend in international law toward the individualization of sovereign activity, examples of which are the prosecution of Slobodan Milosevic for war crimes and the use of the Alien Torts Claims Act for survivors of torture and other human rights abuses abroad to sue the perpetrators in U.S. courts."[168]

They then add that a sovereign debt is odious if (1) its purpose does not benefit the people, and (2) if it is incurred without the consent of the people.[169] The same authors, however, acknowledge that "others hold" that a third requirement is necessary to make a debt non-transferable – namely that "creditors were aware *in advance* that (1) and (2) held".[170]

The main objective of these authors is to show the need for the creation of an institution[171] that would assess in advance whether certain governments are "odious" or "illegitimate". Potential lenders would therefore be ex ante put in the position of calculating the risk they are facing when entering into loan agreements with such "odious" or "illegitimate"governments.[172] These authors propose to utilize the concept of "odious debts" as "loan sanctions".[173] They discuss in detail various scenarios in which governments, whether democratic or not, behave "odiously" (a particularly important case is that of legitimate governments borrowing to finance corrupt or economically disastrous policies)[174] or support an investment despite its being unproductive.[175]

Stiglitz points in the same direction when, in his paper on "odious rulers, odious debts", he is more concerned with stressing the need to establish an international bankruptcy court than with defining the necessary elements for a debt to be classified as "odious":

"We need an international 'bankruptcy' court, with no vested national interest, to deal with debt restructuring and relief, and to ensure a fair sharing of the burdens this would create. The United Nations could devise a set of principles – a rule of law – that would guide the court as it assessed the validity of contracts made with, and debts incurred by, outlaw regimes. Loans to build schools might be permitted, and the debt obligation, accordingly, would not be treated as odious; loans to buy arms might not be permitted."[176]

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166 Ibid., p. 21.
167 See Kremer and Jayachandran, 2002; Jayachandran and Kremer, 2006; and Jayachandran, Kremer and Shafter, 2006. See also Mahmud, p. 2 (in the printed version).
168 See Kremer and Jayachandran, pp. 1ff.
169 Ibid., p. 6. See also Jayachandran, Kremer and Shafter, p. 2. (These authors criticize the "classical model" of odious debt and contrast it with what they call an "economic model of odious debt".)
170 Kremer and Jayachandran, p. 6, referring to Sack and O'Connell.
171 For criticism of this approach, see Bonilla, pp. 20ff.
172 Jayachandran, Kremer and Shafter, pp. 6ff. Gelpern too sees the only future of the "odious debts doctrine" in exercising an *ex ante* effect on lenders and borrowers (pp. 410ff.).
173 In particular, Jayachandran and Kremer, 2006, pp. 82ff.
174 Kremer and Jayachandran, p. 4.
175 Ibid., p. 27, footnote 23.
176 Stiglitz, 2003, p. 4 (in the printout).

(3) In their paper headed "Odious Debts – Odious Creditors?", Kaiser and Queck articulate a proposal to free Iraq of its debts by referring to Sack's writings. This is how they summarize the key elements of Sack's doctrine:

"(a) The debt is contracted without the consent of the population affected: It can normally be assumed that this condition is given when a loan is granted to a regime which has not been legitimized by democratic or constitutional means…The condition may be given if a formally legitimate government makes use of an illegitimate procedure to acquire a loan. An example would be borrowing by a government without the constitutionally stipulated approval of a supervisory parliamentary body.

(b) The credit did not benefit the population concerned: While there are fairly clear formal rules governing the first condition, the second condition allows for far greater scope for interpretation due to the vague nature of the term 'benefit'… Loans not 'odious' in the sense of this condition include credits which have been granted to a country and, despite dictatorial rule, benefited e.g. private companies and subsequently been used to bring about recognizable benefits.

(c) At the time the loan was granted the creditors were aware of the illegitimate status of their partner as well as of the fact that the debt incurred would not be used to the benefit of the population of the recipient country… Playing naïve won't do either".[177]

(4) Some ideas in a somewhat different direction have been put forward by Frankenberg and Knieper. Moving from certain premises to the effect that sovereignty is today "a principle of intervention in the name of which an underprivileged State may claim genuine equality, meaning equal opportunities in the domain of development",[178] they then conclude:

"An obligation of all States… can be drawn from the projected aims of the U.N. and its organizations, to make every effort within their powers which are apt to (1) narrow the 'gap in wealth' between the industrially developed and the underdeveloped societies, (2) secure the provision of foodstuffs, and (3) develop and expand production structures which will put especially the LLDC in a position to participate in international trade… Consequently, also debts which are inimical to development have to be regarded as odious."[179]

(b) A further category is what the nef-publication calls "onerous debts".180 The author describes them thus:

"In the UK, under the Consumer Credit Act 1974 (Section 138) debts are recognised as being unenforceable if their terms are unreasonable. This could be applicable to some sovereign debt, especially in cases where the borrower could be considered to have had no choice in their financial circumstances but to accept the terms of the loan, a situation specifically referred to by the Act."

(c) "Unsustainable debts", on the other hand, present these features:

"Where a debt may be legal and used for the benefit of the population and in isolation its terms are not overly onerous, it may nevertheless be unpayable because of the overall level of indebtedness of the country relative to its debt-servicing capacity. The concept of debt sustainability is at present defined very narrowly by the creditors and has focused almost entirely on a country's ability to pay in terms of its export earnings. National governments, however, have an obligation towards their citizens to provide their basic needs for clean water, health and education and at least not to frustrate their citizen's attempts to meet their needs for food, clothing and shelter. The freedom of the population to pursue the meeting of these needs is a fundamental human right".[181]

[177] Kaiser and Queck, p. 8. (Needless to add that Sack had never indicated that the doctrine of odious debts would also be meant to foster democracy). On pp. 16ff., the authors apply these general categories to the specific case of the Iraqi debt.

[178] Frankenberg and Knieper, p. 37 (quoting from Flory, *Droit international du développement*, 1977, pp. 46ff.).

[179] Frankenberg and Knieper, p. 38. On the following page, the authors add that, in contrast to the traditional understanding, private creditors as well "must reckon with a successor government raising the objection that this… commitment… was an odious debt".

[180] Nef-publication, p. 7. (In the same publication, the author writes that a debt may be illegitimate because of other unreasonable aspects, such as "real choice on the part of the debtor".)

[181] Ibid. (The reference to basic needs may have to do with an intervention by the South African representative at the League of Nations in 1930. See Rosenne,

(d) "Dubious debts" are described by Mahmud as follows:

"The third world's debts in different form originate in shady conditions. Most of the debt is official… In Asia and Latin America, much of the debt is commercial".[182]

(e) The same author, Mahmud, lists some more categories, one of them being "honorific debts", which are

"the financial obligations incurred in fulfillment of UN resolutions. Such debts are owed by the international community to the lenders and not by the regime that submitted to UN resolutions. Zambia incurred millions of dollars to follow the UN resolutions on Rhodesia, Mozambique and South Africa for over two decades. In all fairness and justice, why should the people of Zambia be responsible for meeting those expenses and pay as its 'debts'. In the name of justice and equity, Zambia should claim compensation from the UN for loss of life and damage to its economy in pursuing UN resolutions".[183]

(f) Further categories listed in Mahmud's article are, for instance, "debts due to experts' fees", "debts due to accumulation of interest", "debts due to foreign exchange volatility". There is also a category relating to the Bretton Wood Institutions:

"Last but not least, there are debts incurred by the developing countries because their development policies were misguided by IMF, World Bank and lending countries could not fulfill development targets. Many IMF or World Bank designed strategies of 'development' failed, exacerbating the debt burden… Hence, the debts owed by countries as a result of the failure of the Bretton Wood Institutions' strategies of 'development' are both illegitimate and unpayable."[184]

League of Nations, Conference for the Codification of International Law (1930), vol. II, 1975, pp. 459ff.)

182 Mahmud, p. 2 (in the printed version).

183 Ibid., under the heading "honorific debts".

184 Ibid., p. 3.

II. Legal assessment

It clearly emerges, from the foregoing analysis, that terminological precision is not a hallmark of the literature on odious debts. Therefore, it is futile to discuss whether the concept of "odious debt" is the all-encompassing one, or instead "illegitimate debt" may be preferable as the generic expression. Either expression is, in essence, short-hand for a wide category of debts regarding which "something went wrong". Despite this less than encouraging conclusion, two questions need to be answered: (1) are there differences between the traditional notion of "odious debt" and the various proposals to expand the concept; and (2) if there are differences, what is the legal basis of this expanded concept?

1. Differences from the traditional notion

The recent writings from which several quotations have been reproduced above show a tendency to depart from the "traditional approach". In particular, there is a shift from a loan-by-loan test to determine whether a debt is odious to a general and all-encompassing condemnation of "odious regimes", the debts of which would invariably be odious. Instead of applying the (perhaps unsatisfactory but still) specific criteria proposed by Sack, Bedjaoui and others, the authors of these more recent articles seem to favor a "one-criterion approach": if a regime is odious, all the debts it has contracted are odious, irrespective of their actual use.[185] The regime's odiousness "is contagious", so to speak, for the lender, the debt, and the surrounding circumstances.

The consequence of this approach is that more questions are raised than answers given. Buchheit and his co-authors list some of these questions:

"Odiousness – whether of regimes, individuals or cooked green vegetables – is a subjective concept. But in this context, it dangerously invites ethnocentrism. Is a democracy a necessary condition for avoiding the label odious? Is it a sufficient condition? Is universal suffrage a necessary predicate? Equal rights for women? Is a regime odious if it misprizes environmental issues or civil rights? And so forth and endlessly on… Can a regime

185 See Buchheit, Gulati and Thompson, pp. 21ff.

> *be odious one day and honorable the next?... Finally, who is to make the judgement? The lender? Obviously not. Were this the test, the municipality of Rome would still be paying off Caligula's gambling debts. The sovereign debtor?"*[186]

Even though many writers are ready to follow-up on Sack's idea of an international tribunal, not all agree. As difficult as the decision about the interest or consent of the population may be, it is a purely political question whether a particular government is "odious" or not. What an international tribunal could achieve, what its composition should be, are questions the answers to which present even greater challenges today than in Sack's time.

2. Is there a legal basis for an expanded concept?

A comprehensive answer to this question is impossible as long as there is (1) no established doctrine of "odious debts" and – even more importantly – (2) no specific court or tribunal with the jurisdiction to decide claims brought against odious debts.[187] Under these circumstances, the scenario discussed by Buchheit and his co-authors is a pragmatic and reasonable starting point that leads to searching a solution in national law. However, as the issue is a global one, a worldwide uniform concept – whether in its original or in its expanded version – appears to be preferable to ensure consistent outcomes when deciding similar cases in different jurisdictions. However, as long as there is no truly convincing evidence of an internationally legally binding norm regarding the traditional notion of "odious debts", there is a fortiori no legal basis for any expansion of the concept.

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186 Ibid., pp. 27ff. On these questions, see also Paulus, pp. 93ff.

187 For a brief discussion of possible options on which authority may be called to decide on a claim that a debt is odious, see Paulus, pp. 101ff. For an overview of the existing alternatives, see Khalfan, King and Thomas, pp. 57ff.; Marcelli, *Il debito estero dei paesi in via di sviluppo nel diritto internazionale*, 2004, pp. 21ff.

Appendix: Annotated Bibliography

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Are lenders serious about the 2015 debt crisis?

Gail Hurley
EURODAD

With respect to developing country debt, the question which currently dominates many policymakers' minds is how to avoid another debt crisis five or ten years from now. Following pledges of $55 billion more in multilateral debt cancellation for the Heavily Indebted Poor Countries (HIPCs) in 2005, many lender governments have tended to portray debt cancellation as "done" and have attempted to move the debate swiftly on to ways to avoid the build-up of new unsustainable debt.

Logically, this should prompt a reflection – by lenders and borrowers – on why countries became so dramatically over-indebted in the first place. How and why did countries accumulate such large amounts of unpayable debt? Answering this question will help the international community develop appropriate tools to avoid the 2015 or 2020 debt crisis.

A vast literature already exists which points to some of the principal causes of the current developing country debt crisis. This has pointed to a range of contributory factors which include the collapse of commodity prices, the unilateral rise in interest rates and appreciation of the US$ which tightened many governments' fiscal positions and balance of payments and forced them to refinance maturing loans with fresh loans. Much literature has also emphasised the role of western banks which ignored signals of an imminent debt crisis and worsened the debt portfolio of many debtor countries by refinancing maturing loans with loans of shorter maturities. And although the role of "obsession lending" (lending which aimed to offload surplus petro-dollars deposited in western banks by oil exporter countries) has been highlighted by many writers on the subject, the role of odious and illegitimate debt as another key contributory factor has to-date been remarkably under-emphasised.

For a debt to be classified 'odious', it must fulfil three conditions simultaneously, namely: a) absence of benefit (for the population of the debtor nation); b) absence of consent (of the citizens of the borrower nation); and c) creditor awareness of the nefarious use of funds. This type of loan is commonly attributed to the cold war period when creditor governments could usefully use promises of new finance to secure crucial political alliances. Illegitimate debt may be defined in looser terms. The term 'illegitimate debt' refers to a category of debts, which for a variety of reasons many citizens in the borrower nation believe should not be repaid by their governments. This may be because the funds were extended to non-viable projects (and lenders should have been aware of this at the time the loan transaction took place), goods or services provided by lenders as part of the loan were sub-standard, mis-sold and/or charged at inflated prices, the economic and financial terms and conditions of the loan were unfair (e.g. interest rates and penalty charges), or loans caused significant social or environmental damage.[188]

Several researchers have attempted to place a dollar value on the amounts of developing country debt which allegedly fulfil the criteria of odiousness or illegitimacy. For example Hanlon (2002) attributes $495 billion to 23 dictators.[189] Mandel (2006) argues that thirteen countries have a total $726 billion in odious debt.[190]

The numbers, although fascinating, are probably not that important. They also depend of course on the definition of 'odious' or 'illegitimate' debt employed. The key argument is essentially that odious and illegitimate debts are a fundamental cause of the current developing country debt crisis and must be addressed by the international community.

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[188] See Hurley, G EURODAD, World Bank Paper on Odious Debt: Dismissive and Limited, 2008: http://www.eurodad.org/debt/report.aspx?id=114&item=02172

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[190] See Mandel, S, Odious lending: debt relief as if morals mattered, 2006, p. 17. These countries are: Indonesia, Argentina, Nigeria, Philippines, Pakistan, Peru, Sudan, South Africa, Democratic Republic of Congo, Nicaragua, Ghana, Malawi and Haiti. See: http://www.neweconomics.org/gen/uploads/v3gdvw45bflbyn55gy1fwr4514092006174700.pdf

If we apply this logic to current debates over ways to avoid the 2015 or 2020 debt crisis, it necessarily follows that both lenders and borrowers must look critically at their respective behaviours in the past in order to learn the lessons of the past and ensure the same mistakes are not repeated in the future.

Yet there is a strange disconnect currently at play. On the one hand, we see many traditional lenders voicing (arguably very valid) concerns about the rapid reaccumulation of debt by many low-income countries. In particular, we are informed that the activities of 'new' lenders such as China, India, Venezuela, Brazil, South Africa and others warrants special attention because these creditors could contribute to new rounds of unsustainable and irresponsible debt in poor countries.

On the other, most lenders seem to have entirely divorced the discussion over new irresponsible debt from the discussion over past irresponsible debt. The two are seen as entirely unrelated issues. It is not seen as even remotely odd to be preaching 'responsible lending' in the future while wilfully ignoring the errors of the past.

In October 2006, Norway became the first government to cancel $80 million in debt owed by five countries admitting "shared responsibility" for the debt.[191] The government admitted that the loans – for the export of ships and other maritime goods – were driven by domestic political pressures to secure jobs in the ship-building industry rather than any objective assessment of the development needs of the recipient nations. The loans represented a "development policy failure" reported the government and these mistakes should never be repeated.

If there is a general agreement that mistakes of the past do exist and that lenders and borrowers share responsibility for them, then it can be argued that there is something tangible in the concept of illegitimate debt. As analysts and policy-makers move forward on this important issue, two essential goals need to be met. Firstly, we have a responsibility to develop and provide an environment in which illegitimate debt claims can be practically distinguished from legitimate debt claims, and secondly to provide active deterrence from the re-accumulation of illegitimate debt in the future.

Current procedures for the management of sovereign debt are unfit for these purposes. With the exception of a few countries which have been classified as Heavily Indebted Poor Countries, no formal process and only the most general guidance has been offered to sovereign borrowers and their creditors as to how to resolve debt difficulties. This has led to a haphazard approach.

The Paris Club is the principle forum for renegotiation of bilateral debt claims but creditors are at the same time judge and jury and the forum has been open to allegations of political interference. For example in 2004, Iraq secured an 80% reduction in its bilateral debt obligations by the Paris Club. Iraq is defined as a middle-income country by the World Bank. This represented a write-down of over $30billion in bilateral debt. At the same time however, Kenya, a much poorer low-income nation, has only ever managed to secure three separate rescheduling agreements at the Paris Club.[192]

With respect to commercial debt, the aggressive stance taken by the Argentine government in 2001 and 2002 in the renegotiation of the country's sovereign bonds led to charges by creditors that they had been unfairly treated. This experience pointed to clear deficiencies within the international debt architecture over how to deal with debt difficulties predictably, efficiently and equitably.

Looking ahead, the World Bank and IMF's new debt sustainability framework had been presented as the supposed 'magic bullet' solution to avoid new rounds of unsustainable debt.[193] The framework has attracted praise from the G8, Paris Club, UN, OECD and other important

[191] The five countries were Ecuador, Egypt, Jamaica, Peru and Sierra Leone. For further details, see Royal Norwegian Ministry of Foreign Affairs, Cancellation of debts incurred as a result of the Norwegian Ship Export Campaign (1976-80): http://www.regjeringen.no/en/dep/ud/Documents/Reports-programmes-of-action-and-plans/Reports/2006/Cancellation-of-debts-incurred-as-a-result-of-the-Norwegian-Ship-Export-Campaign-1976-80.html?id=420457

[192] See Paris Club: http://www.clubdeparis.org/

[193] For more information on the World Bank and IMF debt sustainability framework for low-income countries, see: http://www.worldbank.org/debt

international forums.[194] But this framework analyses simply the quantities of new debt taken-on by low-income countries in order to assess countries' future repayment capacities. On the question of the quality of this finance, the framework is silent. Given that one of the root causes of the current debt crisis is unquestionably poor quality finance, often extended for geopolitical strategic purposes, poorly invested by the borrower (or not invested at all), this framework would seem ill-equipped to deal with these challenges.

Given the realities of deficient international debt management procedures, what are the possible outcomes? First, a government could take unilateral action to either repudiate alleged illegitimate debt or a creditor could decide to unilaterally cancel illegitimate debt. However unilateral action is by nature unpredictable. It can be unfair to one party and is piecemeal in that it cannot tackle the issue comprehensively. Moreover, debtor governments may be reluctant to resort to unilateral action given fears that it may affect their access to new finance of different kinds. A second possibility is the development of an international framework to impartially assess and deal with illegitimate debt claims. This could deal more fairly and equitably with illegitimate debt concerns.

The second proposal is clearly the preferred option. Only where lenders and borrowers can be assured that repayment difficulties and disputes will be dealt with by a fair and transparent arbitration type procedure will there be sufficient incentive to modify behaviour. The key features of international arbitration would include a neutral decision-making body to arbitrate and decide which debts need to be declared null and void, and which need to be repaid; the rights of both debtor and creditor to be heard by arbitrators; protection of the human, social and economic rights of the citizens of the debtor nation; the institution of automatic stay; the right to appeal and transparency of process and decisions. [195]

At the same time, a fair and transparent arbitration type procedure must be accompanied by clear internationally recognised legal standards for responsible lending and borrowing. The key components of a responsible, legitimate loan – and the criteria that lenders and borrowers must fulfil during the loan transaction process – are outlined in Eurodad's Charter on Responsible Lending.[196] These include provisions which ensure the terms and conditions of the loan are fair to both parties, provisions which ensure transparency and public consent, protection of human rights and the environment, measures to curb corruption and inflated costs and clear processes where there are concerns raised by either lender or borrower.

So how do we avoid the 2015 debt crisis? A set of clear and equitable ex-ante and ex-post rules of the road are the only way to enforce and reward responsible lending and borrowing behaviour. It is wishful thinking indeed to hope that creditors will voluntarily and of their own free will sign-up to a loose coordination framework which restricts the volume of finance they can grant to certain low-income countries when creditors' claims will be considered universally valid and collectible in any court of law, no matter what the purpose or terms and conditions of the funds. If current lenders efforts on responsible lending are to be seen as credible, they must be seen to put their own houses in order and to initiate and support international dialogue on how to resolve the issue of odious and illegitimate debt. In parallel, lenders could submit certain of their own credits which they know have been problematic to independent audit in order to assess their potential (il)legitimacy. These actions would send a clear signal to the international community that lenders are indeed serious about avoiding the 2015 debt crisis.

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[194] See for example, "OECD countries agree sustainable lending principles for official export credits", January 2008: http://www.oecd.org

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Odious debts: a lesson for a better management, transparency and auditing of public debt

Arturo González de Aragón, cpa
Auditor General of Mexico

Public debt is deeply linked to countries' development, governmental performance as a whole, growth of financial institutions and opening to international markets.

In the last decades, debt has been related to instability, devaluation, capital flights, speculation and international crisis infection phenomena. Besides its fiscal, financial and economical function, debt has direct implications in the society's relationships, and is nowadays increasingly present within democratic nations.

Public debt –specially the external one— is unquestionably a crucial concern for the correct functioning of democracies within countries, given its deep implications on distributive issues and economical stability.

From a universal point of view, the management, problematic and nullity of public debt are relatively contemporary issues, mainly subject to analysis by its ruling body: International Law. A debt act legally exercised by a certain government, produces consequences which should be assumed by subsequent governments. According to this rule, the State is responsibly obliged by the legal acts agreed by previous governments.

According to International Law, there is a Debt Transference Principle by means of which a legal government act should be recognized, regardless of its origin (not considering if this act was signed by a dictatorship or by a democratic government). These acts will always be considered as acts of the State, executed by those organisms acting on the State's behalf. According to this principle, as well as to the Continuity of the State principle (a correlative principle to the permanent existence of the entity of the Generally Accepted Accounting Standards), debts from the previous government should be recognized by the succeeding one.

Nevertheless, another perspective based on the transnational experience holds that contracted public debts can and should be valued by the succeeding government, or should be evaluated during the corresponding succeeding processes. This way, debts acquired by an usurping government or contracted to serve illicit purposes, can be disclaimed by the government taking power and, therefore, remain not obliged to the corresponding reimbursement.

International legal practice establishes that all acts by which an illegitimate government contracted obligations on behalf of the State, can be considered nullified acts. In this case, debt contracted by this regime would not be considered obligatory for a nation and would consequently disappear with the fall of such regime.

These same considerations apply for creditors. In 1847, the Court of Paris issued a sentence that leaves no room for questioning. Firstly, it establishes that all creditors grant loans to usurping governments at their own risk and under their full responsibility. In order to claim payments, creditors must prove that debts were contracted by a legitimate government and for a legal purpose, at all times abiding the internal order of the State. In second place, the sentence establishes that it can be assumed that creditors granting loans to these kind of governments act in a dolus and fraudulent manner, and can therefore be subject even to criminal charges.

The international legal doctrine that supports the argumentation regarding irregular debt contraction was developed by Alexander Nahum Sack in 1927, a fourth of a century after the Hispanic-American War. Sack was a ministerial precursor of the Russian czarism and, after the Russian Revolution, a Law professor in Paris.

Sack never ceased to acknowledge that obligations contracted as public debt should remain intact, since they represent obligations for the State according to a territorial component, rather than as a specific governmental structure. He based his argument not only on a strict principle of natural justice, but also on the international trade demands, stating that chaos could take control in the relations among nations without rigorous rules.

The true essence of Sack's doctrine takes into account that, in view of the colonial territories' independence, the States and Colonies experienced a change in power, Monarchies were replaced by Republics, and military rules by civil ones; constant fluctuations were experienced in the European frontiers and new ideologies emerged.

Sack observed that debts contracted not for the benefit of the State's interests should not be tied to inflexible rules, since this kind of legal acts were rejected by society and therefore considered as "Odious Debts". Thus, he argues that if a despotic power has incurred in debt as a result not of the national needs or interest, but to reinforce the regimen or repress oppositional citizens, such debt would be rejected by all the State's society.

The odious debt doctrine is subject to an abusive interpretation, with the risk of favouring merely particular interests. To avoid an eventual misinterpretation of the odious debt doctrine, Sack proposed new governments to prove that their debts would be contracted in benefit of the public interest, and that the corresponding creditors should be well informed about it.

In order to claim reimbursement of granted loans, creditors must prove, by means of auditing tasks, that granted borrowings were used in benefit of the State. Failure in proving this before an international court would result in a non-compulsory debt.

For the last 40 years, the wealth in the world has multiplied itself eight times; yet, 25% of the global population lives with less than USD $1 per day, and 50% lives with twice of such an undersized figure.

This problem has been faced via financing and borrowing. Yet, a hard-to-break vicious circle is implied in this solution, since developed nations demand from developing countries debt payment in exchange for new capital flows to overcome poverty.

There are three convergent ways to mend the damage produced by this situation in undeveloped economies. The first one is to implement the model adopted by the United States of America in 1898, in the Conference of Paris, when this country --acting as the new "defender" of the Caribbean island-- established that the Cuban debt contracted with Spain was not to be recognized. An argument was made, stating that such debt was contracted by the occupation of Iberia's strength. With this measure, the concept of "Odious Debt" felt present, and has almost fallen into oblivion nowadays.

In legal terms, there are background cases in which public debts contracted by despotic governments were nullified, like the beginning of the great progression of Latin-American public debt scenario, occurred during the 70's.

The second, less-radical measure is to negotiate with creditors a new schedule for the debt's reimbursement. Considering there is no question about its authenticity, the debt would be paid but not under the creditor's conditions, but within the debtor's possibilities, taking into consideration thereby that enough resources are left to promote the country's internal development and growth.

The third way to avoid "odious" debt reimbursement is "payment cessation", which means to simply stop paying any obligation whatsoever regarding the debt. This alternative is not accepted, not only by the loyal representatives of the legal framework, but also by large population segments which realize that such measure can provoke domestic international capitals to abandon their country.

In Mexico, moratoria, payment deferments and debt restructuring have been a constant in the country's History. The first moratorium took place in 1828, just four years before the establishment of the Republic. During the first century of independency, the government was unable to reimburse external debt payments due to foreign invasions, disclaimed debts contracted by previous administrations and the revolutionary war.

On the other hand, it is also true that all along the Mexican history, debts have been contracted due to the oil and railroad nationalizations. The last episode of public debt significant increase in Mexico took place between 1994 and 1995, as a result of the banking system rescue. In this case, serious questions were raised regarding the transparency and adequacy of such debt contraction.

In view of its significant risks and implications, contracting external or internal debt should be based on a country-development-financing strategy. A sustainability basis is required, as well as reasonable cost levels in order to pay for the fiscal deficit, as well as for the current account within the payment balance.

The lack of a viability and risk analysis when contracting entitled, contingent or implicit debt, leads to the perception of a threat to growth, in light of the significant fiscal burden that its eventual payment represents.

A well-balanced examination of associated costs and benefits should take into consideration the magnitude of the debt's amount, its financial requirements for appropriate compensation, its management efficiency, and the expected outcomes of its administration.

Within this context, Supreme Audit Institutions play a crucial role, since they are the revising institutions that foster, before the responsible managers, adoption of best practices in public debt administration.

Therefore, it is a priority to promote an efficient and professional public debt management, in order to decrease financial costs and risks implied.

It is essential to carry out, under different scenarios, an accurate evaluation of the fiscal sustainability for debt payment, as well as to incorporate contingent and implicit liabilities that in time may affect its structure.

With the intention of reducing financial crisis risks, a wide dissemination of information on public debt should be encouraged, as well as banking system regulatory mechanisms and an efficient transparency and accountability scenario, in order to allow for a more objective and reliable assessment and analysis regarding the debt's fiscal vulnerability.

The advantages of transparency in debt management can be grouped into four categories: 1) it is beneficial to the efficiency of the private sector; 2) it reduces costs and probable financial risks; 3) it promotes confidence, thus avoiding external crisis widespread; and, 4) it supports and encourages democracy.

Despite the significant potential benefits offered by debt's information disclosure, institutional transparency in middle-income countries has been unable to prevent crisis caused by infection or speculation.

In order to play an efficient role, transparency must be global and should include all of the international financial system actors. It also requires including a sufficient amount of information for the heads and officers of the central banks in developing countries, regarding international and coverage funds.

The classification of financial information in Mexico has experienced major changes. During the 70's and 80's, governmental creditors and public debt conditions were not disclosed. In the middle 90´s, information regarding the international reserves of Banco de Mexico (the Mexican Central Bank) was disseminated only twice a year. Currently, in our country some information is still classified, even though it is limited, exceptional and justified.

Transparency is a technical and costly task, which requires the development of regulations, institutions, practices, systems, education, as well as social and cultural feedback. Transparency generates responsibilities to public officers and is therefore not always welcomed. Public officers tend to carry out their tasks as a technical function instead of as a political or social one. They would like to be judged by their results instead of by the decisions they make. Certainly, transparency brings complexity to the public sphere.

Through the revision of public debt's theory and function, it becomes evident that public debt is the result of the economical system performance and the implementation of public policies. Public debt transparency should be seen as a whole and include the following information areas:

- Use and purpose of the debt.
- Public policies related to debt management and its exercise.
- Form and frequency of debt payment.
- Negotiations with creditors.
- Assets and liabilities balance.
- Composition and operations of the stock, banking and commercial debt.
- Indirect and contingent debt.

- Solvency or capital requirements to face risks.
- Obligations resulting from unfunded constitutional or legal rights (implicit liabilities).
- Social Pact: regulatory government and counterpart.
- Fiscal sustainability of the internal and external debt.
- Adopted prudential criteria.

The debate regarding a new international financial system structure comes, in part, as a consequence of the global debt crisis, the frequent banking crisis and its widespread effects. These changes would help shaping a new face to capital accounts opening, and would support more creative ways of insertion within the global economy.

On the other hand, public debt auditing should assess compliance with the legal and regulatory dispositions, the effects in the economy and its impact on the government's action range. Among the main issues to be revised, the following should be highlighted:

1 Legal and regulatory public debt framework

2 Debt purpose and its income-yield capacity in social-economic terms

3 Debt's administrative cost and payment

4 "Commitment" costs per commission fee

5 Public debt management

6 Public debt fiscal sustainability

7 Liabilities and contingent or implicit obligations

8 Quality and opportunity of accountability

Supreme Audit Institutions must report to the Parliaments or Houses the outcomes of the analysis and assessment performed on all the aforementioned issues, including, if that is the case, the magnitude of the fiscal risks that could compromise the financial, economic and political stability.

The role of the International Organization of Supreme Audit Institutions (INTOSAI) stands out within the assessment and auditing tasks of the public debt general scheme. The exchange of experience between the 188 members of the Organization and the subsequent technical progress attained, guarantee the passage of public auditing into new horizons.

INTOSAI supports its members by providing them information and experience on the challenges faced by the world today, in the auditing and performance audits spheres.

Additionally, the Organization comprises the Initiative for INTOSAI Development (IDI), a training-providing body, as well as the Public Debt Committee, responsible for carrying out studies and research on this subject.

Since the year 1991, the Public Debt Committee was established by INTOSAI. It currently includes Supreme Audit Institutions from 16 country-members, as well as from 5 country-observers.

Research and analysis papers on public debt have been undertaken and are available in the Committee's Website (www.intosaipdc.org.mx), including the following themes:

- Guidance on Definition and Disclosure of Public Debt;
- Guidance for Planning and Conducting an Audit of Internal Controls of Public Debt;
- Guidance on the Reporting of Public Debt;
- Public Debt Management and Fiscal Vulnerability;
- Fiscal Exposures: Implications for Debt Management and the Role for Supreme Audit Institutions (SAIs);
- Performance Audit on Public Debt and Terms of Reference;
- Substantive Procedural Guide for Auditing Public Debt; and finally,
- General Policies and Best Practice in Public Debt Management.

Given the importance of auditing public debt, its management, accountability and audit was chosen as material for the XIX INTOSAI Congress, held in Mexico City from November 5 to 10. During this event, the Superior Audit Office of Mexico was appointed Chair of the Organization for the period 2007 to 2010.

Until now, audits on public debt management have been limited to verify the compliance with the legal and regulatory dispositions, accounting records and payments revision, balance conciliation, and assessment of internal control mechanisms. However, these revisions have turned out to be insufficient, due to the following:

- Inadequate disclosure of the debt's structure, in terms of contracting, evolution, sources and financing;
- Scarce and unreliable information regarding amortization and interests payment;
- Discretional decisions regarding debt purposes (expenditure or investment);
- Insufficient regulation and lack of supervision and control, regarding financial institutions;
- Lack of transparency and accountability on public debt, and finally,
- Limited control and auditing, and an historical or short-term approach.

For all the abovementioned, the mission of Supreme Audit Institutions should include overseeing and assessing the correct and honest allocation of public debt resources. The essence of the debate resides in encouraging a culture of transparency and accountability on this issue, and to promote among governments a responsible and committed attitude regarding the future generations.

SOVEREIGN PUBLIC DEBT INDICATORS

a) Total Public Debt Indicators

i. Total Public Debt and Debt Service / GDP,

ii. Budgetary Deficit and Financial Cost / GDP,

iii. Total Public Debt Service / Export Income,

iv. Average Maturity and Duration.

b) External Public Debt Indicators

i. External Public Debt and its Service / GDP

ii. External Public Debt Service / External Public Debt

iii. Short-term External Public Debt / Total Exports, or External Public Debt and Service / Total Exports

iv. Short-term External Public Debt / Foreign Exchange Reserves and Exports

v. Capital Account of the Balance of Payments / Current Account

c) Domestic Public Debt Indicators

i. Domestic Public Debt and Short-term Debt / Ordinary Revenue

ii. Service of Domestic Public Debt / Ordinary Revenue

iii. Interest on Domestic Public Debt / Ordinary Revenue

iv. Interest on Domestic Public Debt / Net Expenditure

CONTINGENT PUBLIC DEBT INDICATORS

i. Total Amount of Contingent Liabilities / GDP

ii. Total Amount of Contingent Liabilities / Total Amount of Direct Debt

iii. Total Amount of Contingent Liabilities / Public Sector Total Net Expenditure

iv. Public Sector Ordinary Revenue (1, 5 and 10 years)

v. Estimated Payment of the Financial Costs of the Contingent Liabilities / Estimated Payment of the Financial Costs of the Direct Public Debt (1, 5 and 10 years)

vi. Estimated Payment of the Financial Costs of the Contingent Liabilities / Public Sector Total Net Expenditure (1, 5 and 10 years)

vii. Estimated Payment of the Financial Costs of the Contingent Liabilities / Expected Public Sector Ordinary Revenue (1, 5 and 10 years)

The concept of odious debt in public international law

Robert Howse

Note:
This is an abstract of the paper published as an UNCTAD discussion paper[197] in July 2007. The opinions expressed in the paper are those of the author and are not to be taken as the official views of UNCTAD or its member States.

The concept of "odious debt" regroups a particular set of equitable considerations that have often been raised to adjust or sever debt obligations in the context of political transitions, based on the purported odiousness of the previous regime and the notion that the debt it incurred did not benefit, or was used to repress, the people.

The paper begins with an exploration of the grounds of the "odious debt" concept in basic international law structures and principles. The international law obligation to repay debt has never been accepted as absolute, and has been frequently limited or qualified by a range of equitable considerations, some of which may be regrouped under the concept of "odiousness".

This is consistent with the accepted view that equity constitutes part of the content of the "general principles of law of civilized nations", one of the fundamental sources of international law stipulated in the State of the International Court of Justice. At the same time, most debt contracts between States and private creditors are governed by the domestic private law specified in the contract.

The legal systems of these jurisdictions may well have concepts such as "clean hands" or the notion that contracts related to illegal purposes are invalid. These concepts overlap with elements of the notion of "odiousness" as a basis for invalidating debt obligations. Investor/state arbitration tribunals, for example, have been comfortable taking into account such considerations in determining whether repudiation of contractual obligations to an investor by the host State is consistent with international law. This suggests that such concepts may indeed form part of the content of equity as a "general principle of law of civilized nations", especially if widely shared among different legal systems.

The paper surveys a range of actual transitional situations in order to articulate the various ways in which "odiousness" has been invoked by a successor regime as a ground for limiting its obligations to repay debt incurred by the previous regime. The paper also looks at some situations where other States' tribunals have rejected or questioned claims of a transitional regime to adjust or sever debt obligations based on considerations on "odiousness".

Examination of these situations does not lead to skepticism concerning the legal grounds for a notion of "odious debt". Usually, in the cases examined, there were doubts concerning the facts as to whether the debt in question was "odious" or actually conferred some benefits on the population or the new regime, or whether the transitional regime's claim was based on an overly broad notion of "odiousness".

In none of these situations was a claim of odious debt rejected on grounds that international law simply does not countenance alteration in state-to-state debt obligations based on any equitable considerations whatsoever. The paper concludes that, due to the complexity and variety of transitional contexts, there is no single obvious legal forum for the adjudication or settlement of claims of odiousness. Depending on context, such claims might appropriately be raised in bilateral or multilateral negotiations on debt relief, or they could be adjudicated in the context of arbitration or domestic litigation. State-to-state debt contracts may specify a forum for the settlement of disputes. However, invocation of the concept of odious debt in multiple forums in respect of diverse debt contracts involving the same debtor State risks inconsistent decisions. Here, the examination of considerations of odiousness by a single special transitional tribunal seized with all the claims related to the political transition in question may be an attractive solution.

[197] UNCTAD discussion paper No. 185, UNCTAD/OSG/DP/2007/4.

Panel 2

Concessional lending – practice of the past?

Concessional lending – practice of the past?
Summary of panel discussion

Moderator: Mr. François Bourguignon, Professor, Paris School of Economics, France & Former Chief Economist and Senior Vice President, World Bank

Speakers: Mr. Stefan Nalletamby, Advisor to the Vice President, Finance, African Development Bank
Mr. Daniel Cohen, Professor of Economic Science, ENS, Paris, France
Mr. Claudio Spinedi, Deputy Director, Economic Cooperation, Ministry of Foreign Affairs, Italy

Concessional lending has not brought developing countries out of the debt trap. Some will argue that this lending has brought countries into an additional trap, the "trap of conditionality" where they no longer have the freedom to act, and transact, as they themselves feel appropriate. Several countries, particularly in Asia and Latin America have reacted by building up foreign currency reserves and/or repaying the multilateral lenders. Therefore, what is the future of concessional lending and the conditions that come with these debts?

Mr. Bourguignon opened the panel discussion by defining concessional lending and by highlighting some of the main issues pertinent to it. Mr. Bourguignon defined concessional lending as lending to developing countries at a rate of interest which is lower in some proportion to the risk free competitive rate of interest observed in international capital markets. The difference at which the loans is made and the competitive rate is the 'grant' element of concessional lending, he said. Concessional lending, he added, was common practice in many multilateral development organizations and bilateral development agencies. Although it could be argued that such lending could accelerate the development process – where the return in investment exceeds the rate of interest of the loans - this type of delivery of development aid, nevertheless has drawn two main critiques. The first critique asserts that lending should be decoupled into two parts consisting of a loan provided at the competitive market rate and a grant provided to the country. However, this would assume that countries can borrow directly on the commercial market at the competitive market rate, which is still not always the case. Whereas, within the concessional lending process, financial institutions often give loans to countries that would either not normally have access to them or provide loans at more favorable rates than what they would normally receive on the competitive market. The second argument asserts that it is better to give money rather than lend it to countries so as to avoid risking greater indebtedness as concessional lending has also contributed to the debt crises of the past.

What was important was that concessional lending be made only with certain conditions in place, he said. This included good governance and making sure that the money would be used for development purposes. It also included having an effective debt sustainability framework in place. With the changing world and the emergence of new actors, more and more lenders and donors, the formulation of an effective Debt Sustainability Framework is becoming more and more complex, but this is a process that needs to be improved rather than eliminated.

Mr. Nalletamby, started his presentation by highlighting the recent broad economic trends in Africa and showing that since 2002, both real GDP growth as well as terms of trade and the fiscal balance had been favourable, with the latter having improved at least partly due to debt relief . On an individual country basis, however, it was important to differentiate the economic prospects of those countries that were mineral rich from those that were not. Despite Africa's economic progress, he also pointed out, extreme poverty in Africa currently directly touched 40 per cent of the population and it was unlikely that the Millennium Development Goals would be met by 2015.

Addressing the MDG achievement, he said, was by large a financing issue and several recent independent studies had all come to the conclusion that additional financing needs ranged between 50-100 billion US dollars per year until 2015. Already basic infrastructure financing needs – the area in which the African Development Bank (AfDB) is an important player – were estimated at around 10 billion US dollars per annum until 2015. If financing toward Africa should be reduced to concessional lending only, he said, there would be serious shortfalls. Relying on ODA flows, where 42 per cent of it in 2006 was dedicated to debt forgiveness (which had a huge impact on poverty related spending of the governments) and emergency aid would also not be appropriate. Other forms of aid/financing were therefore necessary to compensate for this financing gap.

Regarding so-called non-traditional lenders, he explained that China's engagement with Africa was was government-to-government as well as private-sector to private-sector. A recent example was their 20 per cent ownership acquisition of South Africa's Standard Bank, the biggest bank on the continent. The trade balance of Africa with non-traditional lenders he said was also in surplus. FDI in the region doubled between 2004 and 2006, and was now at about 36 billion USD. This increase he said was surprisingly driven by south-south investments (mainly from China, India and Korea), but also from engagements of private equity funds. When looking into details, he said, it became clear however, that only few countries have benefited from this FDI boom and the bulk of it (85–90 per cent) goes to five countries only. From the bond side of the market, the US subprime crises can be regarded almost favourable for the African continent, as for investors in developed countries the need for diversification increased, which boosts investments in African bonds. Some bonds, e.g. the recently issued Ghanaian one, are well-received as they focus on infrastructure financing and returns are likely to cover the costs. Kenya and Gabon are moving into the same direction, but most countries have to go through rating exercises beforehand.

While concessional and non-concessional lending both have their pros and cons, he said that there was no unique first-best way of looking at financing. As such, the African Development Bank by reconciling the two approaches through the promotion of public-private-partnerships, support of public institutions as well as providing suitable incentives to both parties in order to maximize the strategic fit between the public and the private side.

Moreover, the AfDB considerably supports some of the most important initiatives on the African continent, such as NEPAD (with a support of 1.2 billion USD in loans and grants in 2006), 14.2 billion USD for water initiatives up to 2015, as well as major contributions to the Infrastructure Consortium for Africa, the Post-Conflict Country Facility as well as the Investment Climate Facility.

Mr. Cohen began his presentation by pointing out that the idea of soft loans (concessional loans) is simple: poor countries cannot afford to pay expensive loans, so soft loans are meant to be easily repaid. Essentially soft loans can be broken down into two components: a grant element and a market rate loan. With the HIPC and MDRI initiatives it was clear that even soft loans can also become too big and too difficult to repay. At the time of the HIPC Initiative, it was believed that debt should be forgiven but not forgotten by cancelling their debt and giving them grants.

Mr. Cohen presented two main schools of thought on the topic of concessional lending. The first strand of literature is advanced by Bulow and Rogoff who pose the questions: Why is the private sector not lending to these countries in the first place? What makes the public sector think that it is worthwhile to lend to these countries? Generally these countries are found have such weak governance and institutions that they are judged to be less able to repay their debt. They question whether there is reason to believe that the public sector is better equipped that the private sector? If not then the public sector should not have any illusions about the ability of those countries to repay their debt. The evidence suggests that the public sector is less likely to be repaid by sovereign debtors than the private sector. Conclusion: forget about the loan component and give grants.

The alternative literature in favor of providing soft loans is founded in the broader growth theory debate. This line of reasoning argues that institutions are the driver of economic growth. There is a growing literature arguing that the poorest countries have the weakest institutions due to their colonial roots. The literature argues that poor institutions were set up by colonial powers and that these poor governance structures have persisted over time. Mr. Cohen did not find this argument to be credible. Poor countries are not just poor with weak institutions, they are also very volatile. It is difficult to forecast whether these countries will embark on a high or low growth path. The reason why they do not have access to capital markets is due to this volatility. The risk premium for these countries to access the international capital market is so high that the cost of capital becomes prohibitive.

Mr. Cohen argued that in instances when projects are not financially profitable but rather are socially profitable, then it is better to provide 100 percent grant financing. He stated that the HIPC Initiative is an example of how the soft loans that were made were not contingent upon the growth path of those countries. The example illustrates the need to extend highly contingent loans to highly volatile countries. This consideration should be incorporated into the design of the loan rather than discovering this ex post when it is too late.

Mr. Spinedi focused his presentation on debt relief and sustainable lending from a national viewpoint. It was already mentioned on this panel that new lenders have changed the traditional patterns of lending (either commercial or concessional) to low income countries in Africa.

These new patterns could emerge also because the HIPC and MDRI initiatives have effectively succeeded in re-establishing external debt sustainability in an increasing number of countries that have reached completion point. Even more encouraging is the fact that debt relief has provided sufficient space to enable completion point countries to increase significantly their spending on programmes to reduce poverty and promote economic growth.

Italy believes that the 3.2 billion euros of debt relief it has bilaterally provided since October 2001 to HIPC countries, cancelling 100 per cent of bilateral debt, as well as Italy's commitment to provide its share of financing of the MDRI to ensure dollar for dollar compensation for lost credit reflows, have been sound decisions.

The reduction of debt ratios in many LICs has created the appropriate environment for the adoption two years ago by the SECA (Italy's export credit agency) of a new strategy for Sub-Saharan Africa. In this period (2006–2007) non-concessional officially supported export credits have more than doubled, albeit from a very low base. Presently 5.3 per cent of SACE's commitments are with Sub-Saharan Africa. The new debtors are almost entirely from the corporate and banking sector, involved in projects expected to generate net positive economic returns.

No new sovereign commercial debt has been created. Italy recognizes that grants and concessional lending remain the most appropriate source of external financing for LICs Governments. HIPC countries that have not yet reached completion point are basically eligible only for grants. Post-completion point HIPCs are eligible to grants/soft loans, taking into account the lending limits established in PRGF programmes and/or DSAs. LICs other than HIPCs, are eligible to soft loans under the same conditions as Post-completion point HIPCs. As a result, new Italian ODA loans to HIPCs and other LICs may incorporate a grant element up to 90 per cent.

Italy also looks forward to the perspectives for a partnership between SACE and the African Trade Insurance Agency (ATI), the African ECA (export credit agency) based in Nairobi, which has just hosted last week the first meeting in Africa of the Prague Club. The Prague Club is an international club of some 30 emerging market and developing countries ECAs established by the Berne Union and assisted by the EBRD. Following the lead of MIGA and some other European ECAs (e.g. Atradius, OND Ducroire), a partnership between SACE and ATI could create a favourable environment for a larger participation of European small and medium sized enterprises in the development of Africa. This fits well within the picture of Africa presented by UNCTAD's 2007 World Investment Report. For a variety of factors, including the surge in commodity prices and debt relief, between 2004 and 2006 FDI into Africa doubled, with LDCs receiving 23 per cent of FDI inflows.

Italy is particularly concerned for HIPC countries and other low income countries about how they can maintain their new found debt sustainability over the long-term. Italy believes that the intertwined issues of responsible lending/responsible borrowing have to be addressed by lenders and borrowers.

As a lender, Italy is committed in the relevant international fora (not only the OECD, but also the IFIs, the Paris Club, the G20 and, last but not least, the UN) to promote the adoption of principles and guidelines to ensure that concessional and commercial lending are coherent with the stated aim of safeguarding long term debt sustainability.

Italy, together with a certain number of other European partners at the OECD, has co-sponsored the proposal for the adoption of principles and guidelines to promote responsible (or sustainable) lending practices in the provision of officially supported export credits to LICs. This proposal was welcomed by the finance ministers of HIPCs at their meeting in Washington on October 19 during the Annual Meetings. The ministers stressed the need to stay engaged with the Bretton Woods institutions to contribute more to the preparation of DSAs and to avoid poor quality lending. This proposal has been discussed also at the OECD on November 6-7, with the participation of non-member countries, such as China, Brazil, India and South Africa, which are increasingly important lenders.

This latest initiative by lenders follows the adoption by the OECD in July 2007 of an updated Statement of Principles on Unproductive Expenditure. OECD member countries and their ECAs have expanded the cover of the Statement to include all IDA-only countries, in addition to HIPC countries. The first principle urges all lenders (and their export credit agencies) to base their lending decision on the joint Debt Sustainability Framework (DSF) for low income countries of the IMF and World Bank, as a key tool for adhering to sustainable and transparent practices. The second fundamental principle obviously relates to the necessity that export credit agencies avoid supporting transactions that do not contribute to the social or economic development of LICs and the achievement of the MDGs. The voluntary basis of this Statement does not endanger its effectiveness, because OECD members have agreed to report transactions with IDA-only countries supported by export credit agencies and to review them on an annual basis. Peer reviews are an effective tool to achieve satisfactory levels of compliance to rules designed to ensure sustainable development for LICs and a level-playing field among lenders (or at least a significant number of important lenders), without having to make the rules compulsory.

Following this same approach the proposal discussed at the OECD intends to build a wide consensus among member countries and non-member countries around the following principles: a) members will provide support for non-concessional credits only in so far that this will allow borrowers to continue to meet the concessionality requirements of the IMF and IDA or, for those LICs without concessionality requirements, this will be consistent with the country-specific DSAs conducted within the DSF; b) transactions involving a public or publicly guaranteed buyer are in line with the country's borrowing and development plans as defined according to national legislation.

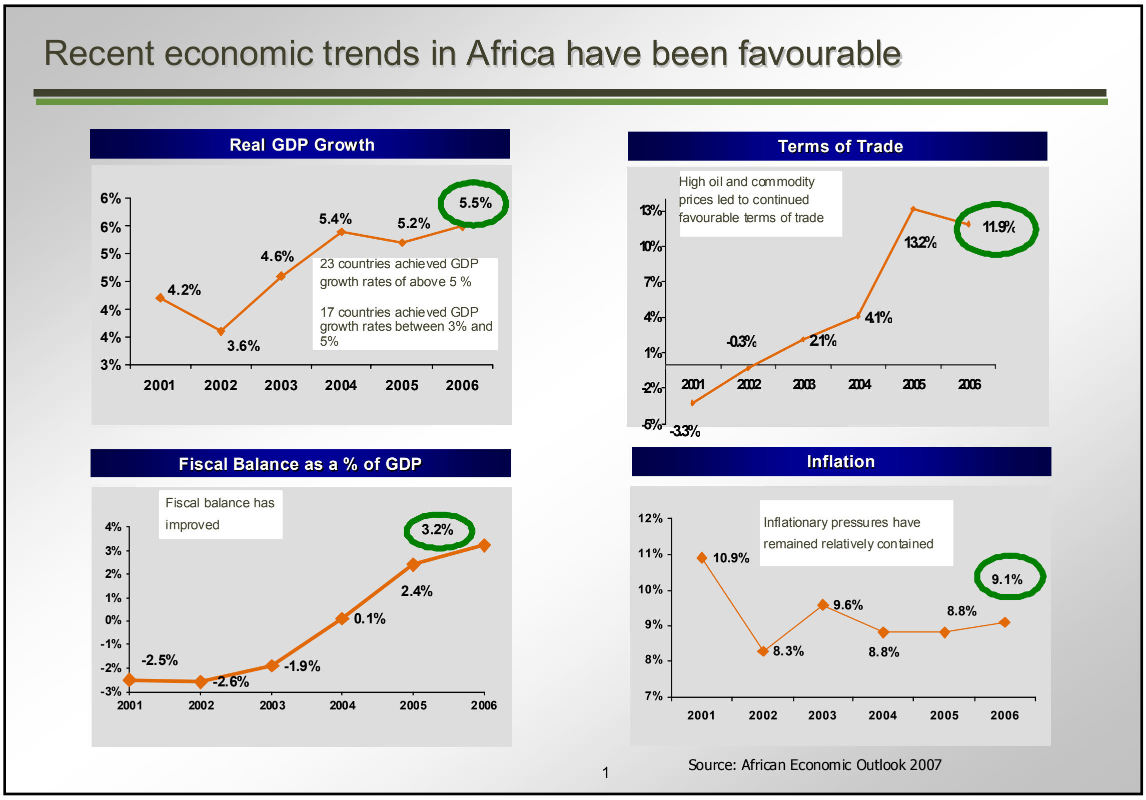
These basic principles would target the transactions with 67 borrowing LICs. Italy thinks it is extremely important that these principles are operationalized not only by ECAs in OECD countries, but also adopted and operationalized by the major emerging economies. Italy is impressed by the presentation and positive role played by the representatives of South Africa's Export Credity Agency (ECIC) at the OECD, considering that a large share of ECIC's exposure is with LICs in Sub-Saharan Africa, such as neighbouring Mozambique.

Italy also sincerely welcomed the expression of interest and appreciation by the "outreach" countries Brazil, China, India for the basic principles of sustainable lending, elaborated by the OECD. Italy believes that this positive approach to sustainable lending can be understood also looking at the figures presented at the OECD by the Chinese and Indian export credit agencies. After Asia, which is obviously its larger market, SINOSURE's liabilities are 29.4 per cent with Africa and 13 per cent with Latin America. Italy sees here a common interest of OECD Countries and "outreach" countries to ensure that LICs preserve their capacity to service orderly foreign debt. This is a good base to pursue the dialogue on principles and guidelines for sustainable lending.

New lenders and the effect on the markets

Stefan Nalletamby

Recent economic trends have been favourable for Africa in terms of GDP growth, terms of trade, steady inflation and improvements in the fiscal balance.



However economic challenges may differ according to whether individual countries are oil-exporting or oil-importing.

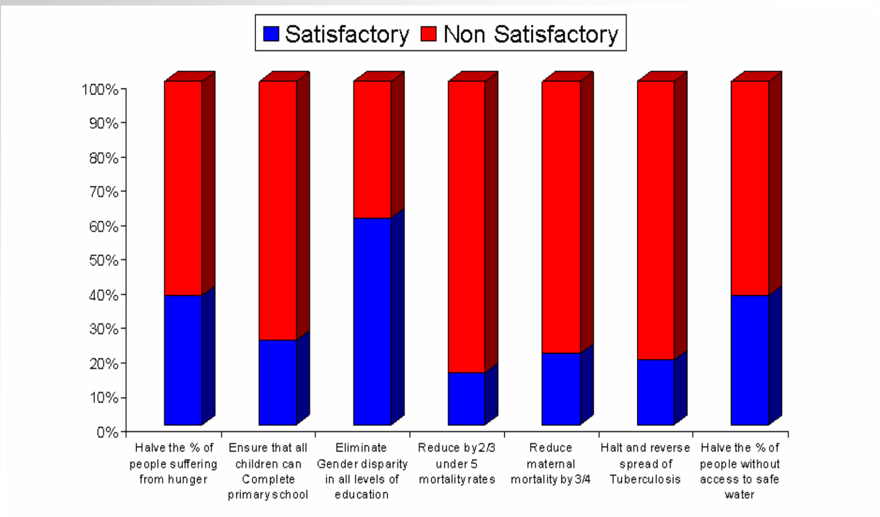
However economic challenges ahead may differ

GDP Growth	1998-2004	2005	2006(e)	2007(p)	2008(p)
Total Africa	4.0	5.2	6.3	6.0	6.0
Net Oil exporters	4.5	5.9	6.0	7.4	6.3
Net Oil importers	3.6	4.7	5.1	4.7	4.7
CPI Inflation					
Total Africa	10.0	8.8	9.1	9.2	9.5
Net Oil exporters	11.6	9.4	5.7	5.3	5.3
Net Oil importers	8.8	8.4	12.0	12.7	12.9
Fiscal Balance					
Total Africa	-2.0	2.4	3.2	2.7	2.0
Net Oil exporters	-0.8	7.0	8.2	7.3	6.4
Net Oil importers	-3.1	-1.9	-2.3	-2.2	-2.4
Trade Balance					
Total Africa	1.8	6.7	7.8	7.6	6.6
Net Oil exporters	7.5	20.3	21.3	20.6	19.4
Net Oil importers	-3.4	-6.2	-6.5	-6.2	-6.8

Source: African Economic Outlook 2007

2

Progress towards reaching the MDGs remains slow



Source: African Economic Outlook 2007

3

While financing needs remain significant

Financing MDGs

- Several independent studies estimate the additional financial needs between USD 50 to 100 BN per annum until 2015 (source: World Development vol. 35, 2007)
- Basic infrastructure financing needs for Africa are close to USD 10 BN per annum (source: Commission for Africa)

Need for Increased Development Assistance

- Multilateral and Bilateral development partners have been sole providers of development assistance on ***concessional terms.***
- In 2006, 42% of total ODA, USD 107 BN, was dedicated to debt forgiveness and emergency aid (source: African Economic Outlook, 2007)
- Multilateral Debt relief for many African countries is now complete.
- Other forms of aid are needed to rise very quickly to compensate for this financing gap.

4

Non-Traditional lenders are playing an increasing role on the continent

More Prominent Bilateral Relationships

- China: Trade with Africa has risen six fold since 2001 to USD 28.6 BN in 2006. Africa still runs a trade surplus with China of USD 2 BN
- India: Trade with Africa has also risen sharply to USD 9.14 BN in 2005.
- Korea: Will increase bilateral aid to USD 1 BN by 2010

Private Sector Investments

- Foreign Direct Investments doubled between 2004 and 2006 to USD 36 BN, driven by South South investments
- Private Equity Funds: Actis Capital, Aureos Capital, Citibank Africa Fund
- International Bond Fund Managers
- Public/Private Equity funds: Pan African Infrastructure Development Fund; Atlantic Coast Regional Fund

Charitable and Philanthropic Organisations

- Charitable and Philanthropic foundations donations rose to over $11 BN in 2004
- GAVI initiative : Has received pledges for USD 3.2 BN (04/07)

5

This has shed light on the different approaches to financing (1)

CONCESSIONAL LENDING

ADVANTAGES

- Contributes to filling the financing gap
- Cheaper source of financing
- Longer tenors with grace periods
- Promotes international best practices

DISADVANTAGES

- Limited in size
- Hindered by political influences
- Loan conditionality
- Slower responsiveness and speed of delivery

6

This has shed light on the different approaches to financing (2)

NON - CONCESSIONAL LENDING

ADVANTAGES

- No or low loan conditionality
- Better flexibility
- Market driven
- Increased speed of delivery
- Greater transparency in pricing

DISADVANTAGES

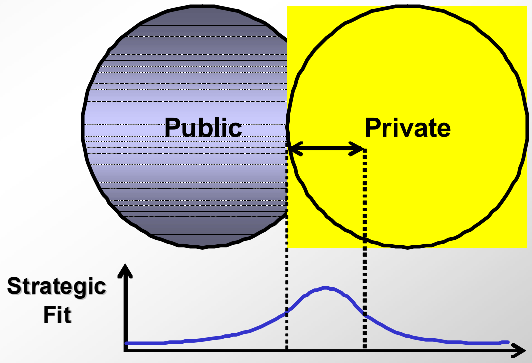
- Costly
- Lumpy
- Selectivity
- Could threaten International best practices
- Risk of leading to unsustainable indebtedness of countries

7

The AfDB looks to reconcile these two approaches

- Promotion of Public Private Partnerships (PPPs) as method of financing
- Ensures an appropriate institutional framework is in place
- Provides suitable incentives to both public and private parties involved
- Major role of public institutions: governments, regional organisations and donors, inspires confidence among partners

Maximizing Strategic Fit



8

…and continues to champion development initiatives across the continent

NEPAD African peer review mechanism

- Lead agency on both infrastructure development and financial and economic reforms. Over USD 1.2 BN loans and grants approved in 2006.

Water Initiatives

- Rural Water Supply and Sanitation Initiative (RWSSI): A USD 14.2 BLN initiative to provide safe water and basic sanitation to 80% of rural populations by 2015.
- Africa Water Facility (AWF): strengthen Water resource management

ICA The Infrastructure Consortium for Africa Le Consortium pour les infrastructures en Afrique

- Hosts the Secretariat to the Infrastructure Consortium for Africa: USD 7.7 BLN committed to infrastructure financing in 2006

Post-Conflict Country Facility

- Created by the Bank to assist countries emerging from conflicts in clearing their arrears. Has been instrumental for 5 « pre HIPC » countries.

Investment Climate Facility (ICF)

- Launched at the World Economic Forum 2006, a Public Private Partnership to improve the « business climate » in Africa

9

In conclusion …

- Financing needs for development in Africa are significant: new lenders are welcome!
- Neither the Public sector nor the private sector alone can meet all these needs;
- Public - Private Partnerships (PPPs) is one way to enhance the benefits of a collaborative approach to development between the Public and Private sectors;
- Governments, Development Finance Institutions and the Private sector should work together to provide the most adequate funding and institutional framework for a sustainable development.

10

Debt relief and sustainable lending from an Italian viewpoint

Claudio Spinedi
Deputy Director General for Economic and Financial Affairs, Ministry of Foreign Affairs of Italy

The first speaker in our panel has explained how much new lenders have changed the traditional patterns of lending (either commercial or concessional) to low income countries in Africa.

These new patterns could emerge also because the HIPC and MDRI Initiatives have effectively succeeded in re-establishing external debt sustainability in the increasing number of countries that have reached completion point. More encouraging still is the fact that debt relief has provided sufficient space to enable CP countries to increase significantly their spending on programmes to reduce poverty and promote economic growth.

Italy believes that the 3,2 billion euros of debt relief it has bilaterally provided since October 2001 to HIPC countries, cancelling 100% of bilateral debt, as well as Italy's commitment to provide its share of financing of the MDRI to ensure dollar for dollar compensation for lost credit reflows, have been sound decisions. The results so far have justified the extensive financial effort decided by the Government and Parliament of my country.

The reduction of debt ratios in many LICs has created the appropriate environment for the adoption two years ago by our ECA (SACE) of a new strategy for Sub-saharan Africa. In this period (2006-2007) non-concessional officially supported export credits have more than doubled, albeit from a very low base. Presently 5,3% of SACE's commitments are with Sub-Saharan Africa. The new debtors are almost entirely from the corporate and banking sector, involved in projects expected to generate net positive economic returns.

No new sovereign commercial debt has been created. Italy recognizes that grants and concessional lending remain the most appropriate source of external financing for LIC's Governments. HIPC Countries that have not yet reached completion point are basically eligible only for grants. Post-completion point HIPCs are eligible to grants/soft loans, taking into account the lending limits established in PRGF programmes and/or DSAs. LICs, other than HIPCs, are eligible to soft loans under the same conditions as Post-completion point HIPCS. New Italian ODA loans to HIPCs and other LICs may incorporate a grant element up to 90%.

We also look forward with great interest at the perspectives for partnership between SACE and the African Trade Insurance Agency (ATI), the African ECA based in Nairobi, which has just hosted last week the first meeting in Africa of the Prague Club. The Prague Club is an international club of some 30 emerging market and developing countries ECAs established by the Berne Union and assisted by the EBRD. Following the lead of MIGA and some other european ECAs (Atradius, OND Ducroire) a partnership between SACE and ATI could create a favourable environment for a larger participation of european SMEs in the development of Africa.

I have reported SACE's experience, because it fits well within the picture of Africa presented by UNCTAD's 2007 World Investment Report. For a variety of factors, including the surge in commodity prices and debt relief, between 2004 and 2006 FDI into Africa doubled, with LDCs receiving 23% of FDI inflows.

We are therefore particularly concerned that HIPC countries, but also other low income countries maintain over the long term their new found debt sustainability. We believe that the intertwined issues of responsible lending/responsible borrowing have to be addressed by lenders and borrowers. I will consider lenders' responsibilities.

As a lender, Italy is committed in the relevant international fora (not only the OECD, but also the IFIs, the Paris Club, the G-20 and, last but not least, the U.N.) to promote the adoption of principle and guidelines to ensure that concessional and commercial lending be coherent with the stated aim of safeguarding long term debt sustainability.

Italy has co-sponsored with a certain number of other european partners at the OECD the proposal for the adoption of principles and guidelines to promote responsible (or sustainable) lending practices in the provision of officially supported export credits to LICs.

This proposal was welcomed by the Finance Ministers of HIPCs, meeting in Washington on October 19 during the Annual Meetings. The Ministers stressed the need to stay engaged with the BWIs to contribute more to the preparation of DSAs and to avoid poor quality lending. This proposal has been discussed at the OECD on November 6-7, with the participation of non-member countries, such as China, Brazil, India and South Africa, which are increasingly important lenders.

This latest initiative by lenders follows the adoption by the OECD in July 2007 of an updated Statement of Principles on Unproductive Expenditure. OECD member countries and their ECAs have expanded the cover of the Statement to include all IDA-only countries, in addition to HIPC Countries. The first principle urges all lenders (and their ECAs) to base their lending decision on the joint DSF for LICs of the IMF/WB, as a key tool for adhering to sustainable and transparent practices. The second fundamental principle obviously relates to the necessity that ECAs avoid supporting transactions that do not contribute to the social or economic development of LICs and the achievement of the MDGs. The voluntary basis of this Statement does not endanger its effectiveness, because OECD members have agreed to report transactions with IDA-only countries supported by ECAs and to review them on an annual basis. Peer reviews are an effective tool to achieve satisfactory levels of compliance to rules designed to ensure sustainable development for LICs and a level-playing field among lenders (or at least a significant number of important lenders), without having to make the rules compulsory.

Following this same approach the proposal discussed at the OECD intends to build a wide consensus among member countries and non-member countries around the following principles: a) members will provide support for non-concessional credits only in so far that this will allow borrowers to continue to meet the concessionality requirements of the IMF and IDA or, for those LICs without concessionality requirements, this will be consistent with the country-specific DSAs conducted within the DSF; b) transactions involving a public or publicly guaranteed buyer are in line with the country's borrowing and development plans as defined according to national legislation.

These basic principles would target the transactions with 67 borrowing LICs. We think it is extremely important that these principles were operationalized not only by ECAs in OECD Countries, but also adopted and operationalized by the Major Emerging Economies. We were very favourably impressed by the presentation and positive role played by the representatives of South Africa's ECA (ECIC) at the OECD, considering that a large share of ECIC exposure is with LICs in Sub-saharan Africa, such as neighbouring Mozambique.

But we have also sincerely welcomed the expression of interest and appreciation by the "outreach" countries Brazil, China, India for the basic principles of sustainable lending, elaborated by the OECD/ECG. I think this positive approach to sustainable lending can be understood also looking at the figures presented at the OECD by the Chinese and Indian ECAs. After Asia, which is obviously its larger market, SINOSURE's liabilities are 29,4% with Africa and 13% with Latin America (compared with only 8,7% with Europe). A large share of Exim India's business is also in Africa. I see here a common interest of OECD Countries and "outreach" Countries to ensure that LICs preserve their capacity to service orderly foreign debt. This is a good base to pursue the dialogue on principles and guidelines for sustainable lending.

Panel 3

Orderly debt settlements

Panel on orderly debt settlements: summary of panel discussion

Moderator: Mr. Carlos Pólit Faggioni, Comptroller General, Ecuador

Panelists: Mr. Thomas Courbe, Secretary General, Paris Club.
Mr. Kunibert Raffer, Associate Professor, University of Vienna, Austria
Mr. Lee C. Buchheit, Partner, Cleary, Gottlieb, Steen & Hamilton, USA

This panel explored the feasibility of alternative, but formalized debt settlement procedures (other than the Paris Club and the failed SDRM). Several alternatives have been proposed by various academics, some of whom presented their views. In the context of alternative debt settlements it is also pertinent to consider the role of the national supreme audit office, in particular because any type of settlement potentially will involve debts of an odious character. Consequently, is there room for an independent debt settlement body? And, would it have a chance of being effective?

Prof. Raffer's main thesis was that the impossibility for setting up a solid international insolvency procedure has led people to look for other solutions. Argentina's successful unilateral offer to its creditors, Nigeria's extremely special treatment by the Paris Club and Ecuador, which for the first time now has a process of screening its debt according to its legal status are just view examples for this. The latter is a first attempt to not only screen with reference to the correct accounting but toward the legal foundation of the debts. However, Prof. Raffer pointed out that all these solutions are at best second bests, as the first best solution remains blocked by the international community.

Creditor litigation is a main issue at the moment. Legally, claims remain valid and creditors just try to enforce their rights. Moreover, there is no insolvency procedure which would avoid continuation of such claims. The problem with recent claims from vulture funds is that they were not restricted by public creditors at all. Instead of showing disgust, public creditors should provide a legal framework under which such litigation would not be possible anymore. In addition, the Paris Club violates other creditors' basic rights, as the debtor has to go to non-Paris Club members asking for debt relief at same rates as agreed upon in Paris Club reschedulings.

The general discussion on debt over the years has moved from unpayable (e.g. Jubilee 2000) to the question of odiousness/illegitimacy. Illegitimacy, however, is a difficult term and there are many definitions circulating at the moment. Basically two types exist: Illegal debts and those that fulfil legal standards but which's existence or servicing violates socially established norms.

To give one example, chapter 11, title 11 USC of US railways shows that if there is some public interest and benefit employed by some service, the haircut for creditors can be larger than otherwise common. There is no reason why this could not be considered also for cases in which child mortality is affected.

By highlighting numerical examples on how losses between creditors and debtors in terms of debt workouts could be shared, two cases are considered: One in which all creditors are equal and one in which IFIs are preferred. In fact the IMF statute does not give the institution a preferred creditor status and also in the IDA statute it is explicitly mentioned that in times of distress, IDA as a lender might lose some of its money. However, this has never been executed.

In his last point, Prof. Raffer tackled the issue on getting insured against losses and how to stabilize financial markets cheaply and effectively. One way for the creditor is to build up reserves for the case of unpayable debts. The costs of such insurance can actually be quite low. However, whatever partial solutions one might look at, a proper solvency procedure is what the international community should aim at.

Mr. Buchheit was talking about the legal framework for sovereign debt workouts, with a focus on the current framework rather than normatively looking at a potential other framework to come. There are several procedures for commercial claims against sovereign borrowers and bilateral claims. For commercial claims, such as loans, bonds, trade finance facilities etc, one can say that they are different but share common features. For instance the legal enforcement of those claims will be typically found in a national court in New York or England nowadays. To that end, these claims contain a trilogy of clauses that permit the creditor to go to these courts. These clauses are (1) consent that loan contract be governed by the law of England of New York, (2) an agreement to the submission to the jurisdiction, (3) waiver of any sovereign immunity.

The idea that private creditors can sue foreign sovereigns in the courts of New York or England is relatively recent. The US law that permits this restricted sovereign immunity is only 31 years old, the UK law only 29 years. Prior to that, diplomatic interventions were the only way of dealing with such instances. With reference to bilateral debts, these are not really enforceable under domestic law, but only by the Paris Club or diplomatic means.

If a country is unable to repay its debts, the workout is similarly different for commercial and bilateral debts. For commercial debt, court enforcement often does not work out, so the rule has often no practical significance. Domestic judges apply some "pedestrian" body of law, as they are not permitted to take into account any geopolitical contexts. What usually happens is a discussion between creditors and the respective sovereign and the sovereign provides an offer, e.g. to exchange existing debt with new instruments with some kind of debt relief involved. No creditor, however, has to accept such an offer. What is absent in this process, is the ability to force non-participating creditors to participate in this process. The inevitable consequence of this process is that there remains a residuum of creditors who decline the offer of the sovereign. These cases are then tackled in national courts, and this is what we talk about when facing most vulture funds or creditor holdouts.

Bilateral workouts are chiefly executed in the Paris Club reschedulings, non Paris Club members are approached individually, while comparability of treatment is asked for. It is notable that both ways of proceeding are consensual. The question remains, how these two different approaches and processes can be unified or at least coordinated in the future and how the inherent asymmetry between Paris Club treatments and private creditors' involvement can be overcome.

Paris Club's role in orderly debt settlements

Thomas Courbe
Secretary General, Paris Club

1- Paris Club's approach to sovereign debt settlements

What is the Paris Club?

- 50 years of debt treatment;
- An informal group of 19 creditor countries;
- Participation of IMF and World Bank to all meetings;
- Debts treated : public or publicly guaranteed debts; and
- Flow and stock treatments.

Principles

- Consensus of participating creditors;
- Solidarity between creditors;
- Conditionality: no debt treatment without an IMF agreement;
- Case-by-case approach;
- Comparability of treatment asked from non-Paris Club creditors.

Standard debt treatments

Terms	Classic	Houston (1990)		Naples (1994)		Cologne (1999)	
Nature of claims	Rescheduling only (typical profile: 10 years of payment including 5 years of grace period)	NODA	ODA	NODA	ODA	NODA	ODA
Cancellation rate		-	-	67%	-	90%	
Payment profile		18 years	20 yrs	23 yrs	40 yrs	23 yrs	40 yrs
Grace period		5 years	10 yrs	6 yrs	16 yrs	6 yrs	16 yrs

HIPC initiative

- The Paris Club is the only group of creditors to have provided all expected debt relief.
- All members of Paris Club go beyond the requirements of HIPC and provide additional bilateral debt relief.
- Since January 2007, 4 new Agreements were concluded in the framework of the HIPC initiative.

Levels of debt relief for HIPCs (figures for post-completion point)

- Paris Club debt treatments in the framework of the HIPC initiative: 10.7 billion dollars (NPV 2006.)
- Additional bilateral efforts from Paris Club creditors: 7 billion dollars (NPV 2006).
- MDRI. : 37.6 billion dollars (in nominal terms).

Evian approach

- The Evian approach was launched in 2003.
- It extends debt sustainability analyses to debt treatments of non-HIPC countries.
- The debt sustainability of the debtor country is assessed before the negotiation on the basis of the IMF DSA.
- The principle of case-by-case treatment is central to the Evian approach.

Countries have been treated under the Evian approach so far

- Sustainable cases:
  - Kenya (January 2004);
  - Dominican Republic (April 2004); and
  - Moldova (May 2006).
- Unsustainable cases

- Iraq (November 2004)
- Kyrgyz Rep. (March 2005)

- Sustainable cases with goodwill clauses:
  - Gabon (June 2004);
  - Georgia (July 2004);
  - Grenada (May 2006).

2 – New challenges for debt settlements and debt sustainability

New challenges

- Ensure the full delivery of HIPC debt relief;
- Contribute to debtor countries active debt management operations;
- Increase inter-creditor coordination;
- Promote debt sustainability.

Full delivery of HIPC debt relief

- Comparability of treatment is crucial:
  - for creditors (fairness);
  - for the debtor (benefit of treatment is greater).
- Specific problems in the HIPC initiative:
  - no debt relief from some bilateral creditors non members of the Paris Club and some private creditors;
  - litigating creditors.
- Paris Club reactions.

Active debt management

- Better financial situation in emerging countries => early repayments
- 2 methods:
  - Prepayment at par;
  - Buyback at market value
- 4 early repayments this year: Macedonia, Peru, Gabon and Jordan

Paris Club creditors look forward increased inter-creditor coordination

- Paris Club creditors acknowledge:
  - the rising role of private creditors as the major creditor
  - the role of other important bilateral creditors
- Paris Club creditors already have regular contacts with representatives of the private sector
- Some non Paris Club creditors participate regularly to Paris Club negotiations.
- A further dialogue is needed with other emerging lenders.

The Paris Club supports the prevention of unsustainable debt situations

- Paris Club knows by experience that a new debt crisis would be very costly for creditors and for debtors.
- Responsible lending and borrowing policies are the only ways to prevent a new debt crisis.
- Paris Club members support the DSF as a common reference for all creditors.
- The Paris Club encourages HIPC countries to adopt commitments regarding responsible borrowing after completion point/MDRI.

Audio transcript:

I will briefly recall Paris Club's recent experience and achievements and then present what we feel are the main challenges the Paris Club is facing in the near future. As you know the Paris Club is part of an embryonic and informal international system which the IMF plays an important role but has no enforcement powers. And in which the Paris Club together with bilateral creditors together with other creditors grant debt relief and debt treatments on a purely voluntary basis. Very basically, the Paris Club negotiates debt treatments covering the financing gap identified by the IMF to sum it up. Since 1956 the Paris Club creditors have negotiated over 400 agreements with over 80 countries for a total amount of debt of over $500 billion.

There are representatives of the IMF and World Bank to all meetings and in our view since almost all countries are members of the IMF and World Bank this participation to all meetings is a guarantee of transparency. Today Paris Club treatments fall under two main frameworks which are the HIPC initiative and the Evian approach. Today the Paris Club is the only group of creditors which have provided all expected debt relief within the HIPC initiative. And in addition to the debt relief expected in the initiative, all Paris Club creditors have granted additional bilateral debt relief. And the Paris Club grants debt treatments to HIPC countries at each stage in the initiative and for example this year four agreements were signed: with two countries having reached decision point of the HIPC initiative (the Central African Republic and Afghanistan) and two countries having reached completion point (Sao Tome and Sierra Leone).

If we focus on the 22 countries that have reached completion point they have received from Paris Club creditors more than $10.7 billion in debt relief within the HIPC initiative and around $7 billion in additional bilateral debt relief. And in addition to these post completion point countries, the ten countries that are in the interim period, between decision and completion point, Paris Club creditors have committed to grant at least $6 billion. The other main framework for debt treatments is the Evian approach which is dedicated to debt treatments for non HIPC countries. It was designed in 2003 to meet the requirements of these countries. And it takes into account debt sustainability considerations. The aim is to tailor the debt treatments that are granted to the very specific needs of the given country. And the Evian approach also tries to further coordination with private creditors which is a main challenge and I will come back to this later.

The framework of the Evian approach is used in two kinds of treatment. When the debt is deemed sustainable the country can receive traditional debt treatment and debt relief. And if the debt is deemed unsustainable, the country can be granted an exit treatment that can include debt stock cancellation so that it can exit from the Paris Club.

You have here the examples of (slide) the 8 countries treated under the (Evian) approach since 2003.

I would like to focus now on what we feel are the main challenges the Paris Club is facing for the future considering the evolution of sovereign financing. We feel there are four main challenges. The first as I have pointed out the Paris Club creditors play an important role in the HIPC initiative and clearly the fact that all HIPC countries can benefit from the full effect of the initiative is a priority for the Paris Club. Another important task for the Paris Club in the coming years is to allow emerging countries to implement the most appropriate actions for debt management including through early repayments. Another important issue is that we usually call Paris Club creditors traditional creditors and one major challenge of the Club is to enhance and increase its coordination with new lenders in particular with emerging economies. And finally Paris Club members, tax payers have made huge financial efforts to solve the debt crises of the 80s and the 90s and as a consequence maintaining long term debt sustainability of low income countries is a priority. Regarding the full delivery of HIPC debt relief, as with other types of debt treatments non-Paris Club creditors are expected to provide debt treatment comparable with the one granted by the Paris Club and it is especially crucial for HIPC countries because when a HIPC country reaches completion point it is supposed to have restored debt sustainability situation through debt relief that is shared by all creditors. And today as you know some bilateral non Paris Club creditors and some private creditors do not provide their share in the HIPC initiative and this is of course unfair to debtors and a big issue for Paris Club creditors who have already provided their efforts. Another significant issue regarding HIPC is aggressive litigation against HIPC countries. Just to give two figures. Aggressive litigators against HIPC countries have already been awarded 1 billion$ by the court whereas in the framework of the HIPC imitative, the private creditors are expected to grant debt relief amounting to 1.5 (billion) $ so the amount awarded to litigating creditors is very significant and Paris Club creditors have decided to try to implement measures to go against litigation against HIPCs. Among these measures, Paris Club creditors are committed not to sell their claims on HIPC countries to creditors that would not commit to provide HIPC debt treatment and they have also decided to implement measures to help HIPC countries assess the comparability of debt offers made by non-Paris Club creditors and to generally speaking to give better information on this issue to all players.

As you know several emerging countries are now able to use their resources or bond issues to repay their Paris Club creditors with obvious economic and even political benefits. Generally speaking, Paris Club creditors support these kinds of offer and strategies. And they have created a general framework with prepayment at par or buy back at market values. So two possible operations for repayment of debt. As pointed out, these operations are different from traditional debt relief since they are voluntary operations. All Paris Club creditors are free to participate or not to the offer made by the debtor country to repay its debt. But experience shows that there is usually a high level of participation of Paris Club creditors to this offer and this year we have signed four agreements. Macedonia and Peru for prepayment of par and Gabon and Jordan for buy back at market value.

As I mentioned previously, an important challenge is the coordination with non Paris Club creditors. As you know, the evolution in the financing markets have come to the situation where bilateral loans by Paris Club creditors represent a much lower part of financing sources for low and middle income countries. Obviously, private creditors – in particular bond holders – and new bilateral creditors – in particular emerging countries – are playing a much more important role than in the past. We acknowledge that. Basically, our relation with these creditors is done through the comparability of treatment principle but there is also a will to strengthen relationship with private creditors. There is already an annual meeting and frequent contacts. Regarding bilateral creditors, some bilateral creditors are already taking part in many Paris Club negotiations such as Brazil, (South) Korea or Israel. And there is also a will to enhance dialogue with new lenders that do not wish to take part in Paris Club negotiations but which have become very significant lenders to low-income countries. And with which we want to enhance and further dialogue.

Finally, Paris Club creditors have agreed with these new emerging lenders that (…) low income countries have very significant financing needs that cannot be covered only by grants and that require new loans. The main idea is that these new loans should be made consistently with what we consider is the main international framework and reference for low income countries' new debt which is the debt sustainability framework. Once again, the international community has decided that a huge financial effort is needed to guarantee that HIPC countries can come back to a sustainable debt situation and we feel that following the guidelines of the DSF if necessary – of an improved DSF –as it was mentioned previously- is an important guideline to prevent new debt crises for these countries.

Structured international debt settlements (SIDS): insolvency vs. contested claims

Kunibert Raffer
Associate Professor, University of Vienna

After the IMF's proposal of a Sovereign Debt Restructuring Mechanism (SDRM) was voted down, the discussion moved away from orderly restructuring of sovereign debt towards analysing the moral and legal foundations of claims, and categorising types of debts, as well as discussing litigation by private creditors. This evolution only occurred because no sovereign insolvency procedure exists. Concepts such as odious debts were revived, new ones, such as criminal or illegitimate debts, or abusive credits have been explored. This evolution should not come as a surprise. Advocating the emulation of US municipal insolvency, I mentioned early on that fair insolvency mechanisms are likely to avoid such discussions: "The fact that fault is not discussed (unless criminal acts have been committed), but the procedure instead sticks to restoring economic viability, may also be appealing." (Raffer 1990, p.310) Appa-rently, it was not appealing enough to creditors. Now they are confronted with close scrutiny of why and how credits were granted. Multilateral claims of being preferred creditors were investigated and found to be without base (cf. Raffer 2004, 2005a, 2007a, 2007b).

Left without a mechanism to solve their problem, over-indebted countries had to seek practical solutions. One example is Argentina's unilateral debt reduction, which may be seen as a return to the pre-WWII scenario where countries often simply discontinued paying, finally either reaching an agreement with their creditors or their acquiescence to losses. Argentina did not turn to the Bretton Woods Institutions (BWIs) that had been unable over decades to provide appropriate solutions. In the case of Iraq strong US interest forced other creditors to grant exceptional reductions. The US even revived its odious debts doctrine, before it realised how welcome that was to debt campaigners.

Politically, Argentina, Nigeria, and Ecuador document a new assertiveness of debtors forced to find a viable solution. Less than two years after her default, Argentina presented a first offer to her bondholders, which was modified somewhat in 2004. In 2005 the government announced that the acceptance of its offer had reached 76.15% of the debt in default. The haircut was roughly 70% (Helleiner 2005, p.959). Taking the amounts exchanged into account (without holdouts) sceptics calculate a much smaller overall reduction, predicting that this haircut – once again suffered by only one class of creditors – will in the end be insufficient. \$62.3 billion of old bonds were exchanged for about \$35.3 billion dollars of new instruments plus the corresponding GDP growth-linked coupons. A substantial percentage of bondholders did not accept, organising themselves into bondholders' associations, without recovering, however, anything so far. The neoliberal privatisation drive now protects Argentina. There is practically nothing left to attach.

Argentina's successful recovery and her growth rates after debt reduction, also illustrate how much better fair insolvency procedures would have been for creditors. It would have been possible to combine generous relief helping Argentina to recover quickly with contingency clauses allowing creditors to participate more fully in the recovery they would have made possible, thus recovering more in the end. This solution would have been better for both Argentina and her creditors. One can only second the UN Secretary General (2007, pp.26f):

> "The debt restructuring exercise in Argentina in 2002 demonstrated again the need for a fair, transparent and orderly process for sovereign debt restructuring.
>
> … The international financial system is incomplete and insecure without a sovereign debt workout mechanism and a new effort needs to be launched in this regard."

A resolution by Nigeria's House of Representatives calling on the President to repudiate Nigeria's external debt on the grounds that they were odious and illegitimate seems to be the reason for Nigeria's treatment by bilateral creditors.

Legislators also sent a team to Europe to canvass debt cancellation in the continent's leading financial centres. The mover of the resolution to repudiate debt was present in Paris when Nigeria negotiated. The decision by creditors may well have had the intention to quell any public discussion initiated by a debtor nation and backed by parliament, even though the Nigerian Senate later voted in favour of ho-nouring debt servicing for that year. Nigeria had chosen not to have a programme with the IMF, following her own economic reforms called NEEDS (National Economic Empowerment and Development Strategy) instead. This was serious, once again challenging the IMF's rule over debtors. It led to the invention of a totally new IMF-instrument, called the Policy Support Instrument (PSI) allowing Nigeria ample policy space. Considering that even Iraq had to sign an IMF programme, this is path-breaking.

Finally, Ecuador decided to have all claims vetted by a debt audit commission to investigate the country's debt burden with foreign creditors on a loan-by-loan basis. The commission was asked to look into legal questions, financial terms and conditions, and any social and/or environmental impacts which may have resulted from the loan, and to report its recommendations to the government. The point now is not whether Ecuador can pay but whether Ecuador should pay. Checking loans as such is not new. Over two decades ago, Costa Rica saved almost 10% of the interest in arrears by verifying past-due interest claimed by banks loan-by-loan. But then, it was checked whether calculations were correct, now the legal title is checked. This is a quantum leap, whatever the results may be.

All these evolutions would not have taken place if a viable and fair solution had been implemented early on. In a way, they are substitutes to a fair sovereign insolvency procedure. Economic facts assert themselves. What cannot be paid must go unpaid. The only question is how losses are distributed. In this respect, discussing the legal base of claims is helpful, because it protects *bona fide* creditors.

This paper will discuss the following issues on which present discussion focuses

- creditor litigation
- illegitimate debts
- intra-creditor distribution of losses in the cases of insolvency and contested claims
- derivates, such as credit default swaps that attempt to attenuate risk

Creditor litigation

Official creditors have steadfastly opposed fair procedures granting all legally interested parties their full rights, especially the right to defend their interests. The Paris Club expects private and non-Paris-Club creditors to implement the Club's decisions - to grant "comparable treatment" - although they had no say and were not even heard. Unsurprisingly, this has produced a wave of litigation. Cases of bilateral creditors selling their claims to commercial creditors are extraordinary examples of double standards. Created by official creditors not providing a proper legal mechanism, the litigation problem has increasingly caught public attention: "Commercial creditors' lawsuits against HIPCs present a growing challenge to the implementation of the HIPC Initiative." (IDA & IMF 2007, p.6) Concern has also been expressed by the UK, the G8, and the Paris Club, without, however, any real action taken.

Eventually, the Paris Club (2007a) suggested contractual changes restricting the right to sell claims, as well as "small amendments to national legislation" banning lawsuits. This is good, could be implemented easily, but may not even be necessary. "With nary a peep from the markets" Iraq's prime assets were put outside creditors' reach, "the most controversial early aspiration of the IMF's Sovereign Debt Restructuring Mechanism (SDRM), shelved just weeks before" (Gelpern 2005, p.396) was implemented. Its most hotly debated element, a stay on lawsuits, was simply implemented at the stroke of a pen, without discussion or resistance. The New York third district court refused to grant attachments against Argentina, arguing that this would disrupt negotiations with other creditors after the US government had presented an *amicus curiae* brief supporting Argentina's request for a stay to all enforcement. In Allied Bank International v. Banco Credito Agricola de Cartago, Costa Rica had been granted insolvency protection, which was withdrawn after the US executive branch clarified as *amicus curiae* that supporting Costa Rica was not U.S. policy. Apparently, stopping lawsuits is as easy as speaking out "in disgust at the recent actions of so-called 'vulture funds'" (Paris Club 2007a). Paris Club members have just chosen not to do it.

The wording of this declaration also invites questions: "Paris Club creditors confirm that they are committed to avoid selling their claims on HIPC countries to other creditors who do not intend to provide debt relief under the HIPC initiative, and urge other creditors to follow suit." (*ibid*.) Literally that means that selling to such "other creditors" is not definitely excluded.

It need be recalled that not only so-called "vultures" have litigated. Original creditors have also sued for fulfillment (cf. IDA & IMF 2007, p.105). They were unjustly and unjustifiedly denied their basic right of participating in a procedure affecting their claims, in other words they simply were expropriated by decisions of public servants meeting in secrecy in Paris. Even if they had in principle been prepared to grant the same reduction – both in absolute and relative terms the private sector has granted more relief so far than several important official creditors – it seems understandable that the disrespect of official creditors for the Rule of Law may well have made some original creditors determined to insist on stipulated amounts. After all, *pacta sunt servanda*, but may be changed by negotiated settlements or laws. Laws may terminate, modify, or permit a party to terminate or modify contracts, explicitly allowing unilateral changes of contractual rights (cf. Raffer 2007b). Although honouring contracts is a fundamental legal, economic, and ethical principle, all legal systems recognise circumstances where contractual rights can no longer be enforced, or indeed cease to exist. But this is stipulated by laws, not enforced by dubious administrative fiat.

Furthermore, the weakest actor, the debtor, is told to gain comparable treatment from excluded creditors, whose rights have just been violated. Should a recalcitrant creditor take debtors to court in a Paris Club member country, debtors will not be protected by this creditor country but lose the case. Putting an end to such absurdities and injustice is in the best interest of all *bona fide* creditors and the debtor. Unfortunately, official creditors are so busily preaching the Rule of Law to others that they have no time left to apply it themselves.

Ten of the 44 cases of litigation listed by IDA & IMF (2007, p. 32; p.105) were filed in courts in the HIPCs themselves. Barring miscarriage of justice, creditors are bound to win, although not necessarily the whole amount sued for. Put in a nutshell: "Given the voluntary nature of the HIPC Initiative, creditors do not have a legally binding obligation to participate in the Initiative." (*ibid*., p.32) Claims continue to exist unchanged unless all creditors agree "voluntarily" to what others have decided.

Of these 44 cases eight, nearly one fifth, were "in arbitration" (including one case at ICSID that was dropped). This underlines that even litigating creditors – *the* pariah group at the moment – are prepared to accept fair arbitration, unlike official creditors torpedoing the very foundation of any legal system that no one must be allowed to be judge in their own case. They have done anything they could to avoid giving up their present dominating role in debt management by agreeing to arbitration on sovereign debts.

The second and more prominent group of litigating creditors (so-called "vultures") buy claims at discounts to sue for their full values. As moral issues have received ample attention, this paper wants to recall boring facts, whose clarification is nevertheless helpful:

- the purely legal characteristic of such claims, and
- the fundamental difference between private creditors subject to laws and official creditors making the laws and obliged to defend decent legal and appropriate economic principles.

Purely legally, vultures exercise their rights in a way no different from what happens every day in practically any country. More risk-averse creditors sell their claims at a discount, and new owners try to get full repayment. Once insolvency proceedings start, which recognizes that full payment to all *bona fide* creditors is or may be impossible, an automatic stay of individual lawsuits occurs. Municipal laws provide this appropriate mechanism safeguarding fairness to anyone affected. Whenever the right of creditors to payments (*pacta sunt servanda*) collides with the principle recognised generally (not only in the case of debts) by all civilised legal systems that fulfilment must not be enforced at the cost of inhuman distress, of violating human rights and human dignity. Human rights enjoy unconditional priority. In contrast to present attempts of making litigators not use their right, this is a proper and fair solution. Any creditor is party, and can influence the outcome. No one is forced to accept what has been decided without their participation. With good reason, municipal laws do not rely on codes of good conduct or moral suasion, hoping that no creditor would try to enforce claims that legally continue to exist and remain enforceable, because of moral considerations. If ethics, morals or expressing "disgust" sufficed, laws would not be needed.

Unfortunately, regarding Southern sovereigns precisely this is propagated as the solution, apparently to avoid a neutral decision maker. The Chancellor of the Exchequer's (Treasury 2007) answer to Parliament puts present official attitudes in a nutshell. Deploring vulture activities, he called himself "determined to limit the damage done by such funds". However, a "voluntary code of conduct", a "Charter on Responsible Lending that includes a commitment to protect developing countries from vulture fund activity" produced by the G8, or to "continue to strengthen debt management capacity amongst HIPCs" will not solve the problem. Those called "responsible creditors" by the Chancellor (presumably those not litigating) have accepted the decisions of the Paris Club, and are likely to continue to do so. For them, such code is basically unnecessary, unless they change their attitude. Those choosing litigation – be they original creditors or "vultures" – are not bound and will presumably not change their behaviour. Why should a method obviously inadequate in all municipal laws work internationally?

More money for IDA's Debt Reduction Facility, to "help countries to eliminate their commercial debts at the earliest possible opportunity" may indeed "reduce the likelihood of debts being sold on to aggressive creditors", but may well raise expectations, thus inducing creditors to demand higher percentages or full repayment. For HIPCs, official creditors participating in the initiative could no doubt cover these claims even if buy-back prices went up. Legal assistance to HIPCs is definitely helpful, but does not eliminate the problem. Legally, these claims remain valid and enforceable – with or without legal assistance.

Not all countries rely on words, though. In June 2006, for example, a bill was tabled in the French Assemblée Nationale, aiming at making lawsuits by vultures more difficult in France. It would give French judges discretional powers to take the efforts of other creditors to provide any debt relief and the debtor's capacities into consideration. "The text is certainly not as strong as it could be and has not yet become law in France but such measures are welcome and are definitely a step in the right direction." (Paris Club 2007a).

The question remains unanswered why official creditors deny an appropriate and efficient mechanism that would abolish this problem, as well as the Rule of Law, to the South, clinging so fervently to being judge and jury in their own cause. It need be mentioned that this is exclusively done in the case of Southern sovereign debtors. Germany's London Accord stipulated arbitration between Germany and its creditors. In fact, my proposal in 1987 to use arbitration rather than national courts was inspired by the German case (Raffer 1989). Again, what's good for the goose is apparently not considered good for the gander by geese themselves.

No government would even dream of behaving in this way when it comes to firms or individuals delinquent in debt service due to them. Most naturally, courts would have the power to decide and to protect debtors. Creditor governments would simply sue and accept court verdicts. Internationally, there is one law for the rich and another one for the poor. There is no logical nor economic justification for this discrimination of debtors. Sadly, it is still highly preferable to live "on right (and mostly white) side of the North-South divide." (Raffer 1990, p.303)

Odious, illegitimate, illegal or legal debts and insolvency

Founded in 1996, the platform Jubilee 2000 UK demanded the cancellation of unpayable debts. Determining these debts, or the capacity of debtors to pay, was to be done by independent arbitration. As the IBRD (2007, p.17) subsumes unpayable debts under "other categories of odious debts" - completely at odds with logic, truth, and the English language – it must be clarified that "unpayable" states a mere fact without any judgement. It has nothing to do with legal questions, simply stating that penniless debtors cannot cough up a penny, irrespective of legal bases or titles of claims. Absolutely legitimate and legal claims may also be irrecoverable. "Unpayable" has nothing to do with "odious".

The same goes for "unsustainable", also subsumed under "odious" by the IBRD, although it equally describes an economic impossibility, not any judgement on the legal base of claims.

Jubilee 2000 UK described my insolvency proposal emulating Chapter 9 US municipal bankruptcy without using the word insolvency still considered too revolutionary by quite a few participating nongovernmental organizations (NGOs). Worldwide, many NGOs have campaigned for this fair and transparent arbitration process, also known by its acronym FTAP. The intransigence of official creditors blocking the emulation of insolvency induced people to look into the legal and moral bases of debts.

Doubtlessly, the revival of the concept of odious debts by the US administration to argue in favour of post-invasion Iraq encouraged NGOs not only to look into odiousness, but also to check whether other criteria applied, when scrutinising debts. Once the US realised what boost it given to debt campaigners, the administration started to back-pedal vigorously. The damage was done, though. It could only be limited by shunning the very word odious. Meanwhile, NGOs have brought forward an array of arguments why certain types of debts should not be honoured – not always arguing as stringently as appropriate, though - as well as an equally impressive array of expressions and concepts. In January 2007 Mitu Gulati organised the first academic Conference on odious debts at Duke University.

Noting a "major shift" away from odious loans towards odious regimes, Buchheit, Gulati & Thompson (2006) highlight the problem: who would paint the scarlet "O" on regimes. Skeptical about appropriateness and workability of defining "odious", the authors

> "investigate how far principles of private (domestic) law could be used to shield a successor government from the legal enforcement of a debt incurred by a prior regime under irregular circumstances … establishing defenses to the legal enforcement of certain of those claims based on well-recognized principles of domestic law may be the more prudent path. The authors believe that such defenses exist under U.S. law (and presumably elsewhere) and could be used to address many, although admittedly not all, cases of allegedly odious debts."
>
> (*ibid.*)

Raffer (2004) similarly focuses on municipal laws and generally recognized legal principles.

In 2005, Norway's Government (2005a) explicitly expressed the intention to support arbitration on illegitimate debts, and to "adopt an even more offensive position in the international work to reduce the debt burden of poor countries. The UN must establish criteria for what can be characterized as illegitimate debt, and such debt must be cancelled". The government firmly opposes undue conditionality regarding privatisation, thus economically unfounded links between debt relief and policy. Norway "will support the work to set up an international debt settlement court that will hear matters concerning illegitimate debt". As "debt settlement" can be understood as "payment" (OED) or "adjustment or accord reached, as in financial matters" (Webster's), but also "deal effectively with, dispose or get rid of" (OED), it should be mentioned that the original formulates clearly that such debts should be dealt with (Norwegian Government 2005b). This, the clear demand for cancelling illegitimate debts, and the financing of expertises on the legal bases of debts make Norway's intentions absolutely clear. Norway has adopted a highly pro-active role in international efforts to reduce the debt burden of poor countries. She also triggered two expertises on the legal foundation of claims that, unfortunately, did not go beyond the concept of odious debt (Howse 2007; IBRD 2007). However, Howse (2007, p.10) seconds Buchheit, Gulati & Thompson (2006) and Raffer (2004), recalling "a rich case law in the common law world concerning the limits of contractual freedom, whereby contractual obligations have been found unenforceable or partly enforceable." He points out that this has "not prevented the growth of sophisticated and well-functioning financial markets." Howse (2007, p.9) also emphasizes that, "despite frequent incantations to that effect by commentators and creditors, there is no evidence of general international law establishing the sanctity" of "state contracts with private creditors". He draws attention to agency law placing "duty of diligence on a third party or creditor in ascertaining whether an agent (the debtor State) is exceeding its authority" derived from its principal, the population (cf. also Buchheit *et al*. 2006) By contrast, the IBRD (2007) rather detracts from the discussion by debatable and wrong formulations than contributing to it.

On 2 October 2006 Norway announced the cancellation of claims to five countries, deriving from her Ship Export Campaign (1976-80), which the government classified as a "development policy failure" (Utenriksdepartment 2006, p.219). Cancellation is unilateral and according to the government's press release unconditional, although the annex specifies conditions in some cases. A shared responsibility of creditors for these debts is recognised. For the first time a creditor government explicitly recognised part of its claims as improper and acted upon that conclusion. Unlike routine with other OECD-donors, Norway will not record this money as ODA. It is additional to normal aid. Although the government itself did not use the word "illegitimate", Norwegian NGOs in particular saw this as a result of their lobbying to cancel illegitimate debts. The budget proposal for 2007 clarified, however, that illegitimacy was not the reason for debt relief: "There is also no base for characterising these debts as 'illegitimate' in the legal sense." (*ibid*.) Thus, Norway did not set a precedent. Norway's very laudable attitude is sadly missing with all other official creditors that have steadfastly refused to apply even generally recognized legal standards and principles to the South so far.

The government conceded that other Paris Club members could interpret its unilateral relief as a breach of the "solidarity principle" (economically: cartel rules). But Norway considered her responsibility as a creditor more important than the creditor cartel's sacred rule not to give more than the stingiest. Nevertheless, she assured that this would be one single exception, and that any future relief would be effected via multilaterally co-ordinated operations (*ibid*.) Thus, no definite step away from Norway's earlier position in her *Debtplan* occurred: "Efforts will be made to cancel the rest in a way that ensures the greatest possible development effect, insofar as this is possible within internationally recognized rules." (Ministry 2004, p.13) Obviously, Norway does not plan to exercise the basic right of any creditor simply to renounce all rights to debt service because the claim is uniquely her property. Future decisions will again depend on whether the BWIs and the (legally not existing) Paris Club condone such reductions.

Legally and economically, this means that co-responsibility, as understood by Norway, reduces these debts, but does not cancel them totally. This may contradict the demands of quite a few NGOs, but is perfectly in line with Norway's own debt strategy stating that "rich countries clearly have a responsibility for helping to relieve the debt burden, but the critics have often omitted to point out the responsibility of governments and elites in poor countries for their own populations." (Ministry 2004, p.17) This may be understood in the way that debtor governments, too, have to shoulder their part of responsibility.

Defining illegitimacy

Encouraged by Norway's example, one should elaborate a more precise definition of what constitutes illegitimacy. Some form of creditor co-responsibility, as argued by Norway, can serve as the basis to do so. Once a meaningful international insolvency procedure for sovereigns exists, this would, however, no longer be as urgent a task for debtors as it is at present.

Unfortunately, the word illegitimate seems to have invited much more creativity than precision so far. Considering the use of the word illegitimate by campaigning NGOs, the Norwegian government had quite understandably a problem when surveying how illegitimate debts had been defined (Ministry 2004, pp.18ff). If all criteria suggested were accepted, to advocate cancelling illegitimate debt may easily be seen as a recommendation to cancel all developing countries' debt. The Ministry's conclusion: "This can hardly be regarded as either appropriate or desirable" – supported by the fact that some NGOs indeed demand the canecallation of all Southern sovereign debts – is perfectly right. One must define the term in a meaningful way, to circumscribe what, precisely, is to be understood by illegitimate debts in order to see how such debts should be treated if accepted legal norms prevailed – unlike they have done so far in the case of Southern sovereign debts. Very broad definitions covering virtually any Southern debts are inoperational, unhelpful, and unfair. Examples are basing illegitimacy on changes in world market interest rates, "loans that should have been grants", or where terms of lending "ultimately increase the cost of the debt, such as dollar convertibility in Argentina, even *if they are accepted by the elected government*." (Hanlon 2006, p.126, stress added) Such criteria strictly applied would make a loan that is not illegitimate a rare bird indeed. Furthermore, not even a perfectly legitimate and legally formed government (Hanlon does not speak of dictators) would be allowed to commit the country, *viz.* to do what governments are formed to do. International lending would disappear.

Trying to find a more precise definition I have proposed to separate "illegitimate" into two categories (Raffer 2007b):

- *Type A:illegal debts*, meaning debts whose existence violates the law, basic legal principles or that are legally null and void. It would comprise debts incurred in violation of national laws, of international law, such as in breach of legal obligations or statutes of International Financial Institutions (IFIs), and general universally accepted legal principles, especially debts, whose servicing violates human rights. There is no doubt that debt service that is only possible if human rights are violated, is illegitimate, as the Norwegian NGO SLUG posited. (Kobbeltvedt 2001, p.11). One should note that this is equivalent to insolvency protection of debtors, or what the *FT* (30 July 1992) described as "politically incapable" of meeting sovereign liabilities.

  Simply put, Type A means applying the same standards world-wide and without regard to passports. Debtor protection and creditor duties accepted and common in all civilised legal systems must also be applied to Southern sovereign debts. Creditor duties might go quite far. Bohoslavsky (forthc.) surveyed laws and judicial practice in eight countries establishing creditor liabilities for loose lending in order to extract common principles from national, domestic laws to transform the theory of the responsibility for abusive granting of credit into a general principle of international law, to make it applicable to cases of sovereign insolvency. He argues that such "abusive credits" should also have consequences in international law. This concept holds lenders liable for damages inflicted on other creditors by lending with disregard for the most basic principles of risk evaluation, thus hiding the debtor's real situation and postponing the insolvent lender's crash, thereby increasing other creditors' losses. In particular, French, Belgian, and Italian jurisprudence have developed this concept. Loans granted without following the most elementary prudential guidelines in the analysis of credit risk, attempting by such means to obtain an unfair advantage over previously-existing creditors should be subordinated to those not classified as abusive. Subsequent creditors, in particular those harmed by having been induced to make loans because of abusive lending to a party that could not or would not repay them, could file claims against abusive lenders generating such false appearance. However, this concept is in a very early stage at present. It still needs be made applicable to cases of sovereign insolvency. It illustrates the evolution of the analysis of debts very clearly, though.

- *Type B: debts that might be legal by strictly formal standards, yet whose existence or servicing violates socially established norms*. Often, servicing them can thus not be enforced or even expected - it would be somehow "illogical" to honour them, unless the debtor is a Southern sovereign. To give an illustration: in some European legal systems gambling debts are legally existing (if paid this extincts an obligation and repayment cannot be demanded later) but nevertheless not enforceable (payment cannot be enforced by the winner-creditor) due to moral considerations reflecting societal disapproval of the underlying reason for such debts. The US has even pressured credit-card companies to reject gaming-related transactions because it considers internet gambling illegal. By contrast official creditors have never singled out claims as unenforceable or void on comparable grounds until Norway's action. The principle *ex turpi causa non oritur actio* was turned on its head in the case of Southern debts.

The distinction between types A and B is not always very clear. Legal restrictions that exist in some countries but not in others may arguably be subsumed under B rather than A. Protecting public interest, which may be an important factor in insolvency cases within creditor countries, has not been an issue for official creditors. In the US, e.g., railroad reorganisation (Subchapter IV of Chapter 11, Title 11 USC, section 1165) protects public interest ''in addition to the interests of the debtor, creditors, and equity security holders.'' Section 1170.a.2 permits courts to abandon railway lines if this is ''consistent with the public interest.'' There exists a public interest in the preservation of rail transportation that mandates finding a balance between various interests, which economically means that creditors may have to lose more than without such balancing. The plan can only be confirmed (section 1173.a.4, 11 USC) if consistent with the public interest. No creditor government has shown a similar public interest in avoiding that debt service increases infant mortality within Southern debtor countries.

The British Money Lenders Act of 1900 enabled courts to reopen any money-lending transaction when interest or charges were excessive and the transaction harsh and unconscionable, or otherwise such that courts of equity would give relief. Debtors needed not pay more than what the court thought to be fairly due. This equity consideration is still relevant (cf. also Howse 2007, who includes unjust enrichment and abuse of rights). Courts may and do protect debtors (Raffer 2007b). Such changes of contracts are generally accepted and universally applied, basically because of moral standards of what constitutes fairness in debtor-creditor relations, unless debtors are "Developing Countries".

Type A would for instance include voiding contracts signed by individuals without the authority to sign or signing in violation of a country's constitution, loans where the lender knew or had reason to know that there was fraud (cf. Raffer 1990, p.309). Briefly, civilised legal norms, such as due diligence or tort law would be brought to bear in the case of the last excluded and discriminated debtors (for details, cf. Raffer 2004, 2007b).

Type A definitely includes tort and liability of consultants. Defending advisers, such as itself, the IBRD (2007, p.22) tries to argue against damage compensation. First, it claims that being "responsible for failure would require isolating their advice … and identify it as the sole cause of failure." Obviously, this is wrong, as a quick look at tort law proves. Grave negligence suffices, even if not the sole cause of damage. Even more disingenuous is the assertion: "Second, even if it can be proved that the advisors are responsible for giving poor advice, there is little logic to suggest that this should result necessarily in refusing loan repayments." Unfortunately, no source is quoted. Knowing literature, one may assume that this refers to my work on financial accountability of IFIs, as it echoes Raffer (2004, p.73). If so, the IBRD misinterprets the proposal, which demands paying damage compensation to the borrowing country simply by netting out (deducting compensation from repayment obligations). Obviously, this is not a refusal to pay. The IBRD's view amounts to demanding that consultants should be allowed to inflict any damage with impunity, a grotesquely absurd request. As practice and the very existence of tort laws shows, liability does not at all "prevent the delivery of technical advice." (*ibid*.) If it did, consultants could not offer their services.

Unfortunately, this is not the only passage where the IBRD (2007) is at odds with logic, the truth, or both. Discussing criminal debts, it (*ibid*., pp.18) first misrepresents the concept by referring exclusively to "officials or businessmen" stealing "the original loans to their governments … or where the debt is incurred to rescue an economy ravaged by corruption." Jeffrey Winters, who coined that term, argued that the IBRD did not take proper measures against corruption in Suharto's Indonesia, and continued its lending when it was widely alleged that about a third of all loans would be embezzled. Before the Senate Committee on Foreign Relations Winters (2004, p.1, stress added) explained: "it was a crime *to allow* the development funds to be stolen", clarifying that he refers to "a World Bank supervisory and auditing failure". At a conference at Northwestern University in 1999, IBRD staff objected vigorously, claiming that losses to corruption were lower, 20–25% at most, although over many years of repeated lending (Raffer 2004, p.64). Whether these employees or Winters are right, criminal debts differ strikingly from the IBRD's description. The concept implies that the Bank knew or had reason to know that large amounts of these loans would be embezzled. The IBRD's (2007, p.19) concern that "lenders may know that corruption exists in a country but may not have any concrete knowledge in advance of plans to siphon proceeds from any individual loan" may often be warranted, but definitely not in the case of criminal debts where lender's knowledge is the essential defining feature. Lenders are not to be "held responsible for the alleged corruption" (*ibid*., p.20), but for aiding and abetting proven corruption. The Bank's concern about the moral hazard of "irresponsible behavior by borrowers" (*ibid*., p.22) is misplaced in this connection. Criminal debts tackle the moral hazard of lenders that could reduce embezzlement by simply stopping lending, as would be expected from any commercial bank fully knowing that the CEO would embezzle large parts of the loans officially granted to her corporation.

Norway's wording that "remaining repayments" on her ship export loans would be cancelled, shows that debt service already paid remains unaffected. This recalls the definition of "illegal contract" by the Oxford Dictionary of Law as "totally void, but neither party (unless innocent of the illegality) can recover back any money paid … under it". On the other hand, though, no Norwegian nor borrower country law seems to have been breached, at least this was never mentioned nor claimed to be the reason for cancellation. The word "inadequate" used by Norway may but does not necessarily mean needs analyses done negligently. Thus Norway's claims clearly fall into Type B above, unless lack of due diligence by Norway could be raised, which NGOs presumably would have done. Only remaining payments are waived. Economically, creditor and lender thus share the financial consequences of these loans, both face their responsibilities. However, if illegality had been recognised, there would have be no need for cancelling. These remaining debts would be void. Even if they were seen precisely like gambling debts, debt service could just stop. Logically, no conditions could be attached in both cases, which Norway does although not for all countries. In Myanmar and Sudan cancellations depend on becoming eligible for multilateral debt relief operations. Sierra Leone will not benefit before the country will have completed its HIPC treatment.

Distributing losses: insolvency and contestable claims

The effect of unfounded claims in sovereign insolvency procedures can be easily shown. Let us assume that country A has total debts of 100, but is only able to service a debt stock of 50, as well as that country A actually gets insolvency protection, no doubt a heroic assumption still when it comes to Southern debts. To simplify we only consider a one-off debt stock reduction. In this case the "haircut" would be 50. If 40 were null and void, A would only have a remaining debt stock of 60, of which 10 would still have to go in order to align A's capacity to pay to debt service due. For A this would not really matter: 50 would go one way or another, although based on very different legal titles. For A's creditors, though, the results differ strongly. In the former case every creditor would receive half their claims. In the latter case, those whose claims are voided would receive nothing, while recognised creditors would receive 83.33%. As economic facts eventually assert themselves – what cannot be paid goes unpaid - denying the Rule of Law to debtors has considerable effects on creditors, both *bona fide* creditors unduly discriminated against, and unduly protected creditors, such as IFIs (cf. Raffer 2005a, 2005b). Public creditors enforcing or supporting the violation of the Rule of Law trigger substantial negative effects for *bona fide* creditors. Treating perfectly legal and legitimate debts like debts lacking such solid foundation inflicts grave injustice. Arguably, classifying and differentiating debts may thus be seen as more in the interest of *bona fide* creditors, even though the application of universally recognised legal principles would have avoided substantial damage to debtor countries and their peoples. In an insolvency procedure respecting existing legal principles, private *bona fide* creditors would recover more than under present public creditor domination.

Quite noteworthy distributional effects are exacerbated by IFIs having been able to secure a privileged treatment of *de facto* preferred creditors for themselves, mostly in breach of their own constitutions (for details *v.* Raffer 2005a). No IFI, including the IMF is a preferred creditor, as one can even read on their own homepages (*v.* Boughton 2001, pp.820f; Raffer 2005a, or the Articles of Agreement of all MDBs). It can be shown that the founders of all IFIs stipulated an obligation to reduce or subordinate multilateral claims (Raffer 2005a, 2007b), which is no longer explicitly enshrined in the IMF' statutes though. The undue privilege of preference is especially problematic in the case of the poorest countries where multilateral claims are substantial percentages of sovereign debts and IFIs have influenced economic policies substantially. Unfortunately, official creditors have repeatedly attached conditionalities to debt relief that are not necessarily connected to economic necessities and have quite often worsened the crisis.

Clients of the IBRD have a statutory right to ask for debt relief, they may "apply to the Bank for a relaxation of the conditions of payment" if suffering "from an acute exchange stringency" pursuant to Article IV.4.c – *viz.* threatening default. It is specifically demanded to take both the Bank's *and* such member's interests into account. One notices that no conditions are stipulated for such relief, except the member's urgent need for help. Article V.3 of IDA's statutes is similar.

If countries in distress exercise their right to ask for relief, the IBRD may – but need not – grant it. While the Bank does not have to grant relief whenever asked, a general obligation to grant relief when and where appropriate certainly exists, an obligation hardly reconcilable with the purported preferred creditor status and the Bank's behaviour so far. Most other creditors, especially the private sector, have no such obligation. The often heard "argument" that relief for multilateral debts cannot be granted or would make development finance inoperable, was not shared by the IBRD's founders formulating its Articles of Agreement. Steadfastly denying debt relief and claiming to be a preferred creditor the IBRD is definitely at severe odds with its statutory duties and the truth. Acting in this way the Bank and IDA have inflicted gravest damage on members under duress, Southern countries forced to turn to them for help because of acute foreign exchange stringency, whose statutory rights were violated. Using the possibilities foreseen, even suggested by their statutes, would doubtlessly have defused quite a few crises.

The private sector has also suffered, especially in the poorest countries, where the shares of its claims are small but IFI-shares high. The Paris Club's demand of comparable treatment is particularly unfair. If we include multilateral debts of 40 in our simple numerical illustration above that must be serviced first, only a non-IFI debt stock of 10 could be serviced. The haircut necessary for these creditors to align capacity to pay and debt to be serviced would be 83.33%. If 40 were voided, and assuming from past practice that no IFI-claims would be voided, a stock of 20 of non-IFI-debt would remain, but only 10 could be serviced (servicing capacity of 50 – IFI-stock of 40). Treated "comparably" non-IFIs would lose half their face values, unless they chose to litigate. Under fair and equal treatment, they would only lose 16.67%. If they win, as is likely, they lose nothing. Considering mathematics and IFI-statutes, even private creditors without "vulture-intentions" may be induced to litigate. Paying insurance against loan losses also remains more costly as long as IFIs remain unduly preferred.

Insuring against losses

Increasingly, creditors try to cover the risk of loan losses by credit derivatives. Risk mitigation tool-sets started to expand. Arguably most important, and a large market growing dramatically within a short period of time, credit default swaps (CDS) allow investors to trade credit risk. CDS are contracts between two parties where a protection buyer pays a premium to the protection seller in exchange for a payment if a credit event occurs to a reference entity. Economically, this simply means that default insurances are sold.

The price of this insurance is determined by the probability of default and the insurer's profit and security margins. If the present value of premia is higher than the discounted expectation value of losses due to insolvency, insolvency procedures would be cheaper to commercial creditors. The legally unfounded preference enforced for IFIs pushes up premia. CDS and similar derivatives, however, spread costs over time, as any insurance fee does, while non-payment occurs at one point in time.

This insurance function of spreading cost over time can also be achieved by an optional feature of my proposal that would stabilise markets: tax-deductibility of loan loss provisions, as usual on the European continent (this passage draws on Raffer 2005b; cf. also 2005c). Tax deductible provisions have often been misunderstood as a taxpayers' subsidy. Costs to taxpayers, and hence the benefits to banks, or other creditors (such as corporations outside the financial sector), have always been strongly exaggerated, which might be the reason why this simple and cheap stabiliser is not universally used.

To the extent that provisions reflect actual losses in the values of loans already suffered but not yet booked, they do not economically constitute taxable income. This would be the case if loan loss reserves set aside during one year are equivalent to the change in factual values during that year. Increasing reserves continuously in line with declining factual values would thus not really cost taxpayers a single cent. Should the economic outlook of the debtor improve, these reserves would, of course, have to be reduced accordingly to keep provisions in line with actual losses. A tax regime without tax deductibility of reserves taxes illusory profits existing only because of tax laws. The Treasury gets an interest-free loan as losses are shifted to the future. An economist can only wonder why banks in jurisdictions restricting or refusing tax deductibility have not protested against paying too much tax.

In practice, one may discuss whether reserves actually match losses already suffered. If reserves are larger banks get a loan by tax authorities equivalent to this difference between reserves and changes in the values of loans; if reserves are smaller this difference is taxed as illusory income. The respective amounts are:

$$\$[100(1 - p) - \text{reserves}]ti_g \qquad (1)$$

where

p	=	repayment probability, hence 100p is expected value,
t	=	tax rate
i_g	=	interest rate at which the Treasury itself borrows.

The first term in square brackets expresses actual losses. If set aside reserves are smaller than actual losses, the term in square brackets is simply illusory income taxed. If reserves are larger, this would be a temporary loan from the Treasury, which carries no interest in many countries. Such a loan would mean costs to taxpayers that are this difference times ti_g. At $t = 40\%$ and $i_g = 4\%$, a difference of \$100 would result in costs of \$1.60 per year. Assuming that supervisory authorities keep loan loss reserves roughly in line with the decline in value of dubious loans, both costs to taxpayers and taxation of illusory profits will be very low or negligible. A substantial stabilising effect can be obtained at no or minimal costs to taxpayers. Simultaneously, the costs of covering risks of loses are spread over time, as in the case of insurance premia. Eliminating avoidable problems is advantageous to both creditors and debtors.

Whether to have tax systems encouraging more prudential provisioning should not be decided without considering the alternatives. Continental Illinois or the case of the Savings and Loan institutions (with bailout costs at least two-hundred billion dollars) may suffice to show that extremely limited tax deductibility does not necessarily prevent costs to taxpayers. Bailouts cost money too, on top of the costs of the crises. The beneficial effect of this cheap and fair stabiliser would not only benefit sovereign lending. It would also have helped to overcome the present sub-prime market crisis much more easily.

Conclusion

The absence of an appropriate mechanism to solve a sovereign debt overhang has triggered alternatives. These are the close scrutiny of the legal and moral base of claims and an increased assertiveness of some debtors, which a quick and fair solution, as proposed early on, would have avoided, as well as attempts to establish IFIs that are not under the influence of Paris Club members, most notably the Bank of the South. The rush in early repayments to the IMF was certainly caused by its role in debt management. Meanwhile, even the Paris Club (2007b) allows buy-backs at a discount, although officially reserved for debtors having emerged from the risk of new Paris Club rescheduling (to be judged by the Paris Club). Although the Club is less than perfectly transparent on this issue, it appears that payments below present values obtained by using actual interest rates are quite possible. This laudable change implicitly recognises the need for more formalised debt reduction procedures. GDP-indexed bonds have been issued, an option also propagated within sovereign insolvency models to overcome the difficulty of determining necessary debt reductions *ex ante*.

While necessary under present conditions, the first best solution remains ending the unjustifiable discrimination of one class of debtors, Southern sovereigns, putting an end to creditor arbitrariness, and finally establishing the Rule of Law in international lending relations. Two important features of my proposal, once declared impossible, were eventually accepted in principle. Debtor protection was introduced in the form of anti-poverty measures under HIPC II and MDRI. Participation of the affected via PRSPs as well as by NGOs making themselves heard is meanwhile an accepted fact. Although IFIs remain unduly preferred, multilateral debts have been reduced too. The last straw official creditors cling to, is their absolute, arbitrary power as overlords of debt management. Denying Southern debtors the position granted to any other debtor upholds a legally and logically indefensible discrimination, which minds more critical than I might call a legal form of *apartheid*.

Less favourable conditions in the global economy might well trigger a number of solvency crises. The shift from official to private debts in middle-income countries calls for avoiding a repetition of the Asian Crisis. An appropriate sovereign insolvency mechanism is part of this, as the High-Level Regional Consultative Meeting on Financing for Development, Asia and Pacific Region (2000) already pointed out. It saw "a need for an international bankruptcy procedure. It should be ensured that private debt does not become government debt." The increased importance of domestic debts is likely to produce the problem of how to treat domestic and foreign creditors equally and fairly in future debt crises. It would be solved by my proposal. A fair and efficient mechanism – contrary to the SDRM - is also in the interest of presently discriminated private creditors. They would be well advised to familiarise themselves with such alternatives to the IMF's model, such as my proposal, because its self-interest will certainly make the IMF push its SDRM again when this would seem strategically advantageous.

All in all one cannot but agree with the UN Secretary General (2007, p.27), who has repeatedly called for a meaningful and fair debt workout mechanism, as in his Report of last August:

> "The increase of concessional and non-concessional lending, including by emerging creditors, would point to the need for work on an internationally accepted debt workout mechanism that involves all creditors. Countries thus need to agree on a set of principles for resolving potential debt crises that provide for fair burden-sharing between the public and private sectors and among debtors, creditors and investors."

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Panel 4

Post restructuring of sovereign debt

Post restructuring of sovereign debt: summary of panel discussion

Moderator: HE Sabir Hassan, Governor**,** Bank of Sudan

Panelists: Mr. Fred Matyama, Principal Economist, External Debt, Ministry of Finance, Planning and Economic Development, Uganda
Mr. Michel Cardona**,** Deputy Director-General, Economics and International Relations, Banque de France
Mr. Jean-Luc Bernasconi**,** Head of Division, Macroeconomic Support, SECO, Switzerland

The panel was intended to be purely forward-looking. The purpose was to explore what life after HIPC might look like. Developing countries will surely keep on borrowing, but whom should they now borrow from? For what purpose and what should be the conditionalites, if any? How much risk do new lenders pose and could this risk lead to a future series of defaults?

Mr. Hassan emphasized that debt offices and policies governing external sovereign borrowing must be based on principles of transparency and accountability. In particular, the adoption of such principles will permit debt offices to resist political pressures to borrow for certain pet projects, which can lead to over borrowing on an aggregated basis and place countries in unsustainable debt positions. Mr. Hassan outlined the special challenges faced by post conflict countries such as Sudan. He stressed that countries in this group require highly concessional loans, that loans must be untied in order for countries to find best prices and the most appropriate technology for their capital goods imports, and that political and economic ties with the international community must be restored rapidly after the end of the conflict in order to give international investors and trading partners confidence to resume normal business activity. He invited panelists to address issues such as borrowing strategies in the post HIPC countries, their sustainability in wake of the debt forgiveness after completion points, and policies for avoiding a new debt cycle.

Mr. Matayama presented Uganda's history of debt management over the last three decades. In the 1980's borrowing decisions were decentralized and each ministry could contract external debt for projects that were deemed to be a priority for individual sectors. Moreover, ministries issued government guarantees for loans contracted by various parastatal companies, which led to a rapid accumulation of Uganda's external debt. By the early 1990's it became clear that Uganda's external debt can not be serviced, and a number of measures had to be taken to return the country to external viability. Debt management procedures were overhauled, and in 1991 debt data and debt servicing projections were centralized. Following the reorganization of the debt office, the government successfully obtained a debt restructuring deal with official bilateral creditors within the Paris Club framework, while a World Bank supported program for a commercial debt buy-back was implemented leading to a substantial reduction in external private debt. However, the burden of multilateral debts made it impossible for Uganda to regain a sustainable debt position, and the country became the first beneficiary of the HIPC initiative in the second part of the 1990's. By the late 1990's all new borrowing was centralized in the Ministry of Finance, and new external loans had to be approved by parliament. After reaching the completion point in the HIPC Initiative, and in particular following the implementation of the MDRI debt relief, Uganda's debt ratios improved considerably. As a result, the country has lost access to concessional loans, and has seen a large influx of private lenders. Mr. Matayama emphasized that this is a delicate situation, as Uganda still needs external financing to meet its expenditure needs related to achieving MDGs, and has suffered a negative balance of payments shock as a result of rising crude oil prices. At the same time, the Government is fully aware that a new spiral of borrowing could lead to another debt crisis in the future. As a result, in 2006 a new debt strategy was adopted focusing on future borrowing and increasing the capacity of debt managers to deal with issues of long term debt sustainability. Mr. Matayama concluded by emphasizing that there is a need to create a borrowing strategy to address the emerging relationship with non-traditional lenders, in particular with China and India.

Mr. Cardona underlined that in the post HIPC environment the possibility to start lending to poorer developing countries has re-emerged as their debt indicators have overall improved. However, there needs to be continued vigilance on the part of lenders and borrowers to avoid a new debt cycle by augmenting the debt stocks of post- HIPCs to unsustainable levels, and for borrowers to be careful in collateralizing their new loans against natural resources. Mr. Cardona noted that the current global macro-economic setting is very favorable to developing countries, with global growth at the highest level in the past 30 years, high commodity prices, and large reductions in the debt stocks of HIPCs. However, financing needs of this group of countries remain extremely high, and they can not be met by ODA alone, which means that HIPCs will need to start borrowing again to create a sufficient domestic capital base. The combination of a currently favorable economic environment, which can suddenly reverse, and large borrowing needs of HIPCs create risks for lenders to expand credit above prudent limits and for borrowers to overestimate their capacity to repay. Mr. Cardona finds that HIPCs should avoid as much as possible non-concessional loans, try to attract more FDI, adopt risk management strategies for managing their currency and maturity exposure, and attempt implementing counter-cyclical borrowing policies. In addition, budget expenditure controls and transparency should be improved, and within existing limits domestic capital markets should be further developed.

Mr. Bernasconi recalled Switzerland's pioneering and multi-faceted approach regarding its debt relief program. He noted that the ODA debt cancellation had begun in the late seventies, buy-backs of non-guaranteed debt had already been implemented in the early nineties, and debt conversion funds, which linked debt relief to poverty reduction, existed since 1994. He continued by examining the question of the world after HIPC. He stressed the fact that responsible borrowing, responsible lending, more effective support for debt management and further considerations on debt distress were crucial in helping countries attain sustainability. Concerning responsible borrowing and ownership by the countries, he asserted that maintaining prudent macroeconomic policies, developing homegrown financing strategies both for external and domestic debt and increasing domestic revenue mobilization, elaborating comprehensive data collection systems and increasing the capacity to appraise projects and programs that are to be financed would help in achieving debt sustainability. Regarding responsible lending or aid, he reiterated the fact that creditors should conform to rules and best practice, should critically examine incentives for unproductive lending, should promote good lending practice and support creditor conciliation. As for effective support for debt management, he mentioned the need for a demand-driven approach based on sound policies, building on existing initiatives and facilitating cross-country networks and information exchange platforms. In relation to this last point, he noted that UNCTAD has an important role to play. Further considerations to be made in order to help developing debtor countries would be to anticipate exogenous shocks through commodity-based facilities, to develop market-based risk insurance schemes and to reexamine the international financial infrastructure's capacity to resolve sovereign defaults. He ended by saying that the international community still falls short of assessing the impact of the HIPC and MDRI initiatives on the citizens of developing countries.

Exit HIPC: where next?

Fred Matyama

Government commitment:

"Debt financing will continue to constitute an important part of budget financing as long as domestic revenues fall significantly short of expenditures"

Background to external debt in Uganda

- 1980s: Debt Crisis
  - Political stability -> massive willingness from international community to lend
  - No effective strategy or discipline in debt management
  - Individual ministries/parastatals contract loans
  - Government guarantees to parastatals/private sector
  - 1990 coffee price fall -> no forex to service debt

Audio transcript

I would like to start from the point that Uganda as a country will recognize that debt financing will continue to be an important part of our budget financing as long as our domestic revenues falls significantly short of our expenditures. So when we talk of "Exit HIPC, what next" we bear in mind that borrowing will still remain part of our financing. But then we look at the historical background of the debt that eventually led to get the debt relief. It has been clearly shown by the first speaker that the 80s came out with the debt crises. For the Uganda case, this was a time when we had just come out of political instability. At that time we didn't have any strategy for debt management, or even discipline in debt contracting. Individual ministries could end up contracting so it was all over whoever had a need would end up contracting. Guarantees were made to private sector and parastatals(?). So without a debt strategy you can see the dilemma we had. We could take on anything.

- Early 1990
  - Due to debt crisis -> Developed debt strategy (1991)
  - Main focus – Pursue debt relief
    - Review debt profile
    - Make projections for debt service
    - Devise method of approaching creditors for debt relief
  - Achievements
    - Little achieved, more debt on non concessional terms
    - World Bank – debt buyback 12%
    - Paris Club – traditional relief mechanism

Audio transcript

So by 1990, there was also a decline in coffee prices and yet coffee is our major… so eventually we ended up not having the capacity to service the debt. That is the time when we thought that there should be something to overcome this crisis. So in the 1990s a debt strategy was developed. This was in 1991. But the focus of this was mainly to pursue some debt relief. This was just a way of trying to come up with our debt portfolio which was to be put together to because of the earlier on haphazard borrowing – anyone could borrow. So the 1990s strategy was just to come up with our debt portfolio and come up with the projected debt service, express the burden and then look for debt relief. So at that time the strategies were just to look for debt relief. Fruits came out of that by World Bank giving the debt buyback to commercial creditors. The Paris Club also gave their traditional debt relief. But still little was achieved and the borrowing continued on non-concessional terms.

- Late 1990s
  - Improved debt strategy (1995)
    - Emphasis on concessional loans
    - Attracted Multilateral Debt Relief Fund (MDF) to service IDA/IMF/AfDB
  - 1995 Constitution
    - Centralized Government borrowing with MFPED
    - Empowered Parliament to approve all new borrowing
  - April 1998
    - HIPC Debt Relief

Audio transcript

It was not until the late 1990s and towards 2000 that we came up with an improved debt strategy which eventually led to targeting the HIPC relief. And this improved debt strategy assisted us that by 1996 when the IMF World Bank HIPC initiative was put in place we got the HIPC relief as the first country. By that time (1995?) we also came up with a constitution which streamlined the borrowing such that it was centralized at the Ministry of Finance and also gave powers to the Parliament to be the sole supreme body to authorize borrowing. So all borrowing was put to Parliamentary approval. Then at that time also we got relief through the multilateral debt relief fund which assisted us to service IDA, IMF and African Development Bank.

- 2006 Multilateral Debt Relief Initiative
  - Cancelled 100% eligible debt
    - IMF's all disbursed and outstanding debt (DOD) as of end December 2003
    - World Bank all DOD as of end December 2004
    - AfDB all DOD as of end December 2004
  - Due to poor absorptive capacity much of the contracted debt not yet disbursed so not eligible

Audio transcript

Then came 2006 with the Multilateral debt relief fund, where 100% of (illegitimate?) debts to the IMF, IDA and ADB was cancelled. I think this is where we start saying: What next after relief? Are we sustainable? Unfortunately due to the poor capacity of the sectors to which the borrowing debt was directed, the (legitimate?) debt at that time was debt disbursed and outstanding. The big percentage of the contracted debt from these creditors IDA and ADB had not yet disbursed. So you realize that although the initiative was there to relief the debt a big percentage of the debt had not been disbursed so as it disburses it puts us back to the debt unsustainability. However as a country we looked at the situation and realized that all the debt strategies that we had put in place were principally for what had already been contracted. And then seeking debt relief.

The new debt strategy 2006/7

- The overriding aim of the debt strategy is to ensure medium to long-term debt sustainability
- debt relief initiatives can provide a basis but do not ensure a permanent exit from debt unsustainability
- Uganda is unlikely to be 'bailed out' yet again in future if Government fails to put in place and implement a prudent external debt management policy to ensure sustainability

Audio transcript

So in 2006 we came up with a new debt strategy. This time round focusing what should be the future borrowing. And it benefits a lot from the previous strategy where we need to emphasis grant financing. We also move into prioritized arriving out of commitment charges which we pay for the debts that are not yet disbursed. The new strategy also emphasizes the synchronizing the terms of new borrowing whether from bilaterals, multilaterals and the new creditors that are coming up. The new strategy has also realized that earlier on there was not any strategy where borrowing would go based on concessionality. Now we have factored in elements of a new borrowing (gap?) which will be guided by our long term deficit path so that the borrowing should be in within the macroeconomic variables that we have targeted for the medium term. The new strategy has also looked at streamlining the institutional and legal framework and also we are looking at emphasizing in capacity building, debt recording and analysis and new contracting. However there are challenges which we are trying to overcome.

Building on lessons from past debt strategy

- The prioritization of grant financing over loans;
- Borrowing on concessional terms;
- Well-defined and transparent process of borrowing (Centralized if possible);
- Absorptive capacity of the sectors into which borrowed funds are to be invested;
- Prioritize sectors to which borrowing is to be directed;
- Scrutinize terms for new borrowing/guarantee;
- Introduced an annual borrowing cap;
- Streamline the institutional and legal framework with emphasis on:
  - Debt recording, reporting and payment
  - Debt policy formulation/analysis
- Monitor all projects to which borrowed funds are directed;
- Emphasize capacity building for debt management;
- Incorporates domestic debt -> development of the domestic financial market;
- Considers clearance of domestic arrears.

"HIPC countries' dilemma"

- MDRI leads to Improved debt ratios, creating more borrowing space
- Improved credit rating -> Inflow of lenders
- Reduced grants from IDA/AfDB
- Need to increase spending to:
  - Meet MDGS

- Respond to shocks e.g. Energy crisis, rising oil prices etc
- Meet second round of debt relief policy spending eg. Universal Secondary Education
- Acquisition of new technologies eg. egovernment, national backbone etc.

Audio transcript

I will call this let's say HIPCs countries dilemma because after the MDRI a country like Uganda. Its debt ratios have substantially improved and according to the World Bank, AfDB, lending based on the CPIA we are totally off the grants and we are only to get credits. So with our strategy which was emphasizing grants we miss out the grants that we were getting from those two – ADB and IDA. We also find that because of the improved debt ratios there is again an influx of lenders including the private sector who were here too skeptical because of our poor ratios. The borrowing space has also been opened up so technically one can take it that we can borrow more. Yet we also need to increase spending mainly our target on meeting the MDGs. We also need to respond to shocks in the economy like wake fest (?) and energy crisis which sends us to adverse whether with concessional or commercial borrowing. Shocks include oil prices which are going up. And we are also faced with second round spending arising from the spending that we took on with the debt relief. Eg. We had universal primary education arising out from the funds that we received from the HIPC relief. And now we are moving on to universal secondary education so the demands are higher.

Are the new creditors a panacea?

- They target the exact demand eg. Energy, Information Technology (IT)
- Not very transparent – need creditor co-responsibility
  - Rates charged not concessional
  - Tied procurement
- Exploit the political arm of government for entry

Audio transcript

New technologies that we must invest in: the ICT. And this is a time when we are also faced with new creditors whom we think they come and target the places that they have already identified.

Public private partnerships (PPP)

- Very Complex to analyze
- Limited capacity to assess them
- Guarantee the unpredictable eg. Production, price, revenue etc.
- May lead to bigger debt burden

Audio transcript

In the Uganda case, we have China and India and private companies from the developed countries who come and say they are the ones that have the direct contact with the export/import banks of their countries. These have turned out not to be very transparent in their terms but they target the exact demands. For example, the energy, the crisis. They will want to come and clear that crisis. So as a borrower you end up in a crisis whereby technically you have laid down the strategy but then the available solution is not so much the streamline. Like yesterday there was the AfDB speaker who was talking about public private partnerships and cited the Ugandan case of Bujugali (?). which is true but then we realize that these are very complex with our limited capacity to assess the future benefits and losses. We think they are also triggered. For example, we have guaranteed energy prices where the control over the water flow is not in our knowledge. So we still realize there is a problem. (…) I mean they target the political areas. They start at the ministerial level and then eventually the technical aspects will be followed later. So as a country, in Uganda, we have put up a new debt strategy which is targeting the new borrowing but still we realize we have a great question as to how we handle the new lenders who are targeting exactly where we feel we have the problem. And we experience the reduced funding from the traditional sources eg. The World Bank, ADB, where then whatever was extended as the relief laid reduction in the allocation that we were getting. Thank you

Post restructuring of sovereign debt

Michel Cardona

Note: Ce papier a bénéficié des contributions et commentaires d'Emmanuel Rocher, du Service de la Zone franc et du Financement du Développement, et de Luc Jacolin, du Service des Relations Monétaires Internationales – Banque de France.

Quels sont les défis du ré-endettement après les annulations bilatérales et multilatérales de dette intervenues ces dernières années ? Cette présentation vise à développer la perspective d'une banque centrale sur ce sujet ; l'approche privilégiera donc l'identification et la gestion des risques, d'une part, et le développement économique et financier des pays concernés, d'autre part.

Plus précisément, trois points seront successivement abordés : d'abord, l'impact des opérations d'annulation de dettes sur la solvabilité des pays à faible revenu et le contexte pouvant inciter au relâchement des disciplines collectives ; ensuite, les risques potentiels d'un ré-endettement non maîtrisé, c'est-à-dire si la soutenabilité de la dette dans son ensemble n'est pas préservée ; enfin, les options disponibles pour parvenir à un ré-endettement maîtrisé.

1. Un assainissement de la situation financière des pays pauvres, ouvrant des perspectives de ré-endettement[198]

1.1. Les allégements de dette ont permis de restaurer la solvabilité des pays en développement

Les pays en développement ont bénéficié d'un double facteur de réduction de dette.

Un facteur commun avec les pays émergents, lié à l'amélioration générale de la conjoncture économique et des conditions de financement, notamment des prix des matières premières. La croissance du PIB des pays d'Afrique subsaharienne (qui concentrent 85 pour cent de l'aide PPTE à fin juillet 2007) s'est nettement accélérée depuis 3 ans, à un rythme annuel de 6 pour cent, soit un niveau plus élevé que le coût de la dette concessionnelle, tandis que les exportations ont cru de l'ordre de 35 pour cent depuis 2003. La croissance économique actuelle de ces pays, la plus forte depuis 30 ans, a mécaniquement réduit le poids relatif de la dette au regard du PIB.

Un facteur spécifique lié aux initiatives PPTE (Initiative en faveur des pays pauvres très endettés) et IADM (Initiative d'allégement de la dette multilatérale). Ces opérations de remise sont toujours en cours, mais un point rapide peut être fait à fin juillet 2007 pour l'ensemble des pays PPTE :

- Initiative PPTE : Les remises de dettes accordées atteignaient 67,7 milliards de $ (en valeur actualisée nette).
- Initiative IADM mise en place en 2005 : elle s'est traduite par des remises de dettes (en valeur nominale) de 47,9 milliards de dollars, pour les deux tiers par la Banque mondiale.

En conséquence, la solvabilité des pays à faible revenu s'est améliorée.

La mise en œuvre des initiatives PPTE et IADM en faveur des pays à bas revenus permet ainsi une amélioration sensible de leur situation financière. Pour les 29 pays ayant franchi le point de décision, le service de la dette rapporté aux recettes d'exportations passerait en moyenne de 14 pour cent l'année précédant le point de décision à 3,9 pour cent en 2006 et 3,1 pour cent en 2007.

Une illustration peut être donnée pour les pays de la zone franc :

[198] Pour plus de détails, voir « Les risques de ré-endettement des pays en développement après les annulations de dette », Bulletin de la Banque de France, n° 157, janvier 2007.

		Ratios avant PPTE (en %)[1]	Ratios post-PPTE (en %)[2]	Ratios post-IADM (en %)[3]
Bénin	dette / PIB	67,3	51,3	11
	service payé de la dette / exportations	14,2	8	2,9
Burkina Faso	dette / PIB	57,4	47,7	17
	service payé de la dette / exportations	21,5	11,5	4,6
Cameroun	dette / PIB	76,6	12,7	3
	service payé de la dette / exportations	12,5	3,2	1,5
Mali	dette / PIB	111,9	73,6	27
	service payé de la dette / exportations	14,6	5,8	4,3
Niger	dette / PIB	101,9	69,7	34
	service payé de la dette / exportations	8,4	4,2	3,6
Sénégal	dette / PIB	82,2	49,5	13
	service payé de la dette / exportations	17,1	7,6	4,7

Source : FMI, Banque mondiale, Rapport annuel de la Zone franc 2004 et 2005
[1] données à fin 2000
[2] données constatées au 31/12 de l'année de franchissement du point d'achèvement
[3] estimations FMI-Banque mondiale et AFD pour 2006 (2007 pour le Cameroun)

1.2. Mais le contexte incite à une reprise de l'endettement

Dans cette situation de solvabilité améliorée, plusieurs facteurs incitent à une reprise de l'endettement.

Les besoins de financement restent importants.

Ces besoins sont liés au financement des OMD (Objectifs du Millénaire pour le développement : horizon 2015), et plus largement au financement de politiques de développement (infrastructures en particulier). À titre illustratif, le montant total des financements nécessaires à la réalisation des OMD pourrait atteindre, pour les pays à bas revenus, près de 150 milliards de $ d'ici à 2015199. Pour la majorité des pays d'Afrique sub-saharienne, les coûts de financement des OMD devraient représenter plus de 20 pour cent de leur PIB.

La réalisation de ces objectifs, arrêtés par l'Assemblée générale des Nations Unies en septembre 2000, nécessitera la mobilisation d'importantes ressources extérieures, du fait en particulier :

- de taux de croissance globalement insuffisants dans les pays à bas revenus (entre 5 et 6 % pour les pays africains[200]) au regard des performances estimées à l'origine nécessaires pour atteindre les OMD (7 à 8 % par an), ce qui se traduit par de moindres rentrées fiscales ;
- des difficultés rencontrées pour accéder aux marchés internationaux de capitaux, compte tenu de la qualité de la signature de ces pays.

Ces besoins ne pourront être uniquement financés par des dons. Ces seules ressources sont insuffisantes au regard des besoins et il est nécessaire d'utiliser l'effet de levier associé au recours à l'endettement. Le financement exclusif par dons restreint excessivement les capacités de financement susceptibles d'être mobilisées pour les pays à bas revenus.

L'ensemble de ces éléments rendent légitime un ré-endettement des pays PPTE, à la condition qu'il soit maîtrisé de façon à éviter un nouveau cycle de surendettement.

1.3. Une nouvelle offre de financement apparaît et s'affranchit des disciplines collectives

Cette perspective de reprise de l'endettement dans certains pays en développement s'inscrit dans un contexte international marqué par l'apparition de nouveaux prêteurs (pays émergents d'Asie et d'Amérique latine, pays du Golfe) dont

[199] UN Millenium Project, *Investing in Development*, 2005.

[200] Selon le rapport BAD-OCDE, *Perspectives économiques en Afrique 2005-2006.*

les politiques d'aide aux pays en développement sont particulièrement dynamiques et diffèrent à plusieurs titres de celles observées par les bailleurs « traditionnels ». Les volumes de prêts offerts et leur faible niveau de conditionnalité, en termes de politique économique, en particulier, rendent ces financements attractifs.

En effet, les nouveaux prêteurs offrent des financements pour des montants très substantiels, souvent largement supérieurs à ceux susceptibles d'être mobilisés par le FMI ou l'AID, et sans conditionnalité de politique interne, liée notamment à la gouvernance. Certains de ces financements sont proposés sous forme peu ou non concessionnelle et peuvent être gagés sur des ressources naturelles ou assortis d'engagements de la part des pays récipiendaires (achats de biens d'équipement, fourniture de pétrole à un prix fixé à l'avance…).

2. Quels sont les risques d'un ré-endettement rapide et non maîtrisé ?

Une politique de ré-endettement doit respecter une double contrainte : les fonds doivent être affectés au financement du développement et la soutenabilité de l'endettement doit être préservée.

2.1. Les politiques non coopératives de ré-endettement présentent des risques

Ces risques concernent principalement les pays en développement.

Le risque principal consiste en un ré-endettement rapide et non maîtrisé, aboutissant à une situation de surendettement identique à celle prévalant avant la mise en œuvre des initiatives d'annulation de dettes. Les pays PPTE sont en effet toujours vulnérables à des difficultés de paiement éventuelles, notamment en cas de retournement conjoncturel.

Le FMI note qu'à l'issue des annulations de dette, sur 22 pays ayant franchi le point d'achèvement PPTE, seuls 10 pays sont classés en risque faible en matière de soutenabilité de la dette. Les autres pays PPTE présentent un risque modéré (à l'exception du Rwanda qui présente toujours un risque aigu) indiquant un nouveau franchissement possible des seuils de soutenabilité, en cas de retournement conjoncturel et/ou de variation importante des taux d'intérêt ou de change. En outre, le FMI continue de décourager le recours à une dette non concessionnelle pour les pays sous programme du Fonds.

Le recours aux financements non concessionnels présentent des risques spécifiques : i) ils sont particulièrement coûteux pour les budgets nationaux et pèsent donc lourd dans la dynamique du ré-endettement ; ii) ces prêts, lorsqu'ils sont gagés sur des matières premières, ne s'inscrivent pas toujours dans une stratégie de gestion cohérente de ces ressources aux fins de favoriser le développement ; iii) en l'absence, le plus souvent, de contrepartie en termes de politique économique relative à l'utilisation des financements mis en place, ils n'incitent pas les pays bénéficiaires à une gestion optimale de ces fonds et à une amélioration de leurs systèmes de gouvernance. Ils peuvent ainsi ne pas être cohérents avec les recommandations de la communauté internationale en matière de lutte contre la corruption.

Enfin, en contrepartie de l'annulation de leur dette, les pays PPTE se sont engagés à consacrer une partie de la marge de manœuvre dégagée à des dépenses publiques en faveur de la lutte contre la pauvreté (éducation primaire, services sanitaires de base, développement rural, etc). La réduction des dépenses affectées au service de la dette d'environ 2,6 pour cent du PIB en moyenne dans les pays PPTE a financé une part importante de la progression des dépenses de lutte contre la pauvreté (de 6,8 pour cent à 9,4 pour cent du PIB entre 2000 et 2007). Selon les projections du FMI, les gains supplémentaires attendus de l'initiative IADM (de l'ordre de 1,2 à 1,7 milliards de $ à partir de 2007) contribueront au financement d'une nouvelle progression de ces dépenses qui atteindraient 10 pour cent du PIB de ces pays dans cinq ans.

Du côté des créanciers internationaux, il y a également des risques : le ré-endettement à des taux non concessionnels de pays qui ont bénéficié des initiatives PPTE et IADM remet en cause l'efficacité des efforts déployés afin de restaurer la solvabilité de ces pays, les abandons de créances consentis pouvant n'aboutir qu'à l'accumulation de nouvelles dettes, à des conditions compromettant leur situation financière ; une telle évolution porterait atteinte à la confiance placée dans ces pays et pourrait conduire à une remise en cause fondamentale des politiques d'aide au développement.

2.2. La soutenabilité de l'endettement

Un instrument de mesure de la soutenabilité existe : il s'agit du Cadre de soutenabilité de l'endettement (*Debt Sustainability Framework – DSF-*) défini conjointement par les FMI et la Banque Mondiale pour les pays à faible revenu. Adopté en avril 2005, il a pour objet de faciliter l'identification ex ante des situations de fragilité et de guider les pratiques de financement des bailleurs ainsi que les décisions d'emprunt des pays à bas revenus, en leur apportant une analyse prospective de leur solvabilité.

Le cadre d'analyse de la soutenabilité de la dette (*Debt Sustainability Framework)*

Le DSF classe les pays en trois groupes, en fonction de leurs *performances* à la fois institutionnelles et de politique économique (estimées à partir des notes CPIA -*Country Policy & Institutional Assessment*- de la Banque mondiale) : qualité faible, moyenne et forte. À chaque niveau de performance correspondent des ratios d'endettement maximum.

Seuils d'endettement maximum par niveau de performances

	Stock de dette (en VAN) en % de			Service de la dette en % de	
	Exportations	PIB	recettes budgétaires*	exportations	recettes budgétaires*
Qualité faible	100	30	200	15	25
Qualité moyenne	150	40	250	20	30
Qualité forte	200	50	300	25	35

* recette budgétaires hors dons
Source : FMI et Banque mondiale, mars 2005
VAN : valeur actualisée nette.

Une analyse de la soutenabilité à long terme de la dette est ensuite effectuée, dans le cadre d'un scénario de base et face à des chocs externes (variation du niveau des recettes d'exportation, du prix des matières premières, etc…), cet exercice de *stress testing* ayant pour objet de s'assurer du respect des seuils d'endettement maximum dans le cadre de scénarios macroéconomiques défavorables. L'analyse de soutenabilité permet alors de répartir les pays entre trois classes de *risques* (risque faible, modéré et élevé), en fonction de la réaction des ratios d'endettement selon les différents scénarios :

- les pays à risque faible sont ceux dont les ratios actuels sont inférieurs aux plafonds indiqués ci-dessus (en fonction du classement en termes de performances) et pour lesquels les différents scénarios ne prévoient pas de dépassement significatif des plafonds au cours des 20 ans à venir ;
- les pays à risque modéré sont ceux dont les ratios de dette ne dépassent pas les plafonds dans le cadre du scénario de base mais pour lesquels un dépassement des ratios de stock de dette et/ou une hausse significative du service de la dette s'approchant des plafonds sont observés en présence de stress scénarios (c'est-à-dire incluant l'impact de chocs) ;
- les pays à risque élevé présentent un dépassement des plafonds quel que soit le scénario retenu.

Le niveau de risque de défaut détermine la répartition de l'aide mise en œuvre par l'AID entre prêts et dons : les pays à risque faible ne sont éligibles qu'aux prêts ; ceux à risque modéré auront accès pour moitié aux prêts et pour moitié aux dons ; ceux à risque élevé seront éligibles aux dons exclusivement.

Ce cadre méthodologique doit servir de référence pour une concertation efficace entre pays donateurs et doit permettre de concilier la satisfaction des besoins de financement externes nécessaires au développement et la préservation de la soutenabilité de la dette.

Cet instrument est très important et tous les acteurs doivent se l'approprier car il est destiné à fournir un cadre d'analyse commun à tous. Mais certains aspects méthodologiques de cette approche restent discutés. Il doit donc faire l'objet de concertation entre les pays concernés et les institutions de Bretton Woods.

3. Quelles sont les options disponibles pour un réendettement prudent des pays en voie de développement ?

Il n'y a pas de « solution miracle ». Pour parvenir à maîtriser leur processus de ré-endettement, les pays à faible revenu doivent combiner différentes approches.

3.1. Ne pas céder à l'illusion de la facilité

Les prêts non concessionnels et/ou gagés sur les matières premières ne sont, le plus souvent, pas sans contrepartie (politiques, commerciales…) et présentent un coût très élevé pour la soutenabilité de la dette. Cela ne signifie pas qu'il faille y renoncer. Mais il faut les utiliser exclusivement pour les investissements les plus rentables qui seuls permettront leur remboursement.

Les investissements internationaux (investissements directs étrangers ou investissements de portefeuille) sont hautement souhaitables et de multiples indices montrent qu'ils s'intéressent désormais aux pays à faible revenu, notamment en Afrique. Toutefois, les difficultés liées à ce type de financement ne doivent pas être occultées : i) des conditions préalables (qualité de l'environnement juridique, profondeur et liquidité des marchés financiers domestiques…) sont requises afin d'attirer un volume suffisant d'investissements extérieurs, susceptibles de contribuer significativement au financement du développement ; ii) leur distribution est généralement inégalitaire et tous les pays n'en profiteront pas également ; iii) les expériences passées dans les pays émergents ont montré une certaine volatilité de ces investissements ; iv) enfin, le développement de ces investissements internationaux est une entreprise de longue haleine.

Ces financements extérieurs ne peuvent donc constituer la seule solution. Il est dès lors nécessaire pour les pays en voie de développement d'utiliser plusieurs instruments complémentaires pour protéger la soutenabilité de leur endettement : gérer de façon plus active leur dette, améliorer l'efficacité de la gestion des finances publiques et procéder à des arbitrages entre financements extérieurs et financements intérieurs, ces derniers ne devant pas être négligés dans le cadre d'une stratégie de ré-endettement prudent.

3.2. Mettre en œuvre une gestion plus active de la dette

De fortes contraintes pèsent sur les pays PPTE en vue de mettre en œuvre une telle politique : l'essentiel des financements demeurent concessionnels, à maturités fixes et les marchés financiers domestiques sont peu développés et peu sophistiqués. Toutefois, certaines pistes peuvent être évoquées :

- réduire le risque de change (currency mismatch) par des émissions en monnaie locale et/ou par une diversification des devises de référence (dollar, yen, euro…) ;
- éviter l'accumulation des dettes à court terme et privilégier l'allongement de la maturité moyenne de la dette ; le développement de stratégie d'endettement à moyen terme, en coopération avec le FMI, notamment pour les pays sous programme, et/ou avec la Banque mondiale, doit éviter notamment le recours aux émissions précipitées de titres courts ;
- explorer les voies d'une meilleure gestion des cycles économiques : utiliser une partie de la liquidité existante lors de cycles hauts (accroissement des réserves) pour opérer des réaménagements de la structure de la dette existante (rachats, échanges) ou créer des fonds de réserve.

Cette gestion active peut conduire à faire des arbitrages entre différents objectifs. Ainsi, les pays auront à choisir entre privilégier la réduction du risque de change sur la dette et contenir la charge de l'endettement, le coût relatif de la dette domestique était en général plus élevé. De même, un endettement domestique ne permet pas de bénéficier, le cas échéant, de l'appréciation de la monnaie locale (affaiblissement du dollar). Ces arbitrages conduisent à mieux différencier les avantages de court terme (s'endetter au moindre coût, profiter de l'appréciation de la monnaie locale) et les bénéfices à plus long terme (développer un marché financier domestique, se prémunir contre les risques de change).

Une gestion active de la dette n'est clairement pas à la portée de tous les pays à faible revenu : plutôt que d'adopter les « meilleures pratiques » de gestion des pays émergents, il convient d'adapter les stratégies de gestion aux gardes fous de moyen terme des DSF et aux capacités institutionnelles propres à chaque pays (best fit, case by case method).

3.3. Améliorer la gestion des ressources publiques et l'efficacité des dépenses

L'efficacité économique des nouveaux financements dépend avant tout d'une amélioration de la gouvernance et des finances publiques.

La bonne gouvernance en matière de finances publiques recouvre plusieurs aspects, dont celui relatif à l'utilisation des dépenses : en ce domaine, la nécessité d'un ciblage des dépenses et d'une identification des projets prioritaires a souvent été soulignée, la mise en œuvre des projets devant être assurée dans la durée. À cet égard, la définition de cadres des dépenses budgétaires à moyen terme (CDMT) est indispensable dans la mesure où elle permet de garantir une continuité des projets structurels des États en préservant les budgets d'investissement.

Il est également souhaitable que des règles de bonne gouvernance s'appliquent en matière de suivi des dépenses, afin tout particulièrement d'améliorer la qualité de la dépense publique. La mise en œuvre de procédures d'évaluation régulière des programmes d'investissement public participe à cet objectif. Le suivi des dépenses doit aussi contribuer au respect de la contrainte de soutenabilité de la dette publique. Une forte appropriation, par les administrations locales, des capacités d'analyse de la soutenabilité de la dette est à cet égard souhaitable.

Dans la gestion des ressources, il convient enfin de veiller à affecter prioritairement les financements non concessionnels aux investissements très rentables (cf.. supra).

3.4 Développer des marchés obligataires locaux pour mobiliser l'épargne domestique

Le développement de marchés financiers locaux présente plusieurs avantages.

Il constitue une voie essentielle d'amélioration des modes de financement des États. Dans un contexte marqué par le gel (par exemple : tentatives au Burundi, en Gambie, en Mauritanie et en CEMAC) ou la suppression progressive des avances des banques centrales aux États (cas notamment en UEMOA) et la réduction des crédits bancaires aux États, le recours aux émissions de titres de dette sur le marché intérieur permet de diversifier les sources de financement des États.

Par comparaison avec d'autres modes de financement, le recours au marché présente plusieurs avantages en matière de maîtrise de l'accès à ces ressources (détermination du calendrier, des montants, des échéances), de prévisibilité (ressources non conditionnées), de transparence (les conditions sont publiques) et de gouvernance. Le recours aux marchés obligataires crée ainsi des incitations à une plus grande transparence dans la gestion des finances publiques et favorise la conduite d'une politique budgétaire plus rigoureuse (nécessité de préserver sa crédibilité vis-à-vis des investisseurs résidents sous peine d'une sanction du marché).

Le développement de marchés financiers locaux incite à une amélioration de la gestion de la trésorerie de l'État, en augmentant le coût d'opportunité des disponibilités, en favorisant les arbitrages de placement et en rendant plus nécessaire une gestion prévisionnelle de la trésorerie.

Il contribue puissamment au développement de marchés financiers de la dette privée : les émissions de titres publics constituent normalement la première étape du développement d'un marché obligataire suffisamment structuré et liquide. En effet, le développement d'un marché de titres de dette publique est souvent une condition nécessaire à l'essor des marchés de la dette privée (par la mise en place d'infrastructures de qualité, en constituant des titres de référence…).

Enfin, il réduit le risque de change global, en réduisant les positions de change dans le bilan des agents économiques, notamment celui de l'État.

Le recours à des financements de marché exige néanmoins un certain nombre de préalables :

- le budget de l'État doit faire l'objet d'un minimum de transparence ;
- le financement monétaire de l'État doit être proscrit ou au moins strictement encadré ;
- les taux d'intérêt doivent avoir été largement libéralisés de même que le fonctionnement du marché monétaire ;
- la politique monétaire doit être capable de gérer activement le niveau de liquidité, de manière à éviter que la situation de liquidité ne distorde la formation des taux et l'évaluation du risque.

En outre, sans être une condition préalable, l'ouverture du compte de capital peut être une incitation efficace à la modernisation de la politique monétaire et plus généralement des comportements des agents.

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Les politiques de ré-endettement des pays ayant bénéficié récemment des annulations de dette peuvent être légitimes compte tenu de l'importance des besoins de financement pour le développement. Mais ce ré-endettement doit se faire en préservant la soutenabilité de l'endettement de ces pays. À cet égard, le recours aux offres de financement assorties d'une faible conditionnalité proposées par de nouveaux pays prêteurs doit être considéré avec prudence quand elles ne sont pas destinées à financer des projets à forte rentabilité économique.

Les pays doivent aussi considérer d'autres options de ré-endettement, en particulier le recours à l'endettement interne via le développement de marchés obligataires locaux.

Pour choisir entre ces différentes formes d'endettement, les pays doivent faire un arbitrage entre le court et le moyen terme. En effet, l'endettement obligataire domestique présente d'importants avantages à moyen terme liés aux externalités positives qu'il induit. En particulier, il produit une forte incitation à l'amélioration de la gouvernance publique et de la discipline budgétaire et il contribue puissamment au développement de l'épargne domestique et au financement de l'économie locale.

The world after HIPC

Jean-Luc Bernasconi
State Secretariat for Economic Affairs (SECO)

Outline

1. Switzerland's debt relief program.
2. The world after "HIPC":
   – Responsible borrowing;
   – Responsible lending;
   – More effective support for debt management; and
   – Further considerations on debt distress.
3. A final question.

A pioneering and multi-faceted approach:

1. Bilateral debt relief:
   – ODA debt cancellation and grant-only policy (1978–85);
   – Publicly guaranteed commercial debt (1992-93);
   – Buy-back of "tail-end" non-guaranteed debt (1992–93);
   – Debt conversion funds (1994-present).
2. "International" commercial non-guaranteed debt (IDA debt reduction facility).
3. Multilateral debt relief (Arrears, HIPC, MDRI).
4. Complementary measures (BOP, Capacity Building).

Sustainable borrowing is responsible borrowing:

- Maintaining prudent macroeconomic policies;
- Legal and institutional frameworks for debt management;
- Homegrown financing strategies;
- Capacity to analyze debt sustainability;
- Comprehensive data collection processes and systems;
- Own assessment of needs and priorities for support;
- Most importantly: upstream capacity to appraise projects and programs that are to be financed.

Responsible lending is in creditors' interest:

- Conform to rules and best practice during due diligence processes (DSF, regional or national debt limits);
- Critically examine incentives for unproductive lending;
- Leadership role of multilateral institutions in advising on sustainability thresholds;
- Promote good lending practices and engage with "new lenders";
- Facilitate and support creditor conciliation.

Engaging into effective support for debt management:

- Demand-driven approach and sound diagnostics;
- Building on / learning from existing initiatives;
- Support national and regional capacity as is most cost-effective;
- Facilitate cross-country networks and information exchange platforms (COPs).

Engaging into effective support for debt management:

- Demand-driven approach and sound diagnostics;
- Building on / learning from existing initiatives;
- Support national and regional capacity as is most cost-effective;
- Facilitate cross-country networks and information exchange platforms (COPs).

Further considerations

- Anticipating exogenous shocks through multilateral or commodity-based facilities.
- Market-based risk insurance schemes.

- Reexamining the international financial infrastructure's capacity to resolve sovereign defaults.

Do HIPC and MDRI end with the last graduation to completion point?

The initiatives have clear objectives of poverty reduction: impact of past and present debt relief needs to be regularly assessed:

Audio transcript:

I would just like to complement colleagues' views as a small donor who has been active in debt relief for more than 20 years, and bring about some experience from our view about what the world would look like after HIPC and MDRI for that matter.

I will skip the outline and I will just go through the slides very quickly. A note on Switzerland's programme which started about 20 years ago, so quite early. I think that we were one of the first countries to engage in a comprehensive bilateral debt programme. To be fair, this was not really at the initiative of the bureaucracy or technocracy. This was the initiative of NGOs – some of them are here in this room – Swiss NGOs, which triggered the whole process. But I would like to think that we are quite swift in devising a programme that tackled some of the main issues. What was interesting about this Programme, because it has a link to recent initiatives, was debt conversion funds which linked debt relief to poverty reduction, with all the disadvantages of small projects and small programmes and related transaction costs, but it gave to our tax payers some visibility to our tax payers about debt relief reaching some real people and having a real impact. Also, part of that programme was a local or national buyback, commercial and non-guaranteed buyback programme which was quite innovative at that time. I think that this helped us engage into a more substantive international discussion on future debt relief initiatives.

Last (no. 4 here) is what we call complementary measures. On the one side, Balance of Payments support for those countries that weren't in debt problems but were still subject to exogenous shocks and there is no reason why they should be penalized and, second and most importantly, capacity building initiatives to start early, to pre-empt a new problem following this.

Just four areas for the world after HIPC as we perhaps would like to see it. Sustainable borrowing as responsible borrowing. We put it first knowingly. This is not to be contrary to the intervention by Professor K about corresponsibility but in a prospective fashion from now looking at the future we generally think that responsible borrowing ownership by the countries is the sine quo condition of these whole processes. The sine quo condition for unsustainable debt to not reemerge. Even though lenders do have a responsibility and I will come back to that later also. But this is the focus and as you will see from this long list and as we heard from our colleague from Uganda, the post HIPC world is much more complex than the pre-HIPC world so it is a tall agenda we have here in terms of responsible borrowing starting from the legal institutional frameworks to homegrown financing strategies. I will just stress this in saying that these strategies as our Uganda colleague pointed out are not only about external debt. They are about domestic debt. They are about grant financing. They are also about domestic revenue mobilization and some sort of coherent fiscal framework. So this sort of strategic approach devised by the countries themselves is an absolute priority as far as we are concerned. The other issues related to debt sustainability analysis, data collection processes and so on have been discussed already. Responsible lending or responsible aid and I haven't put it here (slide ref) is also clearly providing concessional or grants resources for financing MDG. And Switzerland pays its share there like many others in this room. In terms of lending, again, trying to have lenders conform to rules and best practices – including due diligence process, critically examine incentives for unproductive lending in our own schemes and this is all work in progress. These are all principles which are easy to write down as broad principles. When it comes down to apply them very concretely they are much more difficult. We are working and I am sure other colleagues are also working on a daily basis to become more responsible lenders.

Obviously recognizing the leadership role of multilateral institutions in advising on xxx roles and advising the whole system to address this…. And promote good lending practices and engage ourselves with the new lenders. And finally facilitate and support creditor conciliation. This is something that we do also and quite regularly. Like now, for instance, in Liberia where we support a commercial creditor conciliation process.

Re. Effective support for debt management. Maybe at the beginning of the HIPC initiative this issue was a little bit neglected. People were very busy trying to reconcile the data, trying to just figure out the numbers – how much debt was out there. The whole management aspect was perhaps set aside. We, with other bilaterals, have been very active in trying to support this as the only exit, possible exit for unsustainable debt and again we welcome recent initiatives like that of the World Bank to also engage into this very, very important topic. We believe that the approach should be demand driven. The country should be in the lead. There should be sound diagnostics and again the Bank is doing very useful work in this area. We should build and learn on the existing initiatives and not start from scratch. We just learned about the progress of how Uganda has gone about during the last 10 years devising their own strategy. I would like to think that they have perhaps received some help from regional organizations or partners for that. So there are some things which have worked which we need to build on. And also facilitate cross-country networks, information platforms, communities of practitioners and UNCTAD has certainly a role to play there. Finally a few further considerations. The issue of exogenous shocks, that debt distress is not only about inadequate lending or inadequate borrowing or poor capacity. There are some exogenous factors for sure. And I certainly join Prof ? on this one. There are also market based solutions for these shocks which are perhaps not available to all countries but to a bigger amount of counties. And also a constant re-examination of the international financial infrastructure to resolve sovereign defaults because these will happen again for sure.

Now the final question which I would like to put to the room is if indeed HIPC… the last graduation to completion point. Yes technically, but these initiatives have clear objectives in terms of poverty reduction and I think that we still fall short of assessing the impact of those initiatives and we owe it collectively to the beneficiaries and the citizens of the beneficiary countries and the financiers – our tax payers – we owe it to them that we look critically in a couple of years or regularly to really look at what was achieved by the fiscal space, as small as it might be, which was facilitated with this process.

Panel 5

The case for further relief

The case for further relief: summary of panel discussion

Moderator:	Mr. E.E. Ngalande, Executive Director, Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI)
Panelists:	Mr. Mark Thomas**,** Lead Economist, Economy Policy and Debt Department, World Bank. Ms. Patria Angeles**,** Deputy Director, International Department, Central Bank, Philippines. Mr. Charles Mutasa, Executive Director, AFRODAD

The panel was intended to take stock of what has been achieved by relief initiatives so far. As the HIPC initiative is slowly coming to an end, and more and more countries receive much-needed relief, some questions still remain. These include questions such as: Are all countries that have received relief now sustainable? If not, is further relief the solution? Has the coverage of countries been wide enough? Additional countries have technically speaking become HIPCs during the implementation process - what to do with them?

Mr. Ngalande posed a number of questions related to debt sustainability, setting the stage for panelists to further develop these issues and attempt to define required actions by the international community and debtor countries for the continued improvement of debt indicators. First, Mr. Ngalande stressed that some post-HIPC countries have still not reached debt sustainability, and asked whether further debt relief will be needed for these countries. Second, he observed that the HIPC Initiative does have a sufficiently wide coverage, and suggested a discussion should take place on actions required to deal with the debt of unsustainable non-HIPCs. Third, Mr. Ngalande noted that some countries face litigation from vulture funds, and underlined that policies should be developed by the international community and debtor countries to deal with this practice. Finally, Mr. Ngalande pointed to the trend of increasing domestic debt stocks in a number of post-HIPCs, and stressed that this could lead to a new set of debt sustainability problems unless action is taken to tackle this issue.

Mr. Thomas began by stressing the importance of debt strategy in countries. He continued by underlining the need for discussion around the Fund's and the World Bank's debt sustainability framework, as an open platform, where tools were freely available and countries could customize them as they saw fit.

Mr. Thomas provided an overview of the impact of the HIPC and MDRI initiatives on the 32 countries (22 of which had reached completion point, and 10 interim countries working towards the completion point). The HIPC initiative on average had halved the debt service of the recipient countries; the MDRI had served to increase that direction of change and debt service in 2011 had been forecasted to be about 3% of exports. The total pro-poor spending for the 32 countries had more than tripled; from \$6 billion in 2000 to about \$20 billion in 2007. The stock of debt relief amounted to \$70 billion in 2006. Regarding the 10 interim and the 9 potential countries, he indicated that there are major challenges pending to get them through the existing framework i.e. arrears and governance as well as qualification and participation. As for further debt relief, the question was asked if it should look like HIPC (i.e. comprehensive but voluntary, with thresholds and conditions), like MDRI (i.e. limited to certain creditors, no thresholds, just eligible debt), like both or completely different. He then pointed out the dangers of further debt relief and mentioned the following four: arbitrary inclusion /exclusion, moral hazard and induced over-borrowing, inefficient allocation and eviscerating development finance.

Ms. Angeles underscored that in the 1980's the Philippines were faced with a debt sustainability problem, which led to declaration of a moratorium on payments on all debt service obligations falling due. In the following ten years a series of steps were taken to restore sustainability. Four Paris Club meetings were held for the Philippines to reschedule USD 5.5 billion. The country also rescheduled USD 9.2 billion of principal owed to commercial creditors in the London Club and obtained a grace period of seven and half years with a maturity of seventeen years on its rescheduled payments. The multilateral debt was not rescheduled, but multilateral institution continued to provide financing to the Philippines, and the World Bank supported market a buy-back operation on parts of the commercial debt. The Philippines also developed a debt-swap program, which eliminated around USD 4 billion of external debt. The odious debt question was never satisfactorily resolved, but by now the Philippines have paid most of it. Whereas in 1983, the Philippines' external debt was composed of 40% of short term debt obligations and 60% of medium and long term debt, after the completion of the restructuring, 16% of the debt stock was comprised of short term debt while 84% of the debt stock was medium and long term debt.

She specified that although creditors should assume part of the responsibility in creating an unsustainable debt situation, most of the work to avoid debt problems needs to be done by the borrower, with particular focus being placed on increasing their debt management capacity. In particular, she stressed that improving fiscal discipline is one of the key measures for keeping the debt burden within sustainable limits. Ms. Angeles underlined that part of the government strategy to keep debt sustainable is to increase the share of domestic debt in the total debt stock, which is now at fifty percent, and it is planned to raise it to sixty percent in the next few years. Ms. Angeles concluded by informing the participants that the Philippines has already installed the DMFAS program in the treasury, and plans are being made to install it in the Central Bank.

Mr. Mutasa outlined that until the end of 2007, out of 22 countries that completed the HIPC process 18 were from Africa. Some of the achievements of the HIPC Initiative were the reduction in infant, child and maternal mortality rates in some African countries, improved access to drinking water, and an increased scope of immunization. However, the MDRI process did not deliver the full expected benefits, and it would appear that debt relief efforts do not necessarily translate in increased education and health expenditure. In addition, Mr. Mutasa stressed that the Monterrey Declaration called for debt relief to be additional to existing aid flows, but donor countries include debt relief figures in their ODA reports, thus artificially inflating the aid flow figures.

Some of the issues that were not properly addressed in the HIPC process is a clear definition of debt sustainability; the adopted definition is too narrow as it ignores the need by countries to fulfill their obligations of providing economic and social rights; the exclusion of domestic debt from DSA; and too many conditions imposed on countries by the IMF. Mr. Mutasa noted that the scope of the debt relief efforts so far has also not been adequate, as only a few multilateral lenders participated in HIPC and MDRI , the private sector is not covered by either of the two initiatives, and the number of countries included in the debt relief efforts is not sufficient. Mr. Mutasa called for special arrangements and provisions to be included for post conflict countries, and underlined that the issue of odious and illegitimate debt has been ignored in the design of debt relief operations. Mr. Mutasa stressed that some underlying challenges in post-HIPCs remain, notably the need for greater domestic resource mobilization, improving the effectiveness and absorptive capacity of development aid, and the ability to attract private capital flows including remittances. In order to overcome these development hurdles, Mr. Mutasa recommended that debt cancellation must be outright and irrevocable, it must provide sufficient fiscal space for human rights promotion, donors must ensure that adequate resources are available for all HIPCs, debt relief should be extended to middle income countries, and a transparent and fair arbitration mechanism should be created.

The case for further debt relief

Mark Thomas
Lead Economist, Economy Policy and Debt Department, World Bank

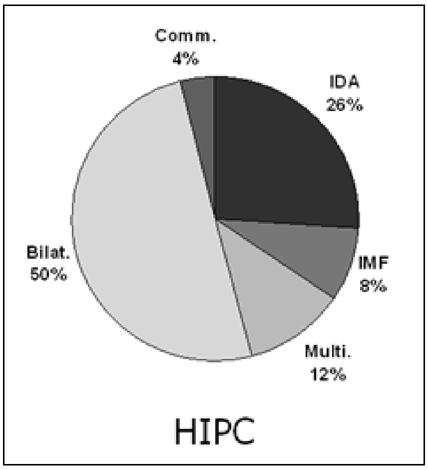
What has been achieved?

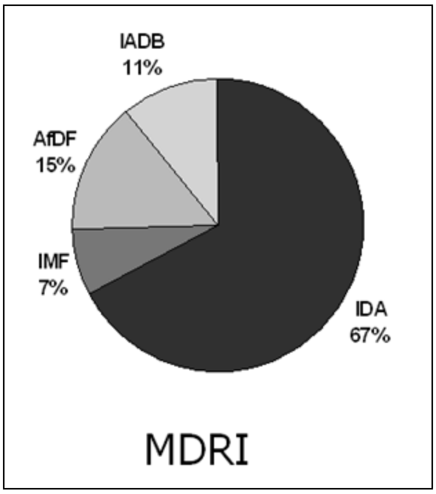
- 22 completion points, 10 interim countries
- $70 billion (2006) committed
- Debt service halved by HIPC
  - 18% of exports at DP to 8% 4 years later
- Debt service cut further by MDRI
  - 10% of exports in 2005 to forecast 3% in 2011
- Pro-poor spending up
  - $6 billion in 2000 to about $20 billion in 2007 ('DP's)

Audio transcript:
WE have 32 countries now receiving HIPC and/or MDRI debt relief. 22 have completed the process and have received irrevocable relief from the majority of their creditors. 10 are in the interim period working towards completion point. That amounts to about 70 billion in today's money committed. And the effects of that we have analyzed very carefully in the Bank and in the Fund. I will give you some broad brush-strokes… The HIPC initiative in round numbers halved debt service on average in its recipient countries. If you look at the decision point countries, the year prior to decision point on average they were using 18% of their export foreign exchange to service the debt, four years later that had fallen to 8. And then MDRI served to increase that direction of change. MDRI countries were using approximately 10% of their export revenue to service their debt in 05. And that is forecasted to fall to about 3% by 2011. Of course that has created budget space and we also try to track the effects of all of this on pro-poor spending. In our decision point countries the 32 the total pro-poor spending that was measured in 2000 was to the order of 6 billion dollars in today's money and that would have risen by the end of the year by a factor of 3.

Finally, and this was mentioned by Mr. Bernasconi, there is the need to track the impact of this beyond the spending. I think it is quite a challenge and you need detailed studies sector by sector on the impact of the spending. There is some debate about the growth impact of debt relief and we have done work on that and I think that there the bottom line is it is probably too optimistic to expect this type of debt relief to really have a significant measurable impact on economic growth in the kind of time horizon that we are talking about – in a small number of years. 70 billion is the total stock of debt relief in today's money. Compare that with ODA flows of something in the order of 100 billion per year. And you can see that this is relaxing relatively minor parts of the financing constraints which most developing countries are facing.

Creditor commitments

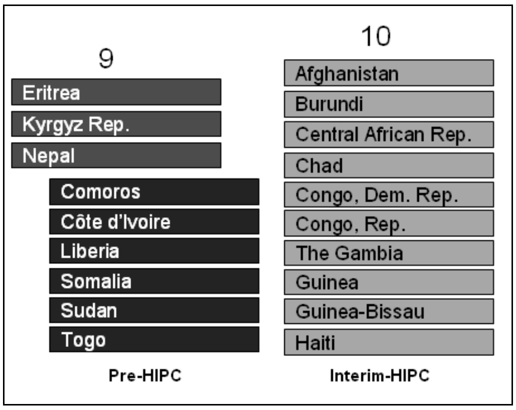




Audio transcript:
This is the composition of debt relief as it was delivered. First you see the HIPC debt relief, half of that was bilateral and then IDA is the largest of the remainder and then the other multilaterals and a small part commercial.

MDRI of course looks different. IDA is the single largest provider in there followed by the AfDB and the Inter-American Development Bank. If you combine these two, IDA turns out to be the largest single provider of debt relief. Another corollary of this graph is that in many low income countries now there isn't much bilateral debt left after the Paris Club has written it all off. Of course there is the question of commercial participation in HIPC. This is a problem that we will talk about this afternoon. Commercial participation is overall quite low. Again I think it is one of those problems where there is a probably a limited amount that can be done about it short of supporting the existing processes in place such as the London Club renegotiations.

HIPC/MDRI: What remains?



- $24+ billion
- Challenges related to:
  - Arrears
  - Governance
- Questions over:
  - Qualification
  - Participation
- Dark matter…

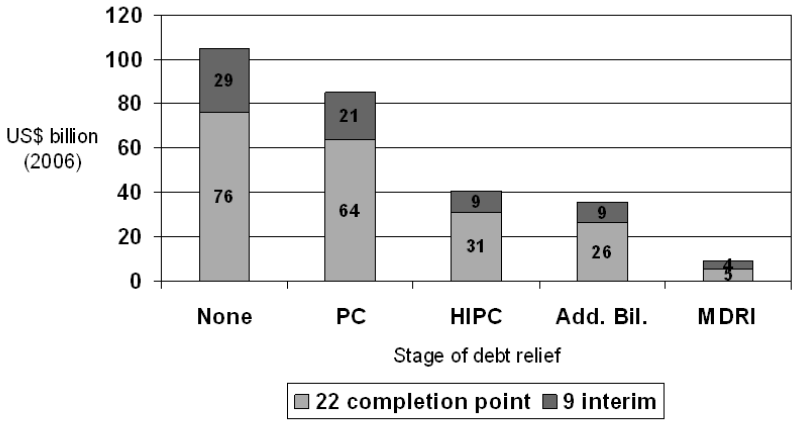
Audio transcript:
What remains to be done? There are 10 countries in the interim period. We hope these countries will progress to completion point. There are nine countries that are potentially eligible for HIPC but which are yet to reach decision point. This group of 9 faces various challenges. There are reasons why of course they haven't reached decision point yet. One challenge for a subset of these countries is for donors to orchestrate timely and efficient and comprehensive arrears clearance operations. We have seen in the case of Liberia recently that that is not always so straightforward when your arrears are so large in relation to the allocations that the banks and the donors have for these countries. There are also some fairly acute governance challenges in some of these countries. It is almost optimistic to talk about governance in some of the countries which are really more focused on overcoming civil strife. There are also questions in this group of nine about whether some of them will eventually even move through the debt relief process. Some countries have expressed a decided lack of interest in HIPC debt relief. It is not at all clear if they will ever take up the possibility. Other countries by the time they do decide or could possibly decide to avail themselves of the initiative may not actually qualify anymore owing to either export or revenue growth. Finally there are countries we have frankly no idea about as of today in terms of their debt ratios, in terms of their potential future qualification for HIPC. And there is nothing sort of legal or regulatory in the HIPC initiative to stop a country like, for example, Myanmar (Burma) or for example Zimbabwe if it were at some point in the future to qualify under all the criteria for HIPC to make its way into the initiative assuming of course that it did qualify and assuming of course that it wanted to.

What would further debt relief look like?

- Like HIPC?
  - Comprehensive but voluntary
  - Thresholds
  - Conditions
- Like MDRI?
  - Not comprehensive, limited to certain creditors
  - No thresholds, just eligible debt
  - Conditions
- Both?
- Something completely different?

Audio transcript:
Before trying to answer some of the questions that Dr. Ngalande asked in his introductory remarks, it is worth asking ourselves what would any further debt relief initiative actually look like before one thinks about its relative attributes. Would it look like the HIPC initiative, would we lower debt thresholds or raise income thresholds to allow new countries in? That would mean that it would have to be a comprehensive but voluntary scheme where all creditors were assumed to burden share. And we would have to set new thresholds. And just like the HIPC initiative, there would presumably be conditions to try to make sure that the funds were used for poverty reduction. Would it look like the MDRI which is not comprehensive. It is limited to certain creditors and doesn't change the thresholds it just eliminates eligible debt. There are of course also conditions as the MDRI is attached to the HIPC machinery. Of course it could be both, it could be something completely different. Let's look at what it might look like if we incrementally think about the HIPC initiative.

Audio transcript:
This graph shows you the $billions debt burdens through the various stages of debt relief based on calculations that we have done, so the graph adds up to over a $100 billion of today's money. This is what was there before any debt relief, then you successfully move through Paris Club, HIPC, additional bilateral and then MDRI. The point is just to show the bulk of what was there in these countries has been forgiven so that has implications for the cost/benefit analysis you might think about when thinking about more debt relief. There is not much more to forgive in HIPCs unless you roll forward and forgive debt



that is based on lending that is going on right now. I will discuss that.

Secondly you could have new countries coming in but by definition those new countries would be richer than the existing HIPCs and or not as highly indebted as the original HIPCs so there is probably limited gain to this kind of notion of further debt relief. Of course there is a possible exception and maybe one or two countries lingering just above the income thresholds with very high debt ratios. I can't think of too many of those. On the other hand I think you would be moving into a territory where there is a significantly high level of commercial debt in the portfolio which might not participate. I would add another point here which already applies to some of the potentially eligible HIPCs. Them saying no thanks is a real possibility here. I could name a number of countries that are not on the existing HIPC list which, if we gave them the option, they wouldn't want to be.

HIPC/MDRI II?

- Not much to forgive in the HIPCs
- Lower debt thresholds, higher income thresholds => new countries?
- But, by definition, limited gain, since debt ratios were not above HIPC thresholds
  - Possible exception of one or two countries just above the income threshold
  - Move into territory with higher commercial share
  - 'No thanks' a real possibility
- MDRI: will donors pay and how do they commit?

Further debt relief or more aid?

- Sunset clause and ring-fencing were designed to avoid moral hazard
  - Repeated/open-ended relief invites overborrowing
  - Especially relevant given private flows
- Unless you believe a very strong overhang story, debt relief does not allocate finance well
  - Countries less capable of using it benefit
- Unless debt relief is additional and pre-financed, it may be 'robbing the poor to pay the poor'

Audio transcript:
Let me now move into slightly more general territory and think what the case for more general debt relief would look like. We have sort of ruled out a marginal increment to the HIPC imitative which in your minds might raise the question of forgiving more recent debt, for example. There are several things that I think need to be said. The first is that debt relief was conceived as the solution to quite a severe problem. It was designed to solve that problem and it also had features in it to avoid the moral hazard of overborrowing if you believe that there is going to be future debt relief in the pipeline. So the sunset clause of the HIPC initiative and the subsequent exercise that was completed last year were specifically designed to avoid the moral hazard of repeated or continuous debt relief in existence. In case it is not clear open ended debt relief simply invites countries not to manage their affairs in a sensible way and to overborrow in the expectation that that borrowing would subsequently be forgiven. This is particularly relevant in today's world where there is increasing private flows looking low income countries, look at Africa in particular and it is really important that countries don't turn to those private flows irresponsibly in an expectation that they somehow will be forgiven in a future debt relief initiative.

The second point here is unless you believe in a very strong story of debt overhang, unless you believe that public debt is what is stopping poor countries from growing in many cases which is a case that I would certainly not maintain then debt relief doesn't allocate finance very well. Remember donors finance debt relief. So a dollar of debt relief substitutes essentially a dollar of aid that could have gone to some other country. You have to ask the question whether that is a good allocation of that dollar or not. In general, a dollar of debt relief goes to a country which borrowed heavily in the past and which typically won't be necessarily be the country that is most capable of using it for poverty reduction or in pursuit of the MDGs or whatever your development objective might be.

And finally a point that was made by the audience is that unless debt relief is really financed by donors, unless it is additional to existing ODA flows and unless it is effectively committed to and ideally pre-financed, there is a real risk that debt relief represents robbing the poor to pay the poor. There have been questions over governments' ability to commit to financing the MDRI dollar for dollar. The MDRI is something which forgives debt service flows over a horizon of perhaps 20, 30, 40 years and of course today's governments have limited instruments at their disposal to commit. This therefore represents real balance sheet risk for development banks and it represents the risk that ultimately developing countries will pay for debt relief themselves.

Conclusion

- There are major challenges pending to get the remaining HIPCs through the existing framework
  - Need for focused donor effort on these cases
  - With significant attached benefits
- Further debt relief may sound attractive…
  … until you consider the details
  - Danger of arbitrary inclusion/exclusion
  - Danger of moral hazard and induced over-borrowing
  - Danger of inefficient allocation
  - Danger of eviscerating development finance

Audio transcript:
To conclude, I haven't made a very strong case for further debt relief and I would like to just answer some of the questions that were raised. Has debt relief guaranteed debt sustainability in low income countries? No and nor could it ever have. You could have zero debt today and if you have a very vulnerable economy, a very narrow export base, volatile growth; you could still face risks in the future from financing deficits or current account deficits to your debt sustainability. Furthermore, should we therefore think of further debt relief? The case that I have made is that the case is very weak for that. I would prefer to put the emphasis on the challenge which is pending which is to get the from managing the debt themselves as we have seen in dialogue with remaining HIPCs through the existing framework to help those countries face the governance and arrears problems that they are facing. There is a need for focussed donor effort in these cases in particular to finance arrears. And there are significant attached benefits for something like 24 billion in today's money of debt relief out there that hasn't yet been committed. This is in the remaining 9 pre-decision point countries.

Further debt relief can sound attractive, but when you consider the details there are several dangers embodied in it. There is the danger of unequal treatment. There is the real possibility that many countries won't be interested in participating because they see benefits several countries. There is a danger of moral hazard and induced overborrowing. There is a danger that scarce donor resources won't be best allocated for poverty reduction and for the MDGs. And if donor funding isn't found, isn't forthcoming, there is a danger that the poor would be made to pay for debt relief themselves.

The debt issue of the Philippines

Patricia Angeles
Deputy Director, International Department of the Central Bank of Philippines

Audio transcript

Our contribution is to give everyone a flavour of what our experience was in regard to the debt problems of 20 years ago. The Philippines hasn't really benefited from any of the initiatives like the HIPC because the country is not classified as a HIPC country. Nonetheless we experienced a very serious debt problem in the early 80s. Rising oil prices, and also the country experienced a major political upheaval in 1983 because of the assassination of the opposition leader. The country has been under military rule for about 20 years.

So we had a major external debt crisis in 1983. The country was forced to declare a moratorium on the payment of its debts. What is the package that has been handed out to the Philippines? It is not the same as what has been given to poorer countries. We sort of froze the available trade credit facility to the country. At the time we had an outstanding of about 3 billion. Just to make sure that we could get the economy going, it was converted into a revolving trade facility and it was available for use by the Philippine enterprises until the end of 1992. This is roughly nine years starting in 1983. And then we underwent four rounds of rescheduling with the Paris Club and restructuring terms went from 10 to 20 years with grace periods of 5 to 10 years. The payment was uniform but the interest rates for the restructuring were negotiated bilaterally with different countries. We also had two rounds of rescheduling with the London Club, or the Commercial Bank restructuring. For the Paris Club, we restructured around 5.5 billion. There was no combination of principle or interest. What happened is that the principle and a certain portion of the interest were deferred and a certain portion of the interest was also considered as part of principle so they were capitalized. For the commercial bank restructuring, a total of 9.2 billion was covered and there were two rounds. The first round involved the restructuring over a ten-year period. In the second round, it was extended to 17.5 years and a 7.5 grace period. And the accounts? Covered by the first round were folded into the second round so they have a total of 9 billion commercial bank restructuring. Unlike the Paris Club case, it is only the principle that was covered by the rescheduling. Interest was required to be paid on… Multilateral debt and those that are owed to bank holders. Those from the voluntary markets were not covered by rescheduling so they had to be paid on due dates. But on a brighter note, because as expected private creditors no longer wanted to put in funds into the country, the multilateral creditors have continued to provide the country with some funds for urgent projects and also for some sectoral adjustment programmes that the country had to undertake to put the country into order. We also had some special facilities from the IMF. This consisted of standby, compensatory, etc. facilities. And then the Japan Bank, the Japan Exim Bank and the World Bank provided some funding for the country to buy back some of its debt from the market. To handle their rescheduling exercises, the Central Bank of the Philippines organized three separate units just to handle their scheduling exercise. So during the rescheduling period, we had to ration the mega foreign exchange receipts of the company, of the country and then the Central Bank required that all had to be surrendered to the Central Bank so that disbursement of the foreign exchange receipts follow the prioritization that governments had tried to offer the country. During the period, the country on its own undertook several debt reductions schemes so we had debtor equity, we had debt buy backs and debt swaps. We reduced the debt stock by about 6 billion via these various exercises.

Now the country has been able to exit from rescheduling after 10 years of putting the house in order.

The debt stock at the start of the crisis in 1983 was 24 billion and the composition was almost 40% short term, and the rest was medium and long term. And then more than two-thirds were owed to commercial creditors and just around a quarter was owed to official creditors. The public sector accounted for around 48% and the private sector around 19%. But after the restructuring, as expected the debt stock moved up from 24 to 32 billion. This is because of the consolidation of restructured debt and some of the new facilities that were made available by the multilateral agencies. But the debt profile had substantially shifted from a 37% share of short term debt down to 16%. And the medium and long term is now up to 84%. Borrowing from commercial sources went down to 18% and official creditors up to 62 %. And the first pubic sector debt shot up to 70% because of the debt consolidation. And the inability of the private sector to obtain new borrowings during the moratorium period.

What were the important lessons that we learned during this period? It wasn't really fully contingent on the creditors doing their own due diligence. Why we do support the idea that creditors should assume shared responsibility in terms of the lending that they are giving to the debtors? I think that much also has to be done on the creditors side. For the Philippine case, one of our lingering problems has been fiscal discipline. But happily over the last few months we have been able to achieve substantial gains in terms of fiscal discipline. We have been increasing our revenues and our reliance on foreign borrowings has been going down particularly for the public sector. The composition of foreign and domestic debt used to be 60:40 but now we are moving towards 50:50 and hopefully 40:60 in the future.

Just to sum up, the relief that we got was not in terms of cancellation (?). It was really just in terms of postponement of the debt that needed to be paid. The issue of odious debt has also been raised. Unfortunately it has not been resolved due to a lack of legal basis and criteria for how to classify and determine categorically that this debt is odious debt. So most of the debt that they used to say was classifiable as odious has practically been paid off at this time. We also wanted to point out that borrowers also have their responsibility to make sure they undertake capacity building particularly in terms of debt management. In our case, when the crisis stopped in 1983, we realized a basic weakness in our system which was that we did not have complete data on the country external debt. So we did not have data on our short term debt. And we did not have data on the liabilities of the banking sector. As a consequence of the prices, we moved towards a total foreign exchange liabilities concept whereby we set up systems to enable us to gather information on short term liabilities and commercial bank liabilities. So this system has been in place for quite some time and now all the statistics published since the moratorium already 20 years consists of all these types of information. The Philippines Central Bank also has a project with UNCTAD. We are acquiring DMFAS which we hope will start in January of this year. Our Bureau of Treasury already has DMFAS so our medium term objective is to link up with the Treasury database with the central bank so that we will have better data sharing.

When creditors draft relief packages for countries in trouble I don't think there should be a one size fits all policy. I think that creditors should look at first what is the reason for the crisis because in many cases these are due to exogenous shocks and maybe the structure of the economy is so fragile that it is not in a position to weather exogenous shocks that it is not prepared for. So I think in the end it is a partnership between the borrowing countries but also to put some responsibility on the creditors' side because at the end of the day when countries get back on track, then they are better able to get back their investment and they are better able to contribute to the development of the economy.

What have relief initiatives achieved and what remains to be covered?

Charles Mutasa
Executive Director, Afrodad

Introduction and background

- Debt Relief has been extended through two vehicles- HIPC (I & II) & MDRI
- HIPC seeks to ensure that debt savings go to country –owned poverty alleviation priorities.
- To date 22 countries completed HIPC process & benefited, 18 of them are in Africa; of the remaining 8 are on interim debt relief & 10 are potentially eligible for debt relief & cancellation.

MDRI beneficiaries

- 22 Countries that have received 100% IMF/World Bank debt Cancellation (21 as of July 1, 2006)
- Benin; Mauritania; Bolivia;
- Mozambique; Burkina Faso; Nicaragua;
- Cambodia (IMF only); Niger; Cameroon;
- Rwanda; Ethiopia ; Senegal
- Ghana; Tajikistan (IMF only); Guyana;
- Tanzania; Honduras; Uganda
- Madagascar; Zambia; Mali & Malawi

Debt relief achievements

- Mozambique: debt service payments have fallen by around two-thirds (1998-2002), in 2002 net school enrolment rate increased to 62.6 percent compared to 44 percent in 1997).
- Other examples include cutting infant, child & maternal mortality rates
- Access to clean drinking water in some places, access to immunisation etc.

Debt relief achievements questions?

- Benefits to MDRI countries are significantly less than expected (No adequate donor funding to fully compensate IFIs for their share of MDRI relief)
- Debt Relief does not necessarily translate into increased education and health expenditures.
- Should be additional to ODA (Monterrey Declaration), but donor countries are "cheating" by including it in reporting, thereby inflating their aid figures
- Increased school enrolment without quality education and more health centers without doctors or medicine should not be an end in itself- The Issue has to do with putting wealth creation on the fore front.
- What is the importance of reducing inflation to below 10% when there are no hospitals and when people are jobless?

Audio transcript

I noticed that the beneficiaries and benefits or achievements of debt relief have been well covered by my colleague from the World Bank so I will focus on the issues that are around this. I take acknowledgement of the fact that that debt relief has brought in additional aid and issues of budget support, issues of credit worthiness to many of the beneficiaries. But if you look at the indices of what say have been improved – child mortality, maternal mortality, access to immunizations, clean water, one gets a sense that all these indicators were distorted by the structural adjustment programmes and what relief has done is to bring us back to those levels where we are. But I would want to concentrate on what I call the achievements questions. One is that we realize that the relief itself has been less than expected. Particularly when you look at the donor funding going towards the MDRI. One also has to question the issue of whether this is really translated into more resources for health and education in the beneficiary countries. Against the big drop of challenges such as the HIV Aids pandemic. One also needs to question how debt relief has been calculated. There has been a lot of literature about debt relief, ODA including debt relief when in fact this was supposed to be additional resources. What others have called the phantom aid and the like. One of the big questions is when we look at the HIPC projects or debt relief projects the issue is if there is increase in school enrolment without quality of education, or if you have a lot of health centres without doctors and medicine, is that supposed to be an end in itself. Because we have seen this in most of our good examples of HIPC achievements. And also questions around sustainability. Whether you say it is important to have less than 10% inflation when actually there are no hospitals or the people are jobless so these are some of the questions that we ask in terms of the achievements

Issues not properly addressed?

- Limited by HIPC I and HIPC II's deficiencies.
  - Debt sustainability remains a highly ambiguous, manipulatable, political notion.
  - Exclusion of domestic debt from DSA Vs debt distress assessment.
    - conditionalities (IMF gate-keeping – over-rigid fiscal & macroeconomic frameworks e.g. wage ceilings)
- 'Anti-free riding' policy & greater IMF surveillance Vs newly emerging lenders (punitive measures for the newly solvent states & WB competing with other creditors):
  - Extensive supervision of countries' borrowing policies→intrusion into domestic affairs Vs sovereignty.
  - Run counter to ownership & alignment principles of the Paris declaration.

Audio transcript

I want to look at the issues which I think have not been properly tackled if HIPC debt relief was going to help us. First of all, most of the deficiencies that we find in the old debt relief are limited to the problems that we have seen in HIPC 1 and HIPC 2. First is the issue of what we call debt sustainability. This is very ambiguous, manipulable, and it is also a political notion. Once you say that this is unsustainable, that means you either deny or give relief to it. The issue of domestic debt has already been touched upon when you are assessing debt distress. The other issue is related to conditionalities that have continued to play a rough game on what could be the achievements of HIPC. The role of the IMF, the issues of over rigid and fiscal and macroeconomic frameworks have also deterred what could be maximum achievements of the debt relief. We have already talked about the issue of the free rider concept. There have been issues about how to put about punitive measures for those who are now solvent and they are actually going to the new lenders without really following what the rest should be following. This really brings problems where you have the World Bank being more like a competitor with other creditors, which is not specifically its role. I think that the issue of the anti free riding policy is something that we need to look at as well as the surveillance of the IMF.

This is tied to extensive supervision of the beneficiary countries in terms of borrowing. This is of course intruding into their domestic affairs and violated their right to sovereignty. They can not make certain choices about meeting development or growth needs of their own population. And this of course runs in contradiction to the whole concept of ownership, the concept of alignment which are some of the things that the Paris declaration is thinking of promoting. I also want to say that the issue of the coverage and scope of debt relief is very limited. We have some relief but it is not enough. If you look at the multilaterals that are involved. They are just three of at least 19 or so. So the issues of leaving the beneficiaries very vulnerable to creditor litigation are very high. And also the issue of other debts that I have mentioned – private sector and domestic debt - is not adequately covered or considered. You also have a limited number of beneficiaries to this debt relief initiative which is a big problem in my view.

***Scope & coverage** ------"We have Some Debt relief but not enough"*

- Only 3/19 multilaterals involved → cases of creditor litigation:
- Private sector debt not covered:
- Domestic debt not considered:
- Too limited in terms of beneficiaries it covers compared to those in need- Middle income countries sidelined (Kenya & Angola).
- Vulture funds threat e.g. Zambia:
- Going through the HIPC surgery before relief is too rough Vs fast track MDRI treatment (at completion debts eligible for relief could be partially/fully paid up).
- Debt Relief counted as aid (aid flows declined in 2005 & 2006):
- Too aid dependent with no exit strategy.
- No policies for prudent debt management & curbing graft.
- No special arrangements/provision for post conflict states.
- Odious & illegitimate debts ignored/forgotten:
- Lack of coherence in global development policies- Aid, Trade & Debt Relief:

Audio transcript

(...) The whole aspect of going through the HIPC surgery before you get the relief is actually rough for many countries. By the time you get to that relief, maybe you have paid almost part of that which is going to be relieved.

So these are some of the issues that I think the relief has not been able to consider. We also have issues – and I have already mentioned relief being counted as aid and decline of aid in that line - we also need to talk about the issue of having an exit strategy rather than keeping debt relief beneficiaries within the confinement of the creditors. They need to have an exit strategy and not be aid dependent. A very good example is if you look at countries like Mozambique: much of their finances are just donor driven. You need to move beyond that if you are talking about sustainable development for that country. Also domestically, you have issues of policies of debt management, and curbing of corruption which is very important. If you look at cases of post conflict areas, you do not find HIPC having enough provision for those countries in how to deal with those countries. There has been a lot of piecemeal solutions given to that. Recently we have seen examples of how a lot of lobbying has been going around Liberia and responses to the Liberia case. I thought that HIPC could have something comprehensive for post conflict areas or states.

The other issue has been the issue of coherence; if you give debt relief and there is not enough in terms of trade and also aid. It is like you look at African pots, it has three legs. If you just deal with one, the pot will not stand. Debt relief is just one leg of out of the three legs which consist of trade and also aid.

Our colleague from the Bank has answered it very well that sustainability is not there, it has not been guaranteed. But this also goes back to how we define it. The debt sustainability framework that the Bank has looked at – which in my view does not consider much of the human development needs of most of the countries.

Has debt relief brought sustainability?

- This should not be limited to the financial ability to service and pay back loans, but also a country's ability to fulfil its obligations which include provisions of economic, social and cultural rights. (Multi-indicators required for DSA)
- Debt Relief beneficiaries are still in need of policy space to meet their human development needs

Underlying Challenges

- Domestic resource mobilization

  (Increased savings, higher tax revenue & capital flight)
- Improving effectiveness & absorptive capacity of development aid
- The problem of International trade as a vehicle for resource mobilization
- Ability to attract private capital flows including remittances→high value added sector & employment.

Audio transcript

What are the underlying challenges of the debt relief for the beneficiaries of debt relief? There are issues of domestic resource mobilization. There are still problems of increasing savings, issues of raising taxes and issues of capital flight which make it very difficult for these countries to move forward. The issue of absorbing aid. The issue also of international trade being a vehicle for resource mobilization remains a problem. The issue of how to attract capital. The issue of making sure that issues of remittances work towards the high value sectors, especially creating employment. Issues that we need to consider.

I think that debt relief will not do everything unless you also look into how to deal with the issues of infrastructure and investment. Also, the policy space needs to be widened. It has been restricted by years of adjustment. Not to mention issues of economic diversification and sustained growth.

There is urgent need for:

- Increased investment in human & physical infrastructure
- A considerable widening of the policy space that has been restricted by years of adjustment.
- Economic diversification & sustained economic growth

Key Recommendations

- Debt cancellation must be outright & irrevocable-include all poor countries & creditors
- Debt relief must be subject to conditionality that promotes the objective of the relief operation itself-creation of fiscal space for human rights achievement.
- New lending architecture:grant-loan mix
- Resolve Debtor-creditor inequality r/ns
- Donors must ensure that adequate resources are available for all HIPCs that can progress through the process without delay.
- Extend debt relief to middle income countries not meeting the HIPC threshold.
- Recognize the necessity of Debt Audits, inclusion of Odious & illegitimate Debts

Call for a Transparent and Fair Arbitration (FTA) Mechanism.

Audio transcript

Let me move on to the key recommendations. I think that the whole aspect of debt cancellation must be outright and irrevocable. It should actually take care of all the poor countries and all the creditors must be brought on board. And what we have at the moment is that many of the creditors are outside and there are now vultures and so on. But if we brought them in, then that would make a difference. I also think that if we are to have conditionalities in debt relief, that is to do with promoting the relief operations themselves and also giving space for human rights achievements. Social, economic and cultural rights should be able to be met within the framework of debt relief. We also need to look at a new lending architecture. How do we mix grants with loans? And one of the key issues which needs to be resolved is the relationship between creditors and debtors. There has been an inequality which goes on. I think that yesterday the colleague from the Commonwealth mentioned HIPC countries that are not able to do debt audits on there own and say which debts are odious and illegitimate. Because diplomatically, they want to carry on receiving something from the donors. So I think that there is need for us to think about how to mend those relationships. I also think that enough resources must be given to all the HIPCs if they are to progress. This is how to fund the whole MDRI. Debt relief, as I have already mentioned, should be extended to middle-income countries. It should also join the others that have been calling for the issue of an arbitration process in order to deal with the situation.

Panel 6

Vulture funds

Vulture funds: moral issue or real threat?
Summary of panel discussion

Moderator: Mr. Hendrik Schmitz, Federal Ministry for Economic Cooperation and Development, Germany

Panelists: Mr. Mark Thomas, Lead Economist, Economy Policy and Debt Department, World Bank.
Mr. Daniel Zavala, Senior Vice President, Debt Advisory International, LLC, USA

"Vulture funds" are investment funds, which buy sovereign debt at a discount and then sue the debtor government for the whole amount, normally with interest and penalties added, cost the debtor countries large amounts of time and legal expenses. Nevertheless, the practice is not illegal, unless bribes or other irregularities are involved. The creditor has been willing to sell, so the funds are generally seen to win their cases. Therefore, are these simply normal business transactions that one has to live with or should the debtor be provided some form of protection?

Mr. Hendrik Schmitz introduced the topic focusing on the importance acquired in the last years by vulture funds (which he defined as funds which buy developing Country debts in order to maximize profits through the liquidity created by debt relief programs, such as HIPC). This, he explained, has been possible because the debt relief initiatives have been partial and many stakeholders, like official creditors not part of the Paris Club or commercial creditors in the case of HIPC, have not been involved. Therefore room has been created for "free-riding" activities, as the ones developed by vulture funds, which can eventually undermine the debt relief programs by threatening their transparency.

Mr. Mark Thomas gave his own definition of vultures ("purchasing with a view to litigation") and agreed on the possible serious damages they can cause to debt relief initiatives: over 24 HIPC Countries were targeted with lawsuits by 46 creditors for a total of round 1 billion US$. He also clarified that this is not a legal issue, but a moral one: on one side these funds divert much needed money away from poorest Countries; on the other they oblige the same to spend resources on legal defenses, or, in same cases, to protect their assets through non transparent accounting. Among the possible solutions he cited law restrictions (for instance: if a Country became HIPC the legal framework for debt claims has to change) or raising the costs of these funds. Another way of responding is to reduce the possible claims by enabling heavily indebted IDA-only Countries to reduce their sovereign commercial external debt as part of broader debt resolutions. Irrespective of these initiatives, he concluded, any situation should be analyzed case by case and the presence of secondary market still remains very important and should not be brought into question because of the presence of vultures.

Mr. Daniel Zavala after noting that not only HIPC Countries are targeting by vulture funds, expressed his view on the topic, pointing out their positive effects. In his opinion, they can be observed from 2 different perspectives. From the economic one, their importance is quite limited: they have been handling round 200 million US$ since the first one came out 15 years ago (the first litigation led to a successful pursuit of Peru for more than 50 US$); the only players are 5 investment funds, all based in NY. From the moral perspective, he noted, the concerns can not be justified if we consider that a huge number of private creditors are not in the position to get Paris Club-similar relief. The positive key-effect of vulture funds is their capacity of attaching stolen and hidden assets. In other words, if there were a continuative action of unveiling hidden assets there would be no space for vulture funds. Many examples can be given in that sense, but attention has been put in particular to the Zambia case, as Mr. Zavala's Advisory firm was directly involved in it and the international press considerably covered it blaming the supposed "predatory" activity of the funds. In 1979 the Republic of Zambia signed a 15 million US$ credit agreement with Romania for the furniture of agricultural machinery. Over the following 20 years Zambia made minimal re-payments and Romania decided to sell the debt to Donegal International Ltd., a company registered in the British Virgin Islands. Mr. Zavala underlined the fact that his firm advise

Donegal to buy these claims because of their financial potential and not for litigation purpose: in that case they would have started immediately a trial, and not after 3 years of negotiation (mainly in the form of debt-for-equity proposals, all rejected by the Zambian government), as they did. In 1997 A British High Court ordered the government of Zambia to pay Donegal 15.5 million dollars being the amount owed under the Settlement Agreement plus interest from the date of default (and equal to the original amount of the contract dated 1979). Therefore, considering the NPV of the flows, the recovery rate has been 43%, comparable with a Paris Club debt restructuring.

Vulture funds: morale issue or real threat?

Mark Roland Thomas

Definitions and facts

- One definition of "vultures" is "purchasing with a view to litigation:"
  - May undermine debt relief, but is legal.
- As "stewards" we encourage full burden sharing by commercial creditors:
  - But HIPC is a voluntary initiative.
- 2007 'Status of Implementation' noted 11/24 responding HIPCs targeted with lawsuits by 46 creditors:
  - Judgments believed to total about $1 billion.

Real or morale?

- Actual amounts may be viewed as not that large… although neither are they insignificant.
- Morally: divert much needed debt relief away from the poorest countries on earth and into the bank accounts of the wealthy.
- HIPCs' responses are a source of inefficiency:
  - Non-transparent accounting to protect assets.
    - Use of intermediaries and shell companies.
    - Manage foreign assets in costly ways.
  - Spend scarce resources on expensive legal defenses.

What can we do?

- Change the law:
  - Probably an unrealistic expectation.
  - *Amicus* briefs?
- "Name and shame"
  - Status of implementation reports.
- Help HIPCs defend themselves:
  - AfDB and Commonwealth Secretariat.
  - World Bank is constrained by operational policies.
  - "Contextual Notes"
- Starve the birdlife.
  - Paris Club undertaking.
  - IDA Debt Reduction Facility (DRF).

The IDA debt reduction facility

- Objective: enable heavily indebted IDA-only countries to reduce their sovereign commercial external debt *as part of a broader debt resolution.*
  - Operations involve a government buying back its PPG debts from external commercial creditors for cash at a deep discount.
  - Strategically allied with HIPC.
- **Supported 23 operations in 21 IDA-only countries**
  - $4.5 billion principal and $3.5 billion interest (arrears and penalties) extinguished.
  - $637 million utilized:
    - $218 million IBRD net income transfers;
    - $207 million donor funding;
    - $212 million beneficiary countries' own resources, IDA credits, and IMF financing.

DRF technical assistance

- Financial and legal advisers hired with grants under WB procurement:
  - Assist with debt reconciliation;
  - Contact creditors to determine market expectations;
  - Agree buy-back strategy with government, IDA (as trustee) and co-financiers;
  - Provide legal advice;
  - Draft offering memorandum to creditors;
  - Act as closing agents for the buy-back.

DRF: recent events

- Oversight Committee established (July 2006).
- DRF extended to July 2012 (April 2007).
- 23rd buyback (Oct. 2007): 2nd Commercial Debt Reduction Operation for Mozambique extinguished all remaining eligible debt.

  - $153 million of principal and interest plus associated penalties.
  - 9 cents on the dollar.
- Invitation to Creditors for 24th buyback (Oct. 2007): 2nd Commercial DRO for Nicaragua.
  - Expected to extinguish 90-95 percent of the country's remaining $1.4 billion of eligible debt.
  - About 4.5 cents on the dollar.
  - Creditors with judgments against Nicaragua forwent litigation and provided HIPC-comparable debt relief

Putting the problem of vulture funds into perspective

Daniel Zavala
Debt Advisory International LLC, Washington DC

Answering the question: "vulture funds: moral issue or real threat?"

a) To put the economic issue in perspective:

As far as we know, no more than USD 200 million has been actually recovered worldwide by "vulture funds" since they started about ten years ago. This includes sums collected on judgments and on out of court settlements, ant it compares to:

- Total African debt of USD215 billion;
- Total capital flows to developing countries annually in 2006: USD 647 Billion;
- "Bribes received by public officials from developing and transition countries is estimated at $20 to $40 billion per year – a figure equivalent to 20 to 40 percent of flows of official development assistance" (excerpt from the joint report by UN and World Bank on Stolen Asset Recovery (StAR), June 2007);
- Cumulative capital flight since the independence years ($400 billion) which represents close to double the debt of the continent (UNCTAD Report on Economic Development in Africa, September 2007);
- "For the first time, IANSA, Oxfam, and Safeworld have estimated the economic cost of armed conflict to Africa's development at $300bn since 1990 lost by Algeria, Angola, Burundi, Central African Republic, Chad, Democratic Republic of Congo (DRC), Republic of Congo, Côte d'Ivoire, Djibouti, Eritrea, Ethiopia, Ghana, Guinea, Guinea-Bissau, Liberia, Niger. (Joint Report of IANSA, Oxfam, and Safeworld "Africa's missing billions: International arms flows and the cost of conflict", October 2007.). This sum is equivalent to international aid from major donors over the same period.

These are very real issues that need to be addressed vis-à-vis Africa and severely indebted lower income countries.

On further financial aspects, the implications of outlawing the sale of sovereign debts to third parties for conversion or collection is that it will kill the secondary market for these claims as it will eliminate the buyers of last resort. The knock on effect of this will be that the cost to lower income governments of unsecured debt (trade lines, open invoice suppliers' credits, construction loans) will rise substantially. Similarly, the cost of insurance in these markets will also rise. In essence, the price of unsecured sovereign debt will go to zero on default, something that never happens if the secondary market is functioning as it should.

b) To put the ethics issue in perspective:

A fact forgotten (sometimes purposely)by the critics of the so called "vulture" funds is that those funds looking for a financial return are not going after very poor countries that have no money and hard currency revenue. They are going after the countries that could quite easily restructure their debt, regain credit worthiness and develop thanks to important export revenues especially from mineral extraction activities (oil, copper, etc.).

The reality is that apart from an early recovery against Peru in 1999, vulture funds are attaching, and trying to be paid out of, assets that were stolen and hidden by the rulers of several mineral-rich countries in Africa whose principal objective is to enrich themselves and their clan and cronies.

If all the export revenues of those countries were duly entered into the budget and balance of payments accounts, and kept as state funds in central banks or commercial banks, they would be protected from lawsuits by the strict rules of sovereign immunity.

If the developed world's governments and the International Financial Institutions they support had exerted the correct amount of pressure so that these dishonest rulers stopped plundering their own countries, there would be no hidden assets for the creditors to attach.

By conducting difficult searches to find those stolen assets and the various creative fraudulent schemes to divert state revenues, and filing costly lawsuits fiercely defended by the countries concerned, the "vulture" funds have done, for the purpose of making a profit, the work that should have been done by others for different purposes.

When stolen asset recovery efforts have been launched and supported by developed nations, they have typically targeted assets stolen by deposed rulers, which is a good thing but not sufficient to stem the permanent flow of public money stealing.

As unveiled by recent investigative journalism and well documented reports by important NGOs, developed countries' governments did not do the clean-up work because of long standing entrenched interest, whether of political or economic nature or both, between them and the dishonest rulers.

They are happy to find scapegoats such as the "vulture" funds to defuse the blame that they should receive for not going after the continuing theft of assets. But they are also embarrassed, or should be, because several of their own highest courts of justice have ruled in favor of "vulture" funds after they found out (and reported in their judgments) how elaborate schemes were set up to defraud the respective states' treasuries and the creditors.

Other private actors have launched judicial initiatives against dishonest rulers; see for instance the recently filed lawsuit in France which unveiled the huge real estate assets accumulated abroad by some of them.

Admittedly, those other actors are not filing those lawsuits to make a profit like the investment funds are. But the origin of the legal actions is the same: money stolen from the states by those who govern them.

Conclusion

With the UN-Word Bank StAR initiative we may at last see a real effort by governments and International Financial Institutions to stem the continuous flow of stolen assets and the schemes set up to divert public money. Such an effort will not go without a major fight from the kleptocrats, who will use ever more sophisticated means to conceal better what they intend to continue stealing.

If the initiative is successful, it will very quickly end the activity of vulture funds. Actually, the latter could provide good advice to the StAR initiative.

Panel 7

Contingent liabilities – the next debt crisis?

Contingent liabilities – the next debt crises? Summary of panel discussion

Moderator: Mr. Vito Tanzi, Private Consultant, Former Director, Fiscal Affairs Department, IMF

Panelists: Mr. Wassawa Kajubi, Director, Trade and External Debt Department, Bank of Uganda
Mr. Udaibir Saran Das, Division Chief, Monetary & Capital Markets Department, IMF
Mr. Thomas Magnusson, Lead Financial Officer, World Bank

Most developing countries carry a portfolio of explicit contingent liabilities through guarantees and on-lending to the private sector. These liabilities can quite easily be monitored and the risk involved can be assessed. Much more of a problem are implicit contingent liabilities since these do not arise from a legal or contractual source, but are recognized after a condition or event is realized. The central bank may for instance consider it a liability to ensure systemic solvency of the banking sector, or the central government may consider it a liability to cover the obligations of sub-national governments. How may information on contingent liabilities be gathered and what are the relevant risk indicators?

Mr. Vito Tanzi started the discussion by underlining that contingent liability have always existed but that we have only begun to know them 10 years ago. Their importance has then rapidly increased. Starting from the '80s, economical policies based on public intervention have been strongly reduced: private-public initiatives have flourished and governments have been encouraging private initiatives also by assuming the risk of failure. Although this has generated moral hazard cases, contingent liabilities (CLs) have been growing due to the fact that they are not reported in balance sheets, since in many Countries public accountancy principles do not consider them.

Recent events, such as global warming, are now raising problematic questions. Among them: to what extent a government should be considered responsible in coverage risks? How can CLs be calculated?

Mr. Kajubi presented the situation of Uganda as an example of HIPC Country (in this Country public debt was reduced from $4 to 1 billion thanks to this initiative) facing problems in dealing with CLs, even if these represent a significant percentage of the total HIPC obligations. In particular, in its process of privatization, Ugandan government has been promoting private sector participation also through CLs. It is the case of the unfunded pensions for civil servants or the obligations assumed by the government in public-private partnerships, for example in the energy sector, which are now getting problematic.

Mr. Ubaibir S.Das stated that there five different dimension in the analysis of CLs: (a) fiscal risk issue (b) contingent claims in case of default and their consequences in sovereign balance sheets (c) their financial stability dimension (d) debt management practices put in place (e) the role of CLs in the context of the whole asset-liability management. In the last years more developing Countries are focusing on CLs, but "hidden deficits" and moral hazard practices are showing that much is still to be done. CLs have to be properly identified and disclosed in budget and fiscal documentation thanks to good practices (including: classification, fiscal impact assessment, information on the past calls of government and information about the reserves created). Then they have to be well managed through a comprehensive cost-and-risk analysis and debt strategies. In particular, Mr. Das highly recommended to centralize these activities in a single DMO in which debt managers should play a pro-active role in evaluating and managing the whole "potential" public portfolio.

Besides of this, he listed other 3 challenging issues that governments have to face: (a) the development of systems for monitoring sub national and private sector debt and estimating its contingent nature; (b) the use of financial derivatives to mitigate financial risks likely to arise from contingent debt; (c) the possible new role of debt audits.

Mr. Tomas Magnusson, first stressed the difference between explicit and implicit contingent liability. The former (ex: outstanding guarantees and indemnities; insurance schemes,..) is a legal obligation, the latter (ex: bank crises, uninsured natural disasters,..) is a political choice. While it is clear the importance of keeping records of CLs, assessing, monitoring and mitigating their risks, it is much more problematic to establish which institutions should be in charge of these activities (debt management offices? Contingent liabilities unit? Special Unit in Ministry of Finance?). As far as the explicit ones are concerned, the role of DMOs is still prevalent; however, for the implicit CLs, Mr. Magnusson left the question open: in that case the question is very delicate because of the moral hazard and political choices it often imply.

Introduction to contingent liabilities

Vito Tanzi

Audio transcript

I just want to say a few things about the topic because it might not be completely known to most of the people. The problem of contingent liabilities is a relatively new problem. It has probably always existed like most problems but we have become aware of it in the last 10 years.

The problem is that the government pursues objectives by using various instruments. One very important instrument is government spending - the level and structure of government spending, taxes, various level of taxes, the structure of taxes, tax expenditure, tax incentives. The government uses regulation for pursuing its objective, certification of some activity, monetary policy, exchange rate policy, industrial policy and so forth. Well in recent years the accumulation of public debt, also the increasing fiscal deficit, tax competition and tax evasion and the changing attitude vis-à-vis the role of the government has brought pressure on governments to reduce and contain public spending. Public spending was very popular in the 60s and 70s when the government could without too many political problems increase spending and acquire popularity by doing so. This is no longer the case. Public spending is very much contained. So governments look at other options, they cannot go the debt option because debt in many countries is still quite high and there is a negative attitude towards it. So there has been a development which is relatively new: the development of contingent liabilities. The government encourages certain activities in the economy, activities pursued by the private sector, by assuming itself responsibility for failure. So, in a way, this is a relatively new development, (it certainly always existed) but new on a larger scale.

There are several examples of contingent liabilities. For example, after 11 September, various governments, also in Europe (eg. the Italian Government where I was a member at the time), took over the responsibility of the insurance of terrorist attacks against airlines. Airlines had great difficulties buying insurance at that time. Therefore the Government stepped in and said that in case of a terrorist attack within the next 6 months it will cover the costs. This was one way of encouraging activities by assuming potential costs. The government assumption of failure in investment – in the past the government was responsible mainly for infrastructure, e.g. roads, canals and so forth were built by governments. In recent years, because of the scarcity of funds and the difficulties of increasing spending, there has been a development of public-private partnerships where the government encourages the private sector, private entrepreneurs, to carry out certain large infrastructure investments. For example, the channel between England and France was built with private money. But the government takes over the responsibility of guaranteeing a certain rate of return to the investors. If the project fails, as often it happens, then the government lends itself with a large amount of money. You have the natural catastrophes as another example. The government very often steps in when there are floods, earthquakes, hurricanes. This encourages in a certain way private people to build in those areas where there is danger. It is a classic problem in the United States where the Government steps in when the Katrina happens etc. It encourages people to buy houses just along the Atlantic in places where hurricanes could happen at any moment. Another example is that of sub-national governments. There is great decentralization today but sometimes the contracts between the sub-national government and the central government is not very clear and there are implications that if the sub-national government spends more than it should and ends up with fiscal deficit, the central government steps in and covers them. You have liabilities in banking crises. Banks can go broke and then what happens to those who have deposited the money. The government steps in sometimes at great cost. In the case of Mexico for example it cost about 15-16% of GDP. In other countries, it cost even more to take over this responsibility. And you have liability in loss making enterprises, the government implicitly when you have a national airline, where the airline loses money, the government steps in to cover the cost. Finally, to mention one colossal one which could come in the future, is global warming. Suppose that global warming really takes place and suppose that many people are displaced from the places that they live, what are the responsibilities that the government has vis-à-vis this? I think that this is an area on which it would be very useful to have clear ideas before the problem happens. Otherwise, we are going to have huge problems. To finish, some of these contingent liabilities might be very, very large and cause possibilities of fiscal crises and so on. Unfortunately they cost nothing when you enter. The government makes a guarantee. As long as everything goes fine there is no cost. The cost does not appear in the budget. The fact that they do not appear in the budget, in a way this encourages governments to engage in them.

What should be done about them? That is where the problems really come. There is a need to take into account the potential liabilities, but how to do it? Accountants have not been able to tell us how to do that. And we really don't know what to put down in the budget. We economists usually encourage people to prepare their budget with a memorandum at the bottom. A footnote that says the government assumes this responsibility. But to put a precise amount in the budget; it would be necessary to make estimates about the probability that something would happen, the cost of that something happening, and this is very difficult. To conclude, this is a big developing problem that can put governments at risk.

Contingent liabilities and debt management strategy

Udaibir S. Das
Division Chief, Sovereign Asset and Liability Management Division
Monetary and Capital Markets Department, IMF

1. Contingent liabilities

- Significance
- Disclosure: good practices
- Management and debt strategy
- Conclusions

2. Definition and motivation

Key aspects

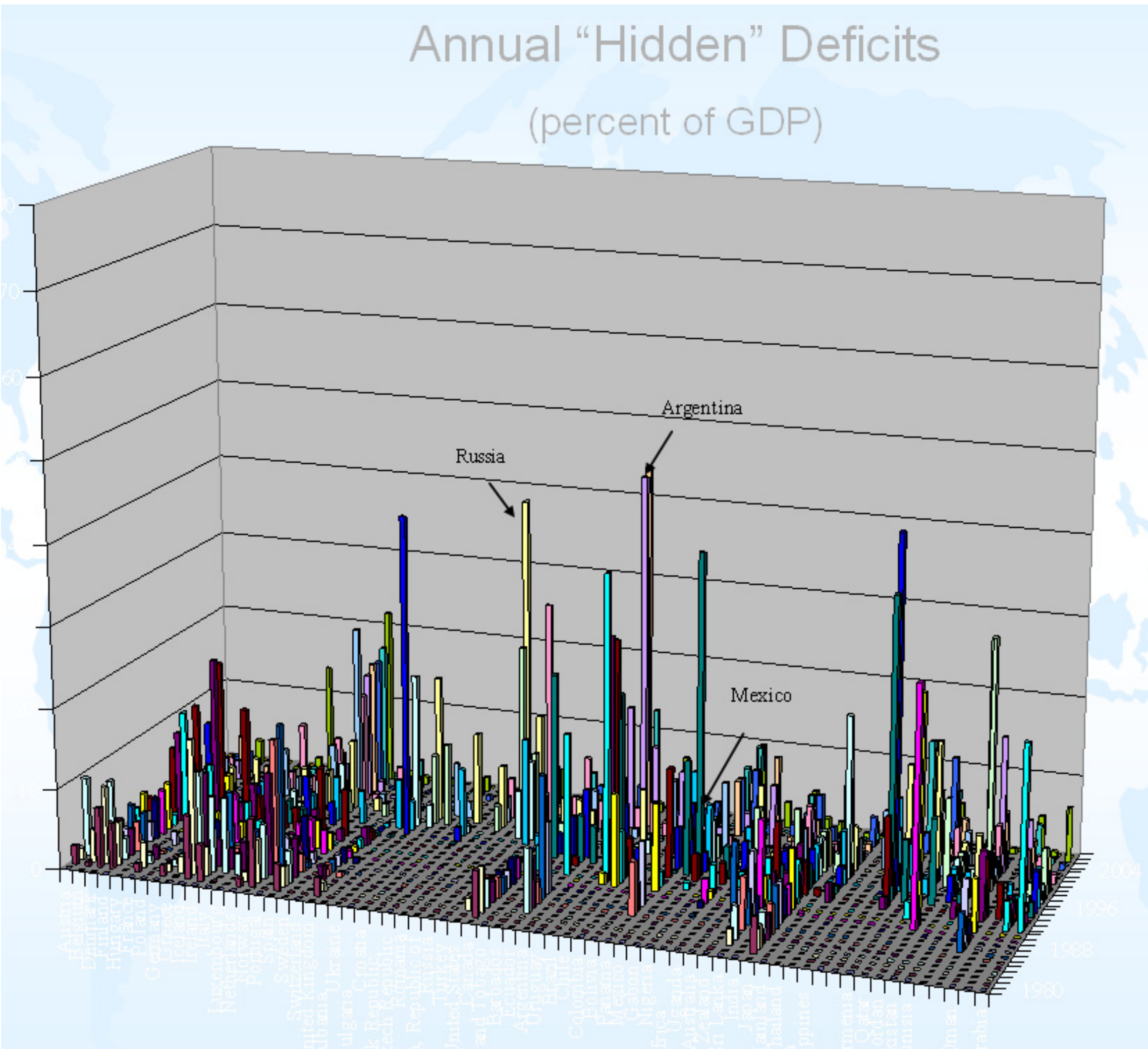
- Timing and amount of obligations contingent on the occurrence of some uncertain future.
- Event outside the control of the government.
- Explicit or implicit.

3. Significance

- Poses significant balance sheet risk:
  - Governments increasingly assuming financial risks for society;
  - Opportunistic use of contingent liabilities (guarantees);
  - Creative financing.
- Not just fiscal, but several often ignored negative spillovers.
- Often leads to large "hidden deficits".
  - fiscal balances and debt build up.

4. Significance of contingent liabilities?

Annual "Hidden" Deficits (percent of GDP)



- Moral hazard:
  - Transfer of risk to the government give rise to moral hazard.
- Particularly strong with implicit contingent liabilities (CLs):
  - Expectations that government would intervene in the event of a crisis.
    Past bailouts: Average cost 12.8% of GDP (40 sample episodes).

5. Contingent liabilities: new challenges

- Changing macroeconomic, financial and capital market landscape.
- Role of sub-nationals, and private sector debt.
- Capital market more discerning.
- Strengthening of debt management capacity.
- Transparency and disclosure.

6. Disclosing contingent liabilities good practices

- Compiled and disclosed in budget documentation, fiscal reports and financial statements.
  Exceptions:
  - Implicit CLs, to minimize moral hazard;
  - Sensitive information;
  - Implicit CLs should be made explicit if:
    - Strong prima facie evidence of a guarantee;
    - A framework to avoid open-ended guarantees;
    - Government is explicit when it will *not* step in.
- Disclosure statements should include:
  1. Classification by major category;
  2. Fiscal significance of government's CLs;
  3. Information on the past calls on the government;
  4. Information about reserve assets set aside against specific contingencies.
- A good practice to collate information on all fiscal risks into a single Statement.

7. Managing contingent liabilities: framework

- CLs should be issued under the guidance of a well-articulated policy framework:
  - Justification;
  - Design;
  - Approval and integration with budget;
  - Management and analysis.
- *A good example:* "Guidelines for Issuing and Managing Indemnities, Guarantees, Warranties and Letters of Comfort".

8. Managing contingent liabilities: justification and design

- When CLs are acceptable and preferable to other forms of support:
  - Market failure or administrative advantages;
  - Risks borne by those best placed to manage them;
  - Risk taken by government should be clearly identifiable.
- Risk sharing with private sector.
- Limiting scope and duration of CL.

9. Managing contingent liabilities: approval

- Issuance of CLs (guarantees) integrated into the budget process and taken by parliament:
  - Explicit CLs are similar to conventional debt;
  - Budget for the cost of CLs, even if budget is cash-based;
  - Legislature can set quantitative ceilings on CLs;
  - Disclose CLs and risks in supporting budget documents to give parliament information;
  - Sub national agencies?
- Country examples.

10. Managing contingent liabilities: budgeting

- Fee reflecting the market cost of the guarantee should be charged ex-ante to the recipient:
  - Prevents disguised expenditures;
  - Recipient bears cost of the guarantee;
  - State subsidy?

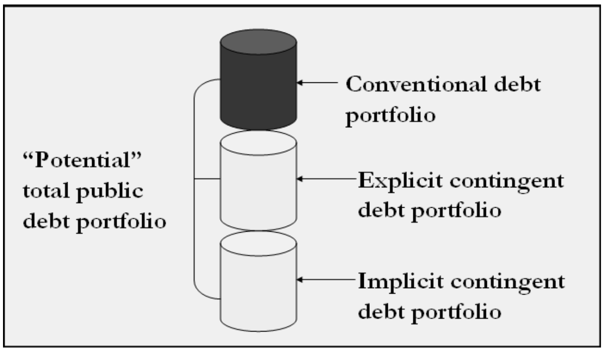
  - Margin over and above expected costs as a buffer for worse case scenario.
- Country examples.
- If subsidize, then market cost of guarantee charged against the budget:
  - Acknowledges and internalizes cost of the decision;
  - Ensures other expenditures are reduced;
  - Removes bias in favor of guarantees:
    - Guarantees often not the most efficient way to provide subsidies

11. Managing contingent liabilities: contingency funds

- Resources should be set aside to meet future costs:
  - Actual reserve funds: invest resources in managing these assets;
  - Notional reserve funds: charges reduce gross debt if other spending is crowded out.
- Other financial tools to meet future costs (natural disasters):
  - Insurance and reinsurance;
  - Calamity Funds/Contracting contingency credits;
  - Allowing contingency margin in current budget.

12. Managing contingent liabilities: integration with debt management

- Risk management of entire stock of government debt, including contingent, should be centralized:
  - Compilation and reporting of an inventory of CLs.
  - If some debts are administered by specialized entities these should be reported to the debt management office.
  - Analysis and management of risk from contingent and non-contingent debts should be integrated.
- Limited role for debt managers in decisions to issue contingent liabilities…
- …. strong case for a bigger role
  - Price CLs
  - Separates the decision to issue guarantees from their pricing.
  - Unbiased assessment of costs and risks.
  - Specialized skills may be needed in project evaluation (PPPs).
  - Guidelines on contingent debts and principles for pricing.
- Expanding the management of public debt by integrating CL makes sense:
  - A latent form of public debt with a positive probability of becoming conventional debt;
  - Represents a potential claim on the Government's balance sheet; and
  - Government's overall fiscal/financial risks better assessed and managed



- But, some informational preconditions are needed:
  - Size (expected cost) of contingent liabilities;
  - Financial risks associated with these contingent liabilities.
- "Easier" to quantify expected cost and risk associated with explicit than implicit ones.

13. Conclusions

- Increasingly important due to the implied vulnerabilities.
- Need to be properly identified and disclosed.
- Well managed, through:
  - Clear framework of CL instruments;
  - Integration in the budget process;
  - Integration with management of conventional debt.

Contingent liabilities – who should assess and monitor the risks?

Tomas Magnusson
Lead Financial Officer, World Bank

Contingent liabilities

- Contingent liabilities are obligations that arise from a particular, discrete event(s) that may or may not occur.
- Contingent liabilities can be explicit or implicit.

Explicit and implicit contingent liabilities

	Contingent Liabilities (examples)
Explicit: Legal obligation!	- Outstanding guarantees and indemnities (loan guarantees, minimum revenue guarantees, etc) - Deposit insurance and other insurance schemes
Implicit: Expectation, a political choice	- Default of non-guaranteed sub-national governments, SOEs, or strategically important private firms - Bank crisis - Failure of a social security fund - Uninsured natural disasters

Mandate of the monitoring entity

- Keep updated and comprehensive records of the contingent liabilities.
- Frequently and independently assess the risks, both the probability of a trigger event and the loss/budget impact in case of a trigger.
- Continuously monitor the risks.
- Recommend risk-mitigating actions.

Explicit contingent liabilities – DMO to be the monitoring entity?

- **Traditional loan guarantees**: Possible, contingent debt is closely related to direct borrowings; models to assess credit risks have some similarities to models used to assess market risks.
- **Minimum revenue guarantees related to project financing**: Possible, project financing normally within the remit of the DMO.
- **Bank deposit insurance:** Possible, this is within the financial sector; local banks are common counterparties to the DMO (primary dealers, credit lines, investment of cash surpluses).

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- **Bank deposit insurance:** Possible, this is within the financial sector; local banks are common counterparties to the DMO (primary dealers, credit lines, investment of cash surpluses).
- **Crop, drought and flood insurances:** Hard to find any competitive advantages of the DMO; trigger event is the weather; risk-mitigating actions include improved seeds/plants, irrigation, etc.

Implicit contingent liabilities – The moral hazard issue

An open risk assessment of non-guaranteed sub-nationals, state-owned enterprises (SOEs) and strategically important private firms may create moral hazard risks:

- Expectation of a government bailout increases → based on this expectation banks overlend to these entities → which increases pressure on the government to intervene in case of default.

Implicit contingent liabilities – A wide field

- Examples of risk-mitigating actions:
  - Place restrictions on bank and sub-national activities in the legislation (Banking Act, Local Governments Act).
  - Strengthen supervision and external auditing of SOEs and sub-nationals.
  - Privatize SOEs.
  - In case of natural disasters, encourage development of markets for risk sharing (re-insurance markets, catastrophe bonds), and strengthen land use regulations and building codes.

Who should monitor the risks in implicit contingent liabilities?

- DMO?
- Macroeconomic Unit?
- Fiscal Strategy Unit?
- A Contingent Liability Unit?
- Line Ministries?

Contingent liabilities – the next debt crisis: size and risk to governments

Cornilious M. Deredza
MEFMI

Note

Although finally unable to attend the panel discussion on continigent liabilities at UNCTAD's sixth Debt Management Conference, MEFMI were originally programmed to contribute to the panel discussion and thus requested that this paper be included as part of these Proceedings as their contribution to the discussion.

I. Introduction

As distinct from direct government liabilities, such as contractual debt servicing, for which outcomes are predictable, contingent government liabilities[201] are, by definition, the potential obligations that would materialize into costs for the government if and when certain discrete events, that however are also uncertain, occurred. A simple example of such an event is a default[202] on a loan obligation by a principal borrower, for which the government would have issued out a loan guarantee or indemnity, either for free or at a fee. In such circumstances, the contingent liability would become an actual obligation when the creditor, having established that an event of default has occurred and without recourse to some collateral, invokes the guarantee, and thus oblige the guarantor, which is the government, to settle the outstanding debt, for the debtor.

Depending on the sources and causes, the likelihood of a contingent liability being realized, and the magnitude of its cost to the sovereign balance sheet, may be either exogenous or endogenous to the government, e.g. natural disasters or consequences of government actions, respectively.

The uncertain or probabilistic nature of contingent liabilities makes them a rather obscure source of latent or invisible fiscal costs and risks, which governments should define, quantify, monitor and mitigate. Unless this is done, the true magnitude of a country’s total public debt burden, and indeed the overall liabilities on the balance sheet of the government, would be under-stated, obviously to the detriment of any holistic management and analyses of sovereign debt and its long-term sustainability.

II. Description of contingent liabilities

Contingent liabilities in general confer some financial incentives or subsidy to the beneficiaries, who may be the lower-tiers of government, such as state, provinces or local authorities, as well as state owned enterprises (SOEs), or the private sector (with subsidies for price or demand shortfalls under investments involving private-public partnerships being a typical example for the latter).

Contingent liabilities may be either explicit or implicit, depending on whether they are contractually created, or they simply arise from a moral obligation that citizens, who are the electorate, places on the government, through public policy, societal expectations or other socio-political pressures and national interests.

The legally binding guarantees and/or ‘letters of comfort’ for loans, investments, public unfunded pension and/or deposit insurance schemes, and/or risks emanating from price fluctuations, e.g. for inflation, exchange rate and commodity prices, are some examples of explicit contingent liabilities. Although the nature of the liability would be known, ex-ante, the costs involved would not be readily easy to establish prior to the occurrence of triggering events, e.g. defaults or price escalations.

Implicit contingent liabilities, on the other hand, may include the defaults of lower tiers of government or private entities, including relief for natural disasters, bailouts for possible wide scale bank, un-funded pension funds, social security fund failures and assumption of liabilities of strategically important SOEs for instance as an incen-

[201] A contingent asset, on the other hand, is one that could arise from past events, and whose existence will only be confirmed by future events that are not wholly within the entity’s control. An example could be on-lending that government holds as a claim on its books, which however only gets realized if the borrower pays back.

[202] Another triggering event could be a pending court case to determine a debt dispute, as for instance has been the case with vulture funds and litigations for debt that should be forgiven under the HIPC Debt Initiative!

tive for their privatization, that would not have been contractually guaranteed up-front by the government, but would be a moral imperative. This may also include unforeseen recurrent costs, e.g. for investments with public interest or involvement, which would not be a legal requirement for government to settle. The government is also expected to cover, usually without having to seek parliamentary authority, those unforeseen costs that may arise in the normal course of business[203], although there may be limits as to the amount that could be covered in this manner, without prior approval of parliament.

Other examples of implicit contingent liabilities are subsidies that may be provided to public utilities that provide public goods, such as water supplies, power, road construction, farming, etc., which may arise due to government's insistence on charging lower-than-market prices. The government may also make payments, ex-ante, to provide for its failure to recover (un-guaranteed) loans that it may have extended to certain public, quasi-public or private sector entities.

III. Accounting, recording and reporting

Accounting for contingent liabilities in debt databases and fiscal data has to be according to sound practice. For instance, the methodology of the Government Finance Statistics Manual (IMF, 2001) requires that transactions for government pension treat contributions as government borrowing (disbursement to government) and payment of pension benefits as debt servicing (amortization). Outstanding pension obligations would be outstanding debt. Such information could therefore be recorded in conventional computer-based debt management systems (CBDMS), such as the UNCTAD DMFAS and COMSEC CSDRMS.

It is also best practice to collect and record data on contingent liabilities in line with accrual-based reporting that captures transactions and other flows like revaluations, rather than the traditional cash-based[204] accounting. This way, the accrual approach appropriately treats the creation and extinguishing of contingent liability as financing items, and not as fiscal revenue and expenditure. In effect, the accrual approach helps to provide a more robust assessment of fiscal sustainability and changes in the net worth of government, per its balance sheet.

The data on contingent liabilities could be usefully classified into explicit and implicit categories, while also the portfolio analysis characteristics of maturity, currency composition and interest rate types, as well as the category of beneficiaries or debtors, could also be defined. They could also be categorized according to the levels of risks that they entail, in terms of the probabilities of call-ups.

The disclosure of contingent liabilities should form part of government's annual accounts[205], and also public debt management reports. Every contingent liability that implies a) creation of economic value through an obliging events; b) transfer of economic benefit; c) is extinguishable; and d) can be estimated[206] should ideally be recorded on an accrual basis for reporting in the annual accounts.

In terms of valuation[207], the liability should be recorded on the date of its incurrence, creation (accrual) or change or transfer of ownership, and should recognize, within the revaluation account (see System of National Accounts 1993), any holding gains or losses from price changes. Statistical treatment of contingent liabilities in the GFSM 2001 may vary from accounting treatment per the approach of the International Accounting Standards and International Public Sector Accounting Standards.

IV. Managing the risks to government

At the most elementary level of risk management, the government needs to deliberately have in a place a policy[208] and the supporting institu-

[203] Examples hereunder are contingent liabilities from non-insurance, where the business concerned would have been approved already, e.g. purchase of goods and services for discharge of Executive operations.
[204] For example, cash-based government pension schemes would be 'pay-as-you-go' in that payment can only be made if adequate receipts have been realized, which may under-estimate the un-funded portion of the pension, which however remains a liability of the government.
[205] Some governments report contingent liabilities as part of off balance sheet items in the financial statements of the Auditor-General.
[206] Actuarial valuations may be employed in estimating some of the liabilities, e.g. pension or insurance schemes.
[207] Monte Carlo simulation analysis and the Black-Scholes options pricing formula are some of the valuation techniques that model the behaviour of the variable that underlies the risk involved in a contingent liability.
[208] Governments may adopt a policy to allow market discipline to take its course in the event of certain fail-

tional mechanisms to limit, control, estimate and honour contingent liabilities, as well as provide for at least all explicit contingent liabilities in the government budget. This is relatively easier for explicit contingent liabilities, than perhaps for the morally imposed and less obvious implicit ones, for which only estimates can be made and provided for. However, care should be taken not to misconstrue high uncertainty as justifying excessive provisioning. As a rule of thumb, provision for contingent liabilities could be justified if it is more that 50% likely to occur. It may also be necessary to discount the liabilities for the time value of money, to get their present value.

At a more advanced level, the government needs to institute a risk management framework for contingent liabilities, be they explicit or implicit. Because it is practically difficult to manage or control that which cannot be measured, a strong back office function that helps to create the necessary database should be prioritized as the 'back bone' rather than the 'back yard' that it traditionally is considered to be. Thus, the process of risk management should ideally begin with the primary level operations that include systematic procedures for comprehensive collection, validation and auditing of the data or information on the contingent liabilities. The necessary information flows; record keeping; and database creation, processing, storage, retrieval and security, should be instituted.

Once a credible database of contingent liabilities has been created, a risk-based analysis of, and reporting on the level, structure, costs and risks of the contingent liabilities should be undertaken. The first step in risk management is risk identification for cash flows of the government revenues and expenditures under consideration. This should be followed by risk quantification and analysis to determine the cost/risk trade-off involved, in relation to the government's chosen or preferred position or strategic benchmark[209], that coincides with its risk tolerance.

The middle office would need to use and monitor the relevant basic informative 'rule-of-thumb' ratios and appropriate risk indicators, within the strategic benchmark, and consistent with set guidelines, systems, procedures and policies for liabilities management. This helps inform and measure the risks that are inherent in a government's contingent liabilities portfolio.

Examples of basic ratios may include:

- Ratios of contingent liabilities and also subsidies (by types and also for the total value) as a percentage of government-income related indicators, such as domestic revenue from all government sources, tax receipts, privatization proceeds, and more broadly, gross national income (GNI)[210]. In this regard, the vulnerability or resilience to shocks for the income variable being considered is an important factor in determining chances of failure to pay for the government;
- Sector-specific indicators that show the level of exposure to non-performance or shocks in those sectors, and hence the maximum possible or likely need for financial bail-outs, e.g. the relative magnitude and characteristics of non-performing loans in banking, pension funds or insurance companies' balance sheets for the country concerned;
- Adherence to annual ceilings for the contraction of liabilities, by category and also for the aggregate or total government liabilities portfolio;
- Indicators of the structure of the liabilities portfolio, including the maturities, currencies, financial terms including interest rates (e.g. floating versus fixed rate liabilities), fees and any other charges, as well as projections of related cash flows under different realistic assumptions for the shock variables and triggers.

Risk analysis indicators[211] which can apply for liabilities management, include:

ures that could impose implicit liabilities onto it. This also includes promoting the sharing of risks as much as rewards with private sector entities. Issuance of guarantees, warrantees, subsidies and tax concessions should also not be open-ended, and should be carefully weighted against other alternatives such as on-lending.

[209] The strategic benchmark portfolio (i.e. mix of types of liabilities, their maturity structure, currency composition, and interest rates) would be that position entailing the lowest cost for the government's acceptable level of risk.

[210] GNI adjust the gross national product for net income from the residents overseas (net of foreign residents in the country concerned).

[211] Adapted from the MEFMI Public Debt Management Procedures Manual (2005).

Cost Measures

Debt Ratios

The following debt to GDP ratios should be computed and should either be including or excluding pipeline/new loans:

- Nominal Debt Stock/GDP
- PV of debt/GDP
  - Including or excluding contingent liabilities
  - Including or excluding domestic debt

Ratio of Interest payments to tax revenues

Interest payments in a given period of time are expressed as a ratio to domestically generated budget revenues. For projections, interest is estimated based on disbursed and outstanding amounts and estimated disbursements on undisbursed balances on loan commitments as well as on pipeline loans and expected new gap filling financing.

Average growth rate of debt

This is the rate the stock of debt is growing.

Present Value of net cash flows

This is the discounted value of future debt service flows of principal and interest. The cash flows are discounted using an appropriate market based interest factor. The discounted amount gives an indication of the value of future debt today.

Average interest rates

These are average borrowing rates of a loan portfolio. The statistic gives a rough indication of the country's cost of borrowing.

Debt service projections

It provides an indication of future debt service obligations, which helps to mitigate roll over risks, which arise from bunching of maturities.

Risks and their measures

Currency risk or exchange rate risk

External debt payable in foreign currency has an unknown local currency or any other currency in which a country's reserves are kept. The payments of the loan in the foreign currency are dependent on the exchange rate at the time payments are made. If a loan is payable in Japanese Yen and the Yen appreciates, more local currency or a currency in which reserves are kept will be required. The risk on this account is known as currency or exchange rate risk.

Measure 1: Increase in debt stock or debt service on account of adverse exchange rate movements [Debt service at Risk due to changes in exchange rates]

Currency trading goes on for 24 hours a day and therefore exchange rates may change. This in turn makes the values of debt stock and debt service to change. A loss in terms of higher debt service payments on account of adverse exchange rate movements is currency risk. Central Bank determines a strategic currency distribution to match the currency distribution of assets with that of liabilities. A deviation from the benchmark currency distribution constitutes risk taking. The benchmark hence has to be developed by both asset and liability managers. The decision on the numerraire currency is important in arriving at the desired benchmark.

Measure 2: Currency composition of debt

Ratio of debt stock denominated in major currencies as a percentage of total debt stock. To manage interest rate and exchange rate volatility and mismatches, this ratio should always be monitored and compared to the benchmark.

Measure 3: Ratio of domestic currency debt to foreign currency debt

This ratio compares the debt stock and could be extended to compare expected debt service in domestic currency and in foreign currency. As in currency composition of debt, this ratio should be constantly monitored and compared with the benchmark. Most developed countries and some emerging markets have set up benchmarks of the ratio of debt that must be denominated in local currency in order to mitigate against exchange rate and interest rate volatilities and to hasten the process of developing debt markets in order to reduce rollover risks.

Interest rate risk

For loans with variable interest rates applicable, the higher the interest rate base, the higher the debt service in terms of interest.

If a country issues bonds in the capital markets, the higher the prevailing interest rates, the lower the bond price implying that investors will purchase the bond at a lower price from bond holders wishing to sell their bonds before maturity. The sensitivity of bond prices to changes in interest rate changes is known as interest rate risk or market risk.

Measure 1: McCauley Duration

Duration is the weighted average term to maturity of a bond's cash flow. It is a measure of interest rate sensitivity. In debt management, Duration is expressed in years and is the average time between interest rate reset periods. For fixed rate instruments the calculation of duration is similar to that of average life but in present value terms. For floating rate instruments, duration is the remaining time to the next reset date. A short duration generally implies a higher proportion of floating interest rate debt and/or debt issuance of very short maturities.

$$D = \frac{\sum PV_i \times t_i}{\sum PV}$$

Where:
D = Duration (McCauley)
PV = Present Value of flows
t = Time measured in years
i = Year

<u>*Modified Duration*</u>:

Modified Duration captures the price sensitivity of a portfolio to interest rate movements. It is a measure of elasticity of price versus interest rate movements. It reasonably describes the interest rate risk of a portfolio in a single number.

$$D_{Mod} = \frac{D_{Mac}}{(1+r)}$$

Where
r = Yield

Measure 2: Present Value of a Basis Point (PVBP or PV01)

PVBP measures the change in the value of a position for 1 basis point change in interest rate.

Measure3: Average Time to Re-fixing

The Average Time to Re-fixing (ATR) gives information on the exposure of the debt portfolio to interest rate changes. High ATR indicates low risk as it implies that a relatively small share of the debt will have its interest rates re-set in a short period of time.

$$\text{ATR} = \sum_{t=0}^{n} \left(\frac{t \times RF_t}{Nom} + \frac{t_0 \times RV}{Nom} \right)$$

Where RF_t denotes redemptions of fixed rate debt at time t and RV is the total outstanding variable rate debt at time t_0. Unlike Duration, interest payments are not taken into consideration in the calculation of ATR. Only payments of Principal are included and distributed over time according to the time of the re-fixing of interest rate (coupon). Also future payments are not discounted (Presentation during a MEFMI workshop on risk management).

Measure 4: Ratio of floating interest rate debt to fixed interest rate debt

Cost stability is achieved by increasing the fixed rate debt to the floating or variable rate debt. Fortunately, most developing countries especially HIPCs have debt portfolios with a high percentage of fixed interest rate debt, most of which is also concessional i.e. with a long maturity period and low interest rates. As countries graduate from HIPC and start issuing debt on the international market, it will become necessary to take the above ratio into consideration. As part of the debt strategy planning, the fixed rate debt structure should be reviewed periodically to assess its suitability given changes in the fiscal and economic environments. However, to encourage investors to invest in government's tradable securities, it may be necessary to issue floating rate debt or even inflation or exchange rate indexed securities.

The debt strategy of developing countries should emphasize the development of a well functioning securities market. A well functioning market attracts broad investor interest, which help to provide stable, low cost financing over time.

Total Market risk

Measure 1: Value at Risk (VaR), which is the increase in debt stock and debt service arising from adverse movements interest rate, exchange rate and commodity prices.

Maximum debt service cost of the portfolio with say, 95 percent confidence, taking into account market variables such as interest rates, exchange rates and commodity prices.

Value at Risk (VaR) measures the minimum loss that can be suffered over a given length of time at a specified confidence level. In fixed income portfolios, the standard deviation of the returns for a given asset shows the potential losses that can be suffered over a given time horizon. Hence, VaR is computed as: Number of standard deviations of Asset times the volatility. E.g. at 95% confidence level with a volatility of 14.402, the VaR for an asset would be: 1.65*14.402%=23.63%.

For a portfolio of $10,000,000, VaR for one year would be: 23.63% * 10,000,000 = $2,363,000.00.

VaR says the following statement: I am X percent certain that I will not lose more than V shillings in the nest N business days where;

X = confidence level
V = Value at Risk
N = Time horizon

In the above example, we would say: I am 95% certain that I will lose not more than $2,363,000.00 in the one year (252 days).

The VaR for one quarter of a year (63 working days) would have been: 23.63%*SQRT (63/252)*10,000,000 = $1,181,500

One of the three can be used to compute VaR namely: Historical simulation, Variance covariance method (assume probability distribution) and Monte Carlo Simulation.

Measure2: Cost at Risk (CaR)

This is also a summary of the total risk in a portfolio but computed using nominal amounts not PV terms, as is the case with VaR.

Other risks and their measures:

Yield curve risk: This measures/monitors changes in the slope of a yield curve

Duration risk: This measures the extent to which Portfolio duration is different from that of the benchmark

Rollover risk/Refinancing risk: Rollover risk refers to the likelihood of being unable to obtain new financing as debt matures, or of only being able to finance new debt at very high cost. In developing countries, this risk should be given high priority because failure to rollover debt can lead to a financial crisis. It can be measured as volatility relative to fiscal cash flows or refinancing gap to GDP or BOP if external debt cannot be rolled over.

Measure 1: Average maturity of debt

This gives the average period a debt portfolio takes to be repaid back. It could be a simple unweighted average or could be weighted by maturities.

Measure 2: Average Time to Maturity (ATM)

Average Time to Maturity is related to Duration as it gives information of the time length of debt obligations. Unlike Duration and like Average Time to Refixing, interest is not taken into account and future payments are not discounted. ATM is a better measure of rollover risk because it takes into account the correct maturity of variable rate bonds. In the calculation of ATM, the weights are the nominal payments of principal.

$$\text{ATM}=\sum\frac{t\times R_t}{Nom}$$

Where R_t is redemption at time t, and Nom is the nominal value of outstanding debt. While ATM gives information on the rollover risk, it is not a perfect indicator of risk. Very different redemption profiles can have the same ATM. Therefore, as with Duration, the ATM should not be used alone in assessing the risk exposure of a debt portfolio. ATM should be supplemented with measures of the share of debt falling due within certain periods and with a graphical description of the redemption profile.

Measure 3: Average life a loan or a portfolio of loans:

This is the average length of time before the principal of a loan is scheduled to be paid through amortization payments.

$$AL=\frac{\sum A_i \times t_i}{\sum A_i} - \frac{\sum D_{ii} \times t_i}{\sum D_i}$$

Where:
AL = Average Life
A = Amortization
t = Time (period of amortization/disbursements)
D = Disbursement
I = Time measured in years (0,5,1.5, 3 etc.).

Measure 4: Medium and long run term structure of debt

These measures indicate the maturity structure of the debt portfolio. A loan portfolio with more debt maturing on the short end of the maturity may imply difficulties in rolling over/forward the debt maturities falling due during the short period. This may cause a solvency or cash flow problem for the country.

Measure 4 a): Percentage of debt maturing in the next 12months

This assessment may be made by inclusive of new debt and/or pipeline debt. The benchmark of this ratio for is 10-15% for external debt and 15-20% for internal debt.

Measure 4 b): Percentage of debt maturing in the next 2 years to total debt: This is the lower end of long-term debt, which needs to be constantly monitored. The debt analyst may decide to include arrears categorized as short-term debt. If no new short-term debt is being contracted, a rise in this ratio signifies more accumulation of arrears.

Measure 4 c): Percentage of debt maturing in the next 5 years to total debt. As in 4 b) above, it is important to monitor this ratio and to establish benchmarks.

Measure 4 d): Percentage of debt maturing after 10 years to total debt
The higher this ratio is the easier it is to roll-over debt maturities, which cannot be immediately payable.

Measure 4 e): Ratio of domestic currency debt to foreign currency debt: Debt issued in local currency is easier to rollover then debt issued in foreign currency.

Measure 4 f): Ratio of financing gap to GDP:

Debt Sustainability at Risk (Dsa R): Debt Sustainability Analysis (DSA) evaluates a country's capacity to repay its debt obligations on time i.e. as scheduled. DSA however, often stops at cost analysis and excludes risk. Computation of DSA ratios is complex as it includes computing, estimating or simulating macroeconomic and financial variables. However, both macro and financial variables could seriously deviate from the expected path. Risk analysis then becomes vital in figuring out the likelihood of not meeting debt service payments on time or indeed a debt overhang.

Other measures include:

- Share of short term, foreign currency and floating rate liabilities, to the total liabilities portfolio;
- Estimated potential increase in cash outflows or outlays arising from changes in the variables to which the portfolio is exposed;
- Traditional debt sustainability indicators or ratios (ideally in present value terms, where applicable) that should incorporate the contingent liabilities in the debt variables.

Any risk analysis envisaged should comprehensively cover the important sources or types of risk, such as market, rollover, liquidity, credit, settlement and operations risks. Market risk[212] would arise from likely adverse changes in price variables (e.g. exchange, interest, inflation rates), while rollover risk would constitute inability to raise the same type or level of financing at least at no greater cost. The modeling of likely future changes in exogenous market variables and other

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[212] There may also be financial derivatives that are related to market risks, as they pertain to changes in market prices.

shocks, including vulnerability analysis, thus becomes important in this regard. Over time, the actual and target or benchmark portfolio would need to be corrected to take into account such market and other pertinent developments

Liquidity risk may be caused by a sudden reduction in the quantum of liquid assets or when there is lack of market depth that may be due to, for instance, investors exiting the bond market. Credit and settlement risks are associated with non-performance by borrowers or counter-parties who would have failed to settle for non-defaults reasons. Operational risk would be due to weak legal, institutional, security or operational systems, procedures and controls.

Effective risk management requires that adequate human[213] and financial resources, supported by appropriate informational and communication technology, are available. An enabling legal and institutional framework would also be critical for the effective management, control and settlement of contingent liabilities, within the wider scope of **liabilities management that include total public debt, in relation to sovereign assets.**

The management of contingent liabilities needs to be integrated into a country's budget and cash management framework, so as to avoid the accumulation of unsustainable levels of total liabilities, including public debt and contingent liabilities. Other active forms of risk management, such as refinancing, use of forward contracts and other derivatives, would need to be considered, in order to immunize the liabilities portfolio, as necessary. But due regard should be paid to the acceptable level of costs of implementing the strategies. In this regard, the extra cost necessary to attain that liabilities portfolio that will absorb shocks may be justifiable.

Provisions for contingent liabilities in the government budget should be made at the best estimate of the gross expenditure[214] (without deducting for possible gains which should be reported separately on the asset side) required to fully settle the present obligation at the balance sheet date, with the present value being adopted where it is materially different from the former.

V. Conclusion

In the aftermath of debt crises and debt reduction, public debt sustainability analyses should be broadened to include estimates of off-balance sheet items, especially explicit contingent liabilities, while also providing for these in government budgets, to avoid possible future debt crises from them (even where the core debt would be sustainable). Policies and regulations should be put in place that limit and control the creation of explicit contingent liabilities, while also creating an enabling market-friendly environment that obviates the need for providing subsidies and fiscal incentives. The necessary information and tools for risk management that deliberately incorporates contingent liabilities need to be developed and applied by all borrower countries. This way, sovereign liabilities would be managed in a more holistic and integrated manner for sovereign assets and liabilities, thereby helping to mitigate the risk exposures that tend to be inherent in any sovereign balance sheet.

[213] The expertise requirements are a combination of portfolio and risk analysis and debt management skills, under an environment of professional risk awareness and performance measurement.

[214] There are incidences of onerous contract, where the unavoidable costs of meeting the obligations of the contract exceed the expected economic benefit. Provisions would be needed for such cases.

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Panel 8

Formulation of strategies for entering domestic and international capital markets

Formulation of strategies for entering domestic and international capital markets: summary of panel discussion

Moderator: Mr. Ugo Panizza, Chief, Debt and Financial Analysis Unit, Debt and Development Finance Branch, Division on Globalization and Development Strategies, UNCTAD

Panelists: Mr. Udaibir Saran Das, Division Chief, Monetary & Capital Markets Department, IMF

Mr. Tadashi Endo, Senior Financial Sector Specialist, Corporate Governance and Capital Markets Department, World Bank

Mr. Dominique de Guerre, Director, Lazard Frères, France

Mr. William Willms, Director, Capital Market and Financial Sectors Division, Asian Development Bank

As foreign financing of development becomes more restricted developing countries turn to the domestic (and some also to the international) securities market for funding. Before doing so, it is important that a sound strategy is in place that aims at minimizing the cost at an acceptable risk. This panel discussed best practices for how to enter the capital market, build confidence and thereby be able to attract longer term funding.

Mr. Ugo Panizza made an introductive speech to the issue focusing on the importance of establishing effective capital markets in Developing Countries, even small, through sound policies. At the same time, he underlined that a good public capital market is condition for a good corporate one, since it creates benchmarks and general creditworthiness, but if it is oversized can even harm the second one (it's the so-called "crowding out" effect).

Then he presented a graph proving that debt levels are not crucial determinants of the perception of default risk as measured by the credit ratings assigned by international agencies. Therefore it is important to know not only the dimension of debt burden but also its composition. And, especially since in the last years we are assisting to a growth of the domestic part of the debt relative to the international one, there is a strong need for reliable national data.

Mr. Udaibir Saran Das, focusing on the recent trend of international capital markets involving low-income countries, evidenced few elements: (a) a new class of Countries is tapping the markets; (b) there are many successful examples but any "general solution" can not be applied, as each Country is unique (c) the implementation of a Medium Term Debt Strategy should be the basis of every decision of entering the markets. New open questions are coming up: the "sub-prime" crisis has had very little effect on Emerging markets, but what if the global outlook worsens? Will the specific situation of each Country taken into account? (Mr. Das is pessimistic in that sense, as their debt is seen as a whole asset class). And more: can debt international issuance led to currency mismatch? Is relevant for these Countries the experience of East Europe Countries that restructured their debt, built up firstly a local market, and then issued international bonds? Or should they follow the experience of Ghana, first HIPC Country in (successfully) tapping international markets?

Whatever are the answers, some typical errors can be highlighted: access the markets when the financial situation worsen, wrong size of the issuance, rush to market, poor selection of lead managers, insufficient choice of proposals, weak investor base, no debt strategy, delayed use of proceeds, insufficient capacity of managing risks.

Mr. Tadashi Endo described the multiple roles of the State (policymaker, regulator/supervisor, issuer and investor) which complicate the formulation a strategy for building up a sound domestic debt market. However, from the example of developed Countries, two dimensions can be outlined for building confidence and attracting longer-term funding. The first is building benchmarks for complete yield curves; the second is to support liquid secondary market of government bond, which can be used as market microstructure, yield seeking assets (to get a good mix between liquid and yield assets, as it is not needed a total liquid market) and performance competition of institutional investors. That is what he called the "3-pillar approach". In doing this, policy coordination among all the players (Central Bank, Capital Market Regulator, DMO, Contractual Savings Regulator involved) is essential

Mr. Dominique de Guerre confirmed, from a private bank point of view, the strong growth of international appetite for emerging markets. In his opinion, there are 3 key criteria in assessing sovereign credibility: transparency of the information; security (in terms of strong legal and fiscal environment); liquidity. Taking this into consideration three main categories of issuers can be highlighted:

1) Certified issuers (enjoying high level of transparency and regulation, active foreign banks, liquid markets, diversified instruments). Ex: Brazil.
2) Intermediate issuers (whose goal is to establish benchmarks and to improve market transparency and liquidity in order to create a good environment for foreign investors). Ex: Egypt.
3) Debut issuers (tending to issue instruments that can meet investors benchmarks, typically US$ 7/10 years bond with bullet repayment, to ensure diversification of sources and be internationally considered as financial players). Ex: Ghana.

Mr. de Guerre concluded stating that, in the last years, emerging markets witnessed improvement of covenants, lowering price, broad instruments and markets but confidence has to be constantly confirmed as it is long to be built but easy to collapse.

Mr. Williams Wills returned to same of the topics previously presented, adding an overview of ADB experience, especially after the Asian (currency and banking) crisis, which highlighted few key financial risks. Among them: the presence of large account deficit financed by unhedged short-term capital inflows; the overdependence on banks as unique intermediaries; the currency and maturity mismatches created by short term funding in foreign currency to finance long-term local currency investments. He lastly presented the Asian Bond Market Initiative, launched by ASEAN countries together with Japan, China and Korea, which aims to develop efficient and liquid bond markets in the region by enhancing the market infrastructure (by supporting, for example, a regional clearing and settlement system and local rating institutions). Other recent ADB initiatives are the Asian Bond online (free bond price, indicators and regulations database) and the ADB's Local Currency Bond Issuance Program.

Sovereign issuers entering international markets: a cross country experience

Udaibir S. Das

Overview

- Trends
- Preconditions
- Strategic Considerations
- Common Mistakes

A caveat

I explicitly abstract from dealing with the question of external issuance and note that I assume the overall envelope of external borrowing has been determined elsewhere in the context of a rigorous DSA and a comprehensive overall medium/long term debt strategy (MTDS), taking into account the relevant macroeconomic risks.

Africa: limited impact of turmoil

- Not noticeably affected African debt or equity markets, except South Africa.
- Explanation:
  - Limited integration with global markets;
  - Small size and low liquidity;
  - Macro story still positive with commodity prices strong;
  - Investor rationale.

What if the outlook worsens?

- Unlikely to lead to major pull backs by foreign banks and portfolio investors.
  - But, retrenchment is possible.
- Most significant risk would be from events on the real side.
- *Open question*: How sharp a decline in growth prospects and commodity prices would lead foreign banks and investors to begin pulling back from Africa?

Low-income countries as an asset class

- Potential first-time international issuers growing; potential re-access.
- Search for yield ends in Africa.
- Relatively unique investor base (Anglo and Francophone connection).
- Funding from local markets available between 1–2 years.
- Will debt issuance integrate them with global markets?
- Could external debt result in *currency mismatch* for many issuers?
- Experience of Eastern Europe *relevant* for Africa?
- Should non-concessional borrowing from international markets be *limited?*
- Swap *Paris Club debt* by issuing debut bonds in international markets?

Offshore financing?

- Subsidiaries of large banks:
  - Conduits for capital inflows.
- Inherent risk from counterparty positions:
  - Risks to balance of payments.
- Currency options market:
  - Who regulates?

Growing investor interest in the 'last frontier"

- Sharp increase in portfolio investor interest
- Drivers:
  - Debt relief restored debt sustainability in many countries;
  - Sustained record of good macroeconomic performance;
  - Diversification and "high yield" – the last region to capitalize on market convergence.
- Official sector is helping catalyze.

Recent experience

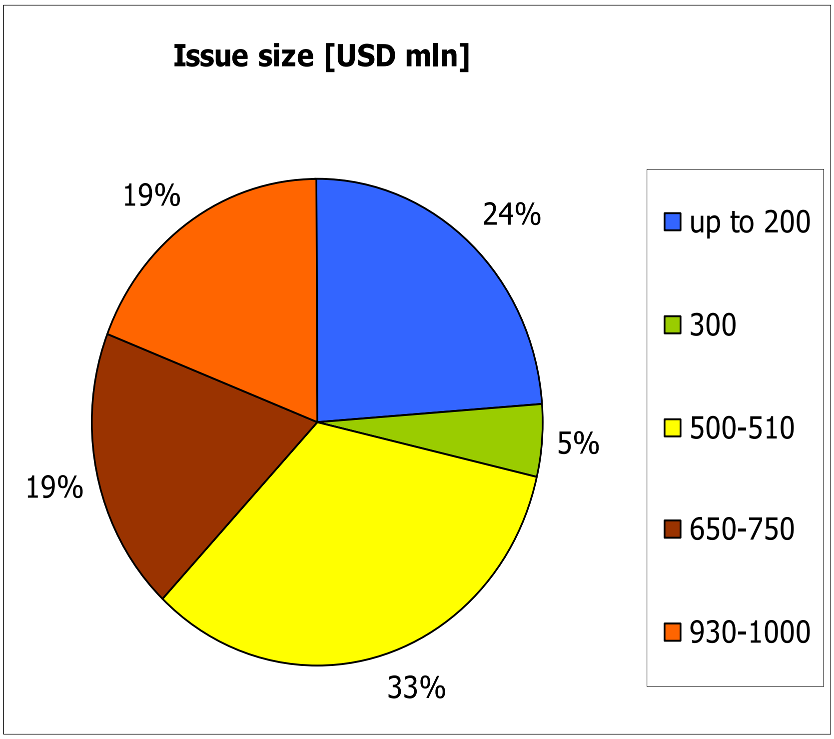
- Timing of issue?
  - Domestic and external conditions are favorable.

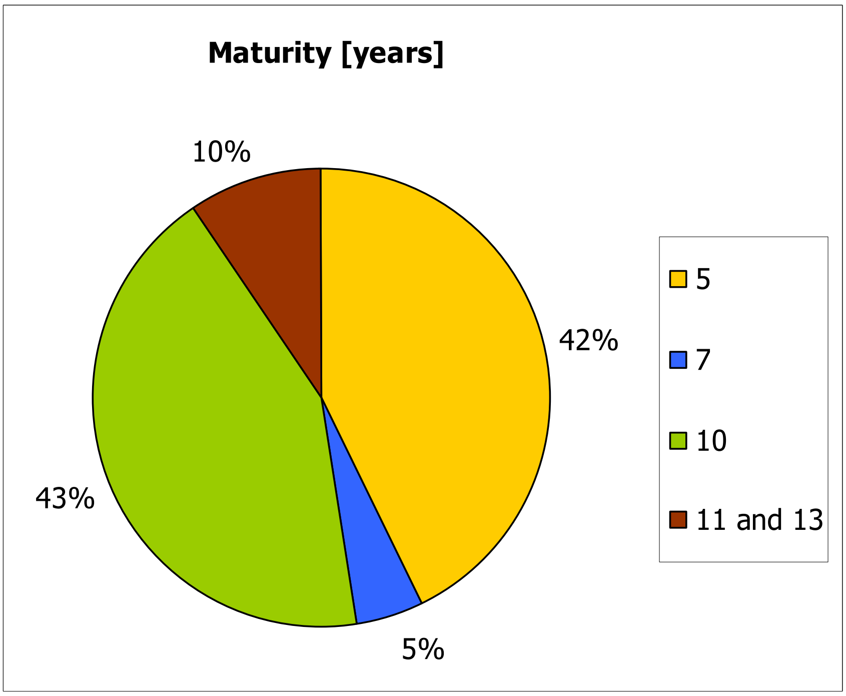
- Medium-term outlook?
  - Growth, inflation, current account, fiscal stance;
  - Servicing of existing public debt;
  - Policy transparency and adequate data dissemination; and
  - Political support in carrying out structural reforms.

External environment

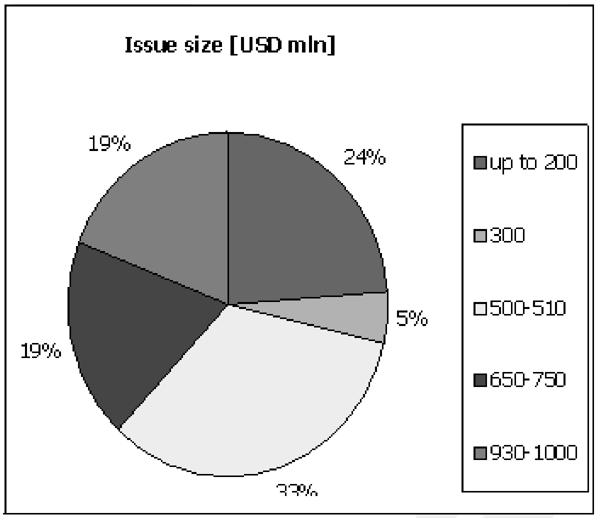
- Most issues occurred when:
  - Global liquidity was ample;
  - Risk appetite high.

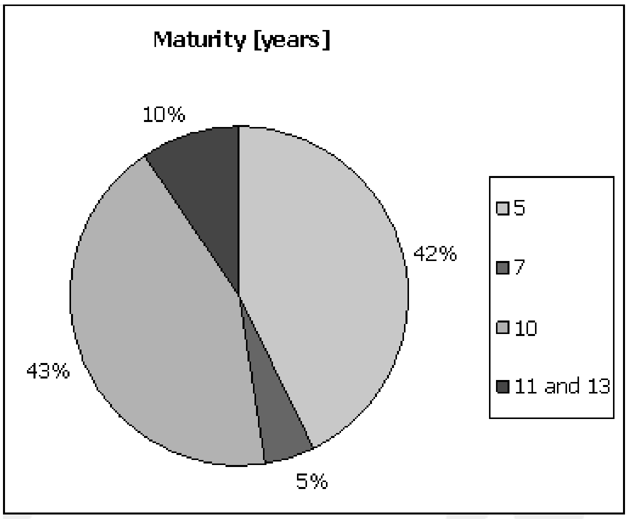
Characteristics of selected bond issues (1)

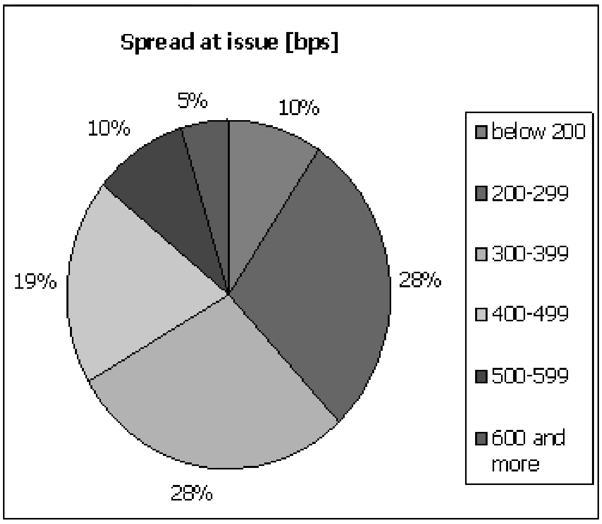


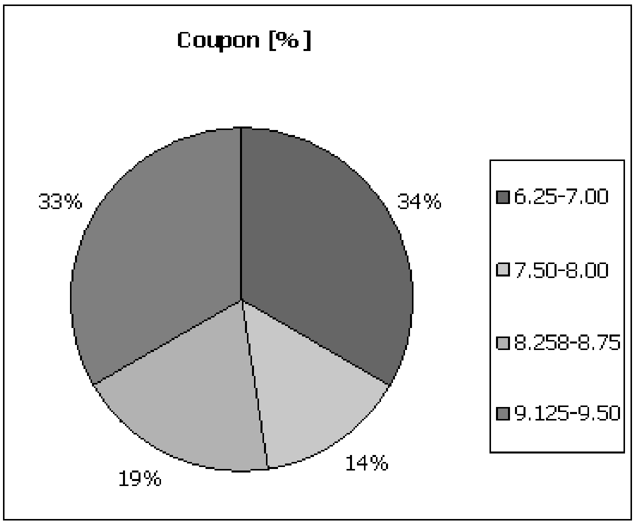


Characteristics of selected bond issues (2)





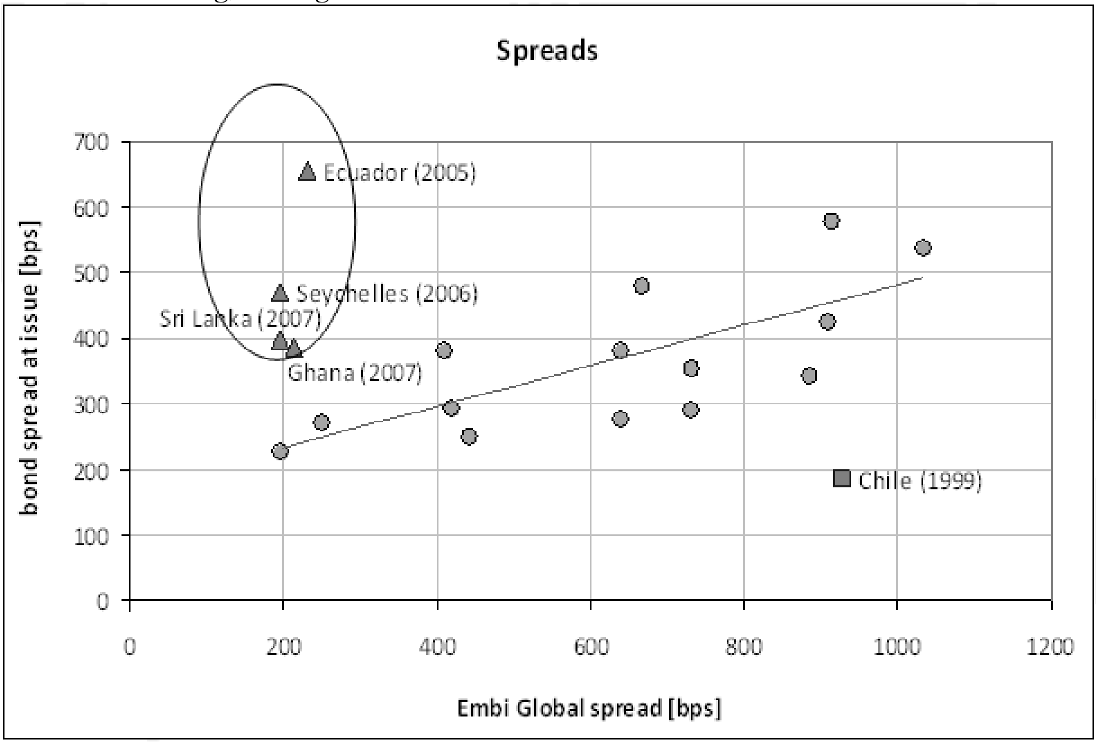




Relative cost of issue

For some issuers, relative cost (spread vs. EMBI Global) was high.

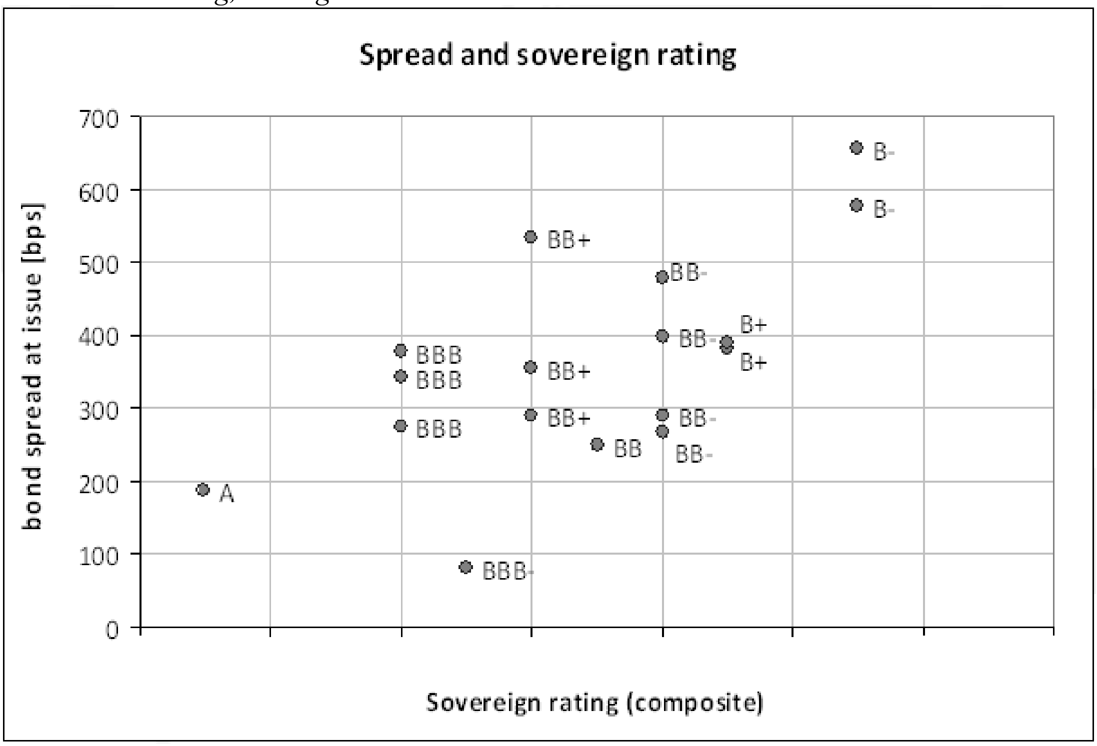
Source: Bloomberg, Dealogic



Spreads and sovereign ratings

Cost of issue (spread) strongly depends on the sovereign credit rating

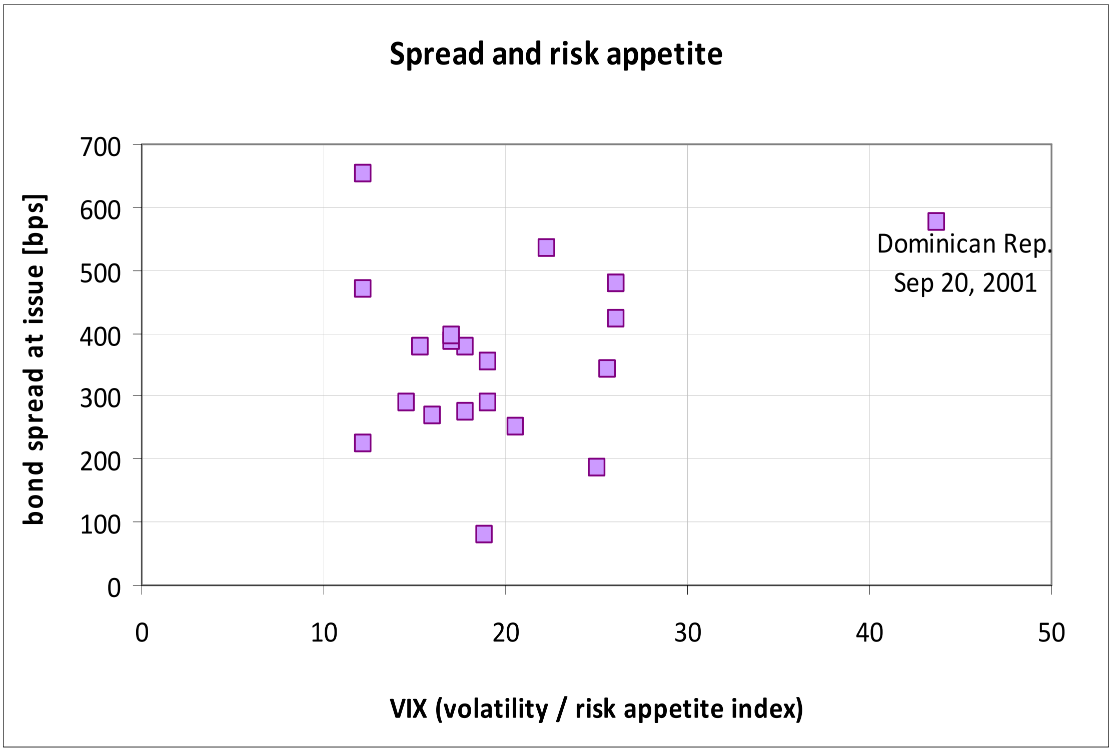
Source: Bloomberg, Dealogic



Market access and risk appetite

Most issuers access markets when risk appetite is high.

Source: Bloomberg, Dealogic.



Benefits of international issuance

- Supplements domestic savings;
- Diversifies external financing sources;
- Obtains longer maturities;
- Establishes a pricing benchmark;
- Closer international market monitoring.

Risks of international issuance

- Exchange rate exposure and debt servicing costs;
- Refinancing risk;
- Swings in terms of trade:
  - And/or when repayment of a bullet bond represents a significant fraction of export earnings.

Use of proceeds is a key factor for early decision:

- Balance sheet operations;
  - Retire existing high cost and/or short maturity debt; Paris club debt;
  - Resolve debt in arrears;
  - Reduce domestic debt.
- Financing specific projects (infrastructure).
- General government purposes (ex ante riskiest).

All within the context of a medium-term debt management plan (MTDS)

- Size, maturity and repayment structure.
- Liquidity and cost considerations.
- Larger-size issue tends to increase the rollover or repayment risk.
- Market conditions also have an effect on the size of a bond issue.

Strategic considerations

- Amortizing structure or a bullet bond?
  - Bullet bonds tend to increase the rollover risk for the issuer;

  - Perspective of reserve adequacy/coverage (R/STD.)
- **Currency denomination of debt?**
  - Considerations related to borrowing costs, currency composition of foreign trade and asset structure, and the investor base.

Tactical issues

- Choice of investor base:
  - Building up a diversified base of international investors.
- Legal jurisdiction and the form of collective action clauses to be included.
- Selection of advisors and managers.

Debt management issues

- Need to balance debt management objectives and investor-base interests:
  - Duration considerations relating to investors' portfolio preferences;
  - Trade-off between size and frequency of issues.

Other pricing issues

- Price discovery should be obtained through auctions or book building (syndication process).
- Execution risk of a new issue could be lowered by market sounding

Common errors

- Issue size; rush to market; "under pricing";
- Poor selection of lead managers;
- Insufficient choice of proposals;
- Weak investor base;
- Issuing without formulating debt strategy;
- Delayed use of proceeds;
- Insufficient capacity to manage financial risks.

Role of fund – debt issues

- As countries integrate more with global markets, the importance of debt and risk management increases.
- For the IMF:
  - Market access and level of market borrowing should be part of fiscal/debt strategy, consistent with the balance of payments' outlook
  - Debt strategy (MTDS) should be embedded in a medium-term macro framework and based on DSA and risk analysis. Work is underway with World Bank.
  - Need for parallel advice, surveillance and program, on important transactions (e.g., 1'st time issuance, restructuring).

Formation of strategies for entering domestic capital markets

Tadashi Endo

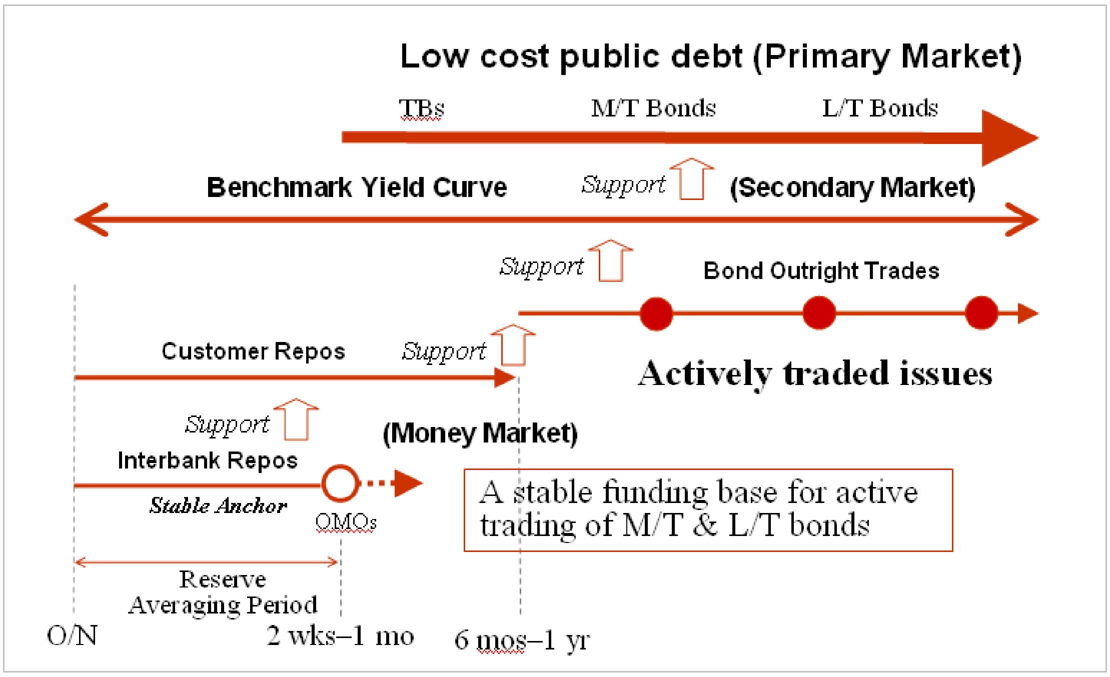
Multiplicity of the State's role in the domestic debt market

- Multiple roles of the State in the domestic debt market:
  - Policymaker for:
    - Development
    - Stability
  - Regulator/supervisor
  - (Owner/Operator of market infrastructure)
  - Issuer
  - Investor
- The multiplicity complicates the strategy formulation.

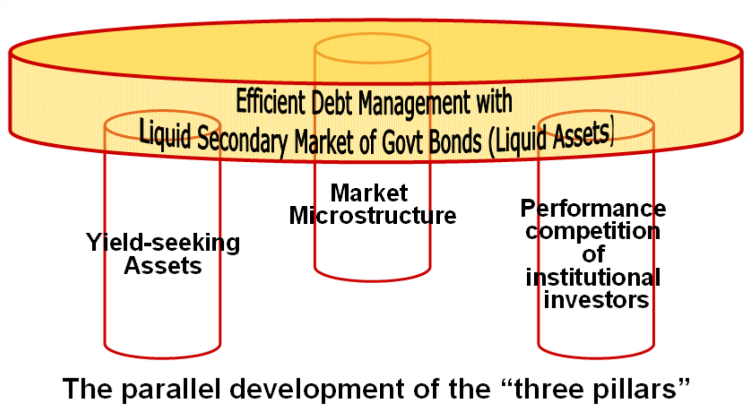
Two dimensions for building confidence & attracting longer-term funding

- Common factors for liquid government bond market
  - Supply: market-based, sizable, widely distributed, regular, predictable, and transparent supply of Treasury bonds of high credit quality, and uniform characteristics;
  - Demand: many, competitive, and diversified demand for the bonds; and,
  - Intermediation: efficient.
- Two strategic dimensions
  - Building blocks for yield curve and low-cost public debt (sequential steps)
  - Three-pillar approach (contemporaneous steps).

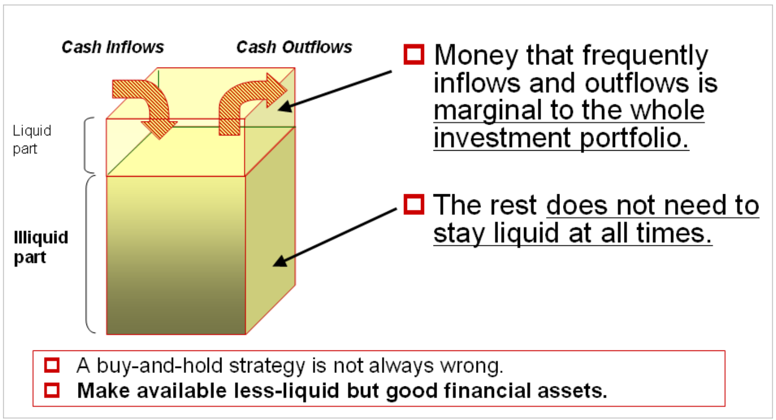
Building blocks for yield curve & low-cost public debt



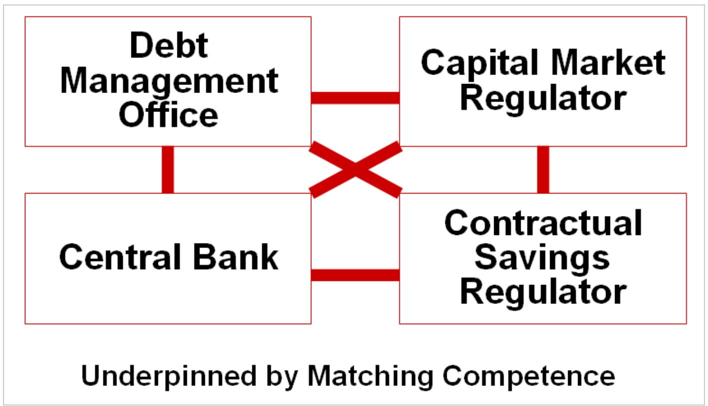
Three-pillar approach to support liquid secondary market of governmentt bonds



Three-pillar approach: liquidity assets & "yield-seeking assets" in a portfolio



Policy coordination → policy synchronization



Formulation of strategies for entering domestic and international markets

Dominique de Guerre

- International investors' appetite for emerging markets debts denominated both in foreign and local currencies has strongly increased:
  - Change and broadening of investor base;
  - Strengthening of the emerging markets as an asset class.
- Transparency, security and liquidity as determinants of sovereign credit worthiness and market credibility.

I. A historical perspective

A major shift in the emerging markets landscape

- A shift in the investor base.
- A sharp drop in the participation of International Banks:
  - The Brady initiative shifted syndicate loan financing towards bonded instruments
  - Asian, Russian and long-term capital management crisis led to a withdrawal of Emerging market assets by banks and traditional trading desks.
- A relative decline of "Emerging markets dedicated investors".
- A rise in the participation of cross-over institutional investors:
  - Growing interest for sovereign emerging instruments by US pension Funds, US mutual funds and insurance companies;
  - Broadening of the investor base to European institutional investors by the early 1990s;
  - Sovereign emerging markets progressively turned into an asset class in the perspective of portfolio diversification:
    - In 2002, merger of the emerging market bond index EMBI and the US high yield Index.
    - Resilience of the emerging markets to the sub-prime crisis.

A radical change in macroeconomic fundamentals and market structure

- A strengthening of the emerging market class
- Improved macro-economic fundamentals;
- Improved governance;
- Relaxation of market rigidities towards more friendly behavior towards foreign investments;
- "Self insurance" policies aiming at increasing market transparency, security and liquidity:
  - Improved assets and liability management practices (debt exchanges);
  - Market friendly exchange rate policies;
  - Strengthening of domestic financial institutions and implementation of prudential supervision and regulation;
  - Development of local securities and derivatives markets.
- As a result:
  - Surge in capital inflows that enabled a lowering of borrowing costs and covenants;
  - Broadening of the investor base;
  - Broadening of the investment universe (countries and instruments, notably local instruments).

Growing number of emerging countries have entered the international capital market

Guatemala (1997), Costa Rica (1998), Slovak Republic (1998), Sri Lanka (1998), Chile (1999), El Salvador (1999), Grenada (1999), Hungary (1999), Latvia (1999), Bulgaria (2001), Dominican Republic (2001), Egypt (2001), Estonia (2002), Peru (2002), Morocco (2003), Bahrein (2003), Vietnam (2005), Seychelles (2006), Ghana (2007).

II. Strategies and constraints

Sovereign credibility

- Levels of transparency, security and liquidity determine credit worthiness and market credibility.
- Hence, 3 categories of emerging market issuers:
  - Certified issuers

- Intermediate issuers
- Debut issuers

Certified issuers

Market characteristics

- A high level of market transparency and regulation.
- A secure environment for institutional investors:
  - Comprehensive custody facilities;
  - Presence of foreign banks actively trading local securities.
- A considerable and growing domestic debt market size.
- Liquid domestic bond market:
  - High daily turnover;
  - Low price inefficiencies (narrow bid-ask spread).
- Diversified investment universes

Objectives

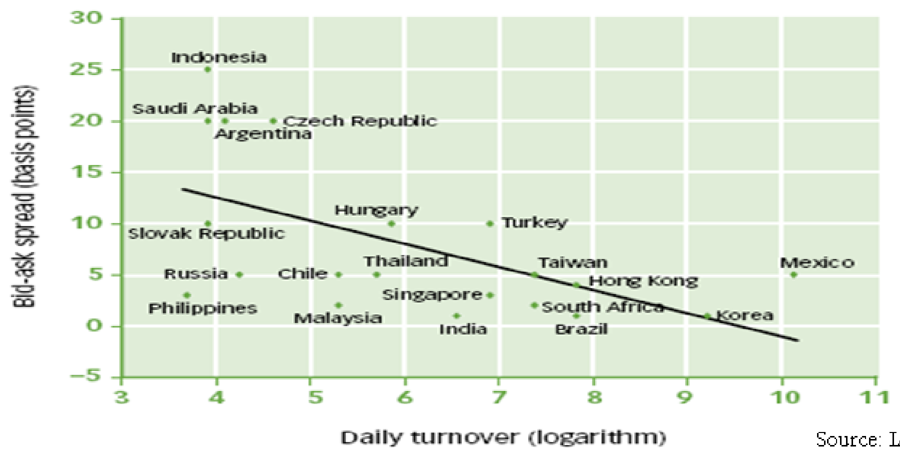
- To strengthen and improve market depth through:
  - Better market transparency
  - Appropriate market regulatory authority
  - Developed accounting, legal, and regulatory systems
  - Appropriate payments and settlements systems
  - Large network of brokers to sell bonds
  - Rigorous disclosure standards
- Efficient strategies for encouraging the participation of foreign investors:
  - Intensive Investor relation programs
  - Regular communication with fund-managers, financial media, etc…

The case of Brazil

Size of the domestic bond market

Domestic bonds /GDP			Domestic bonds /Public debt		
1990-1994	1995-1999	2000-2004	1990-1994	1995-1999	2000-2004
0.22	0.37	0.55	0.56	0.71	0,68

	Type of primary auction	Secondary market	Bid-ask spread	Daily turnover (US$ million)
Brazil	Mostly Yankee	Mostly OTC but also e	1-5	2,500



Source: IADB Living with Debt report

Intermediate issuers

Market characteristics

- Established benchmark of external bond issues
- Growing transparency in data and policies through the adoption of initiatives such as
  - IMF Special Data Dissemination Standards
  - IMF Financial Stability Assessment programs
  - Reviews of standards and codes
- Development of debt management offices with staff with extensive investment banking and trading experience
- Debt exchange programs to extend the maturity of external debt and to avoid bunching of maturities

Objectives

- To cure the original sin by:
  - Issuing in local currency and with longer maturities; and
  - Encouraging institutional and foreign investors to participate in the domestic market.
- To improve market liquidity so as:
  - To promote roll over;
  - To develop a yield curve for corporate debt issuers; and
  - To increase use of local instruments.
- To provide optimal environment for foreign investment:
  - Development of custody facilities.
  - Liberalization of capital flows.

The case of Egypt

- Access to the market in 2001
  - Issue in July 2001 of a 10 year, 1 billion Bullet with a 8.75% coupon
- Development of a yield curve for corporates
  - Government Bonds are available in local currency with up to 20 year tenors.
  - Very Liquid secondary market for treasury bills
- Development of corporate bond issuances in local currency starting in 2004
  - Orascom issued an EGP 400MM, 6 years, amortizing bond
  - The Egyptian Cement Company issued an EGP 1,000 MM 6 years amortizing bond
- In July 2007, highly oversubscribed EGP 6bn local currency denominated 5-year Global bond issue

Debut issuers

Market characteristics

- Issue of instruments must meet investors benchmark : typically 7 to 10 years bullet, US$ denominated
- Improved macro-economic environment, notably improved debt sustainability
- Graduation from official towards private sources of financing
- Transparency operation through Sovereign Ratings

Objectives

- Enter the radar screen of emerging market investors
- Ensure diversification of financing sources

The case of Ghana

- Debut US$750m 10-year Reg S 144a Eurobond/ Priced at par at 8.5% coupon (387bp over Treasuries) (A 7.73 Yield as at November 20th)
- Ghana is the first post-HIPC (Heavily Indebted Poor Countries) country to successfully enter the international capital market
- The sovereign issuer attracted over $3 billion orders received from 158 investors and sold a larger-than-expected $750 million 10-year Eurobond
- Ghana has emerged as a trend-setter in sub-Saharan Africa
  - Political stability
  - Improved macroeconomic policies and extensive external debt relief

Conclusions

- Growing attention to Sovereign Emerging Markets that has been fostered by the Sub-prime crisis:
  - Emerging Market resilience to the crisis;
  - A search for « single name » instruments;
- A surge in capital inflows that enabled a lowering of borrowing costs and covenants;
- No General Solutions but tailor made strategies; and
- Timing opportunities are the essence.

Importance of domestic and regional bond market development – Emerging markets: formulation of strategies for entering domestic and international bond markets

William Willms
Director Asian Development Bank

Section 1: Overview of the Asian Development Bank and its Public and Private Sector Operations

Overview of the Asian Development Bank

- *Mission:* Improving the welfare of the people in Asia and the Pacific by helping developing member countries in sustainable economic growth.
- *Members:* 67 members, 48 from the region and 19 from other parts of the globe.
- *Legal Status:* International Organization with diplomatic status.
- *Offices:* In 22 member countries in Asia with headquarters in Philippines.
- *Key modalities to promote growth:*
  - Lending to member countries;
  - Policy dialogue;
  - Technical assistance for policy/regulatory development; and
  - Investment in private sector companies.
- *Volumes:* ~$6 billion annually (loans & equity), $80 million (technical assistance).
- *Rating:* 'AAA' by S&P/Moody's/Fitch.

The Asian Development Bank's unique positioning

- ADB is a unique international financial institution:
  - Public sector activities and private sector operations are under one roof; and
  - Solely focused on Asia.
- Synergy between policy work and private sector investments:
  - Policy dialogue with governments on the enabling environment for private sector investments; and
  - The Asian Development Bank can catalyze private sector resources for specific projects/transactions.
- **Focus areas of Public Sector Departments:** banking and financial sector, infrastructure development and social sector.
- **Focus areas of Private Sector Operations Department:**
  - Infrastructure (Infrastructure Division); and
  - Financial institutions (FIs) and capital markets (Capital Markets and Financial Sectors Division).

Section 2: Formulation of bond issuance and domestic bond market development strategies

Government bond issuance and development of government securities market are intrinsically linked.

- Government bond issuance activity is key to:
  - Fund fiscal deficits and smooth consumption or investment and to build foreign exchange reserves; and
  - Development of domestic bond markets - create benchmark issues and yield curve for valuation of sovereign credit risk.
- Important to take holistic view when tapping bond markets:
  - Fiscal perspective;
  - Assess need and ability to develop domestic bond market;
  - Implications of International Market exposure for whole economy like:
    (i) effects on cost of foreign borrowing for entire economy;
    (ii) country`s creditworthiness, and
    (iii) foreign exchange exposure.

Importance of domestic bond market

- Development of domestic bond market is key to:
  - *Financial Stability* as shown during the Asian Financial Crisis by reducing foreign

currency exposure and improving financial intermediation
  - *Dispersion of Risks:* Avoiding concentration of intermediation uniquely to banks
  - *Efficient Allocation of Resources:* Market interest rates reflect opportunity cost of funds at given maturity
  - *Efficient Pricing:* Increase price competition instead of relying on banks only
  - *Corporate Funding:* Create possibility of matched currencies
  - *Domestic Savings:* Stimulate domestic Savings
  - *Reduce Cost:* liquid and deep government bond market will over time reduce debt service cost

- Reduces risk of Government relying too heavily on (monetary) Central Bank funding.

- Deep money and bond markets influence effectiveness on Central Bank's monetary policy.

Successful development of Government securities market depends on enabling environment…

- Not always necessary:
  - Government has no budget deficit;
  - Country not large enough to support necessary infrastructure;
  - Other options available (private placement of securities; development of retail market; regional solutions).

- Efficient bond markets are characterized by:
  - Competitive market structure;
  - Low transaction costs;
  - Low levels of fragmentation;
  - Robust and safe market infrastructure;
  - High level of heterogeneity among market participants.

- Concentrate first on establishment of basic prerequisites
  - Credible and stable Government;
  - Sound fiscal and monetary policy;
  - Effective legal, tax and regulatory infrastructure; and
  - Adequate settlement arrangements.

… and formulation of a sustainable debt issuance strategy

- Market-oriented funding strategy
  - Market determined interest rate;
  - Strategy taking into account (i) size of country; (ii) matched macroeconomic policy framework and issuance denomination; (iii) development of institutional investor base; and
  - Broad market access and fairness.

- Close coordination of debt management/fiscal and monetary policy makers.

- Create prudent risk management mechanism (quantify/qualify and regularly monitor and measure market, liquidity, roll-over, credit, settlement and operational Risks).

- Development of primary market structure:
  - Establish efficient sales procedures (auctions, retail schemes, tap sales, and/or syndication) in light of investor base and state of financial system development;
  - Determine how technology can be used to create new distribution channels; and
  - Determine merits for usage of primary market dealers.

- Consider regional integration and cooperation issues.

Certain issuance considerations

- Define optimal Issuance Features
  - *Bond Features:* Fixed vs. floating; maturity; denomination; size; redemption scheme.
  - *Timing:* External environment like emerging market credit spreads and developments in mature bond markets and domestic environment.
  - *Borrowing cost:* Appropriate spread over used benchmark and market comparables.
  - *Placement:* Liquidity considerations and Investor Base as well as bond placement issues (public/ private and underwritten/best efforts/coupon floors).
  - *Rating:* Investor requirements and rating agency selection.
  - *Advisors:* Associated issuance cost and appointment of third-party lead arranger and legal advisors.

- Domestic versus international issuance:
  - Cost of borrowing;
  - Avoidance of crowding-out;
  - Debt service and repayment of principal ability.

N.B. Investor feedback and international as well as domestic market conditions to be assessed – placement, pricing and rating considerations crucial.

Government Securities

- Establishment of domestic Government benchmark yield curve is…
  - Key building block for development of liquid bond market and overall credit curve;
  - Basis for pricing other fixed income instruments, i.e. key building block for the development of other segments of the financial market (e.g. foreign exchange hedging, etc);
  - Provides valuable information about expectations of likely macro economic developments and market reactions to monetary policy.
- Issuance of benchmark securities driven by:
  - Concentration on *popular standard maturities* (3-6 months and 2, 5, 10 years) to create liquidity;
  - But necessity to *build the curve* (spreading benchmark issues across range of maturities);
  - Certain issuance size needed for liquidity but to be balanced with frequency in case of small market;
  - Establish buy-back and re-opening programs.
- Actions to prevent manipulation:
  - *Keep it simple* (Treasury bills and bonds; fixed over floating) and aim for *standardization* (to avoid market fragmentation); and
  - Consolidate wide spread public entity issuance.

Section 3: Bond market development in Asia

Lessons learnt from the 1997/98 Asian

- Asian Crisis culmination of a twin crisis…
  - Currency crisis: due to volatile capital flows;
  - Banking sector crisis: due to rising volume of bad loans
- **…** crystallized certain key financial risks:
  - Large account deficits financed by unhedged short-term (foreign) capital inflows;
  - Excessive reliance on commercial banks for domestic financing (especially when banks are inadequately supervised and lack prudent risk management capacity);
  - Double mismatch problem (currency and maturity mismatches created by borrowing short term in foreign currency to finance long-term local currency investment).
- Development of domestic and regional bond markets key to regional financial stability:
  - Reduce the double mismatch problem (currency and maturity);
  - Reduce over-dependence on bank borrowing and diversifying financial risks;
  - Provide alternative sources of financing for (long-term) private and public investment;
  - Provide alternative mode of wealth holding for Asian households; and
  - Reduce information asymmetries.

Issues and challenges going ahead for fully developed local bond markets across region

- *Lack of liquidity* especially for corporate bonds in both primary and secondary markets
  - Lack of diversified investor base – the more investors the more trading activity
  - Lack of hedging instruments such as currency swaps
  - Lack of investor confidence in legal and judicial systems to hold and enforce contracts
- *No reliable benchmark yield curve* to price long term risk: Bond issuances are not regular and often all or parts of tender issues are rejected to keep interest rates on Government bonds low.

- *Market infrastructure is immature* with weak clearing systems and settlement systems
- *Lack of readily available public information* which limits market's ability to assess credit quality
- *Lack of timely information* which would typically generate market reaction and market activity
- *Lack of post trade transparency* which helps to reduce differences in spreads and promotes liquidity

Key policy recommendations for ASEAN+3 countries

- Enhance market efficiency:
  - Remove policy distortions that effect efficient allocation of savings;
  - Strengthen regulation and supervision of financial sector – introduction of international accounting and disclosure standards;
  - Need to develop benchmark yield curves;
  - Improvements in market infrastructure to enhance transparency and security of transactions (appropriate issuance and bidding modalities and delivery and settlement systems);
  - Create measures to enhance Secondary Market liquidity;
  - Rationalization of taxes needed – abolish any ad hoc tax treatment; and
  - Revise/issue new laws, rules and regulations to adapt to dynamic global market.
- Key is well-defined plan to develop the government and corporate bond markets
  - For example Malaysia – capital market master plan;
  - Philippines – capital market development plan;
  - Thailand (Appendix).

Section 4: Asian Bond Market Initiative (ABMI)

Introduction to ABMI

- Overview

  This Initiative was endorsed by the ASEAN+3 Finance Ministers Meeting in August 2003 in Manila, Philippines. ABMI aims to develop efficient and liquid bond markets in the ASEAN+3 regions. The participation of countries in the initiative is on a voluntary basis.
- ADB as focal point and facilitator
- Focal areas:
  - Facilitate access to market via a wider variety of bond issues in Asia;
  - Enhance domestic market infrastructure for bond issuance;
  - Enhancing Regional Market Infrastructure: (i) regional settlement and clearing system; (ii) strengthening local rating agencies; (iii) regional credit guarantee mechanism;
  - Working Group 1: New Securitized Debt Instruments.
  - Working Group 2: Credit Guarantee and Investment Mechanisms.
  - Working Group 3: FOREX Transactions & Settlement Issues.
  - Working Group 4: Rating Systems.

Further Asian Development Bank efforts in improving local bond markets include:

- Technical assistance and policy advice addressing impediments to domestic bond market development and creating the enabling environment and supporting market infrastructure:
  - For example Thailand capital market Program;
  - Securitization Law program in PRC, Kazahkstan, Philippines;
  - Non Performing Law Initiative in the Philippines, India, Malaysia, PRC
- Provision of (partial/full) credit and political risk guarantees.
- Issuance of Asian Development Bank bonds in local currencies to promote national and regional bond market development.
- Support of regional cooperation through Asian Bond Market Initiative (ABMI).

Asian Development Bank efforts in improving transparency and information dissemination – Asian Bond Online

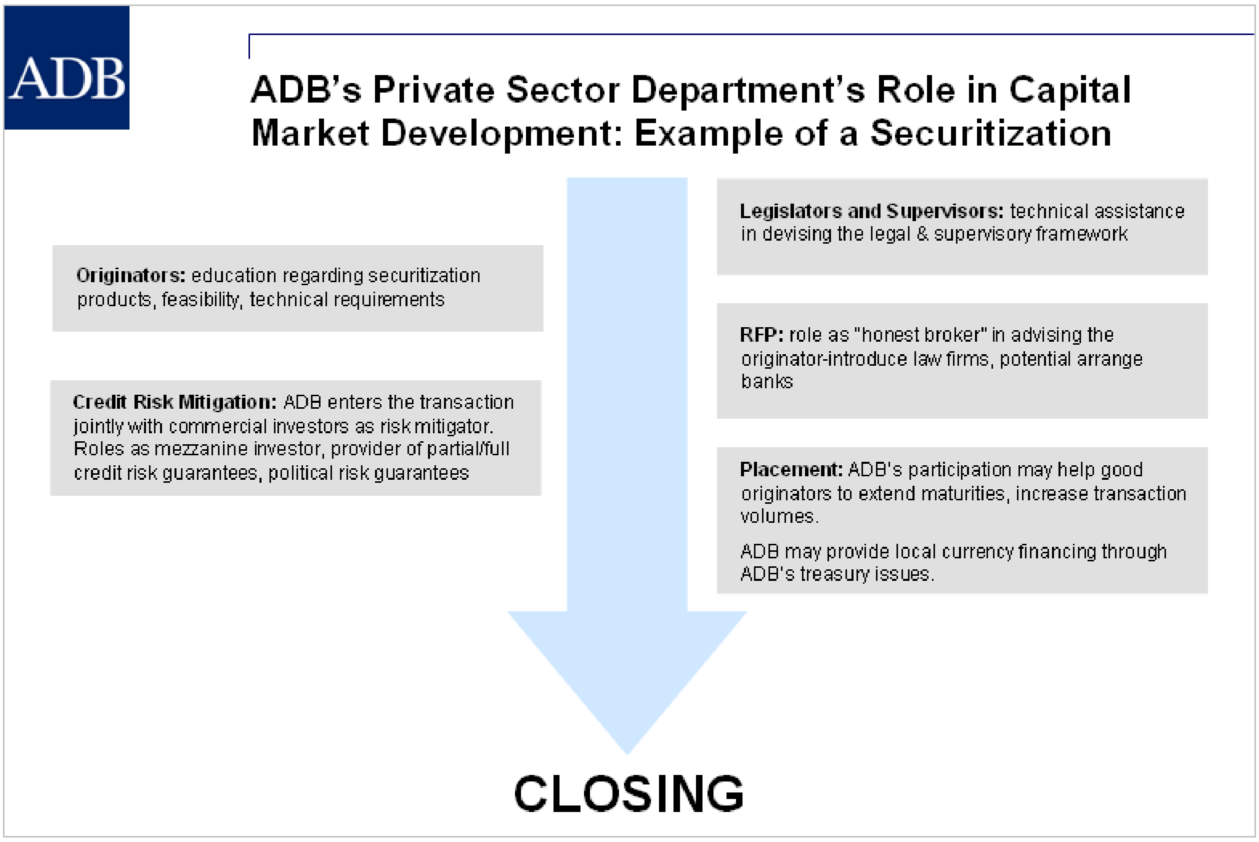
- Asian Bonds Online Website; (http://asianbondsonline.adb.org)

- Launched May 15, 2004 – a one-stop information site on ASAEAN+3 bond markets;
- Completed studies of working groups can be downloaded from this site; and
- 2000 visitor sessions per day.

- Unique features of Asian Bonds Online:
  - Free access (to leading bond market indicators comparable across the ASEAN+3 economies);
  - Updated Government policies and regulations;
  - How to buy bonds (providing investors the step-by-step mechanics of buying and trading government and corporate debt securities covering the entire ASEAN+3 economies);
  - Asian Bond Glossary.
- Asian Bond Monitor: A bi-annual (April/November) publication.

Asian Development Bank efforts in establishing domestic yield curves – Asian Development Bank's Local Currency Bond Issuance Program

- ADB providing benchmark issues in various domestic markets:
  - Samurai bonds in the 1970s opening up the Japanese capital markets;
  - Philippines (2005), Malaysia (2005/2006), People's Republic of China (2005), India (2005), Indonesia (2006), Thailand (2005/2006), Kazakhstan (2007);
  - Newly established Asian Currency Note Program (under English law and ADB MTN Documentation; and
  - Various domestic bonds planned.
- Funds raised are used as matched re-financing for local currency lending activities of the Asian Development Bank's Private Sector Department in Asia emerging markets.



Progress and trends: looking ahead for Asia's bond markets

- Emerging East Asian bond markets are expanding rapidly.
- Excluding Japan, local currency bonds have increased from USD 448 billion in 1996 to over $2.8 trillion as of December 2006.
- Growth in corporate bond market fuelled by demand for annuity by contractual savings institutions.
- Growth in government bonds spurred by:
  - Strong infrastructure spending; and
  - Sterilization requirement.
- Asia's debt markets will continue to attract global investors if they develop risk based regulatory environment:
  - Improve risk hedging options;
  - Adopt measures to improve risk management; and
  - Improve market infrastructure (including securitization markets).

Appendix

Need for regional bond market as key lesson of financial crisis

- Development of regional bond market key to regional financial stability as they can:
  - Reduce the double mismatch problem (currency and maturity);
  - Reduce over-dependence on bank borrowing and diversifying financial risks;
  - Provide alternative sources of financing for (long-term) private and public investment;
  - Provide alternative mode of wealth holdings Asian households; and
  - Reduce information asymmetries.
- Hong Kong, China; Singapore; Taipei, China and Korea have developed successfully domestic bond markets.

Then (1997)

- Asian savings invested abroad and channeled back into the region (on a short term basis to fund long term investments)
- Bank-centered financial intermediation
- Financial sector development more focused on national efforts

Now (2007)

- Use savings for productive investment within the region
- Capital market development (in particular bond market development) on focus area
- Enhanced Regional Cooperation

N.B. development of ASEAN economies:

- Need to deepen and diversify local bond market;
- Enhance market discipline; and
- Improve risk management systems.

Some considerations for international issuance

<u>Benefits of Foreign Capital Inflows</u>

- Investment and growth: if used for investment and low level of corresponding savings;
- Consumption smoothing: to shield consumption from temporary adverse shocks to national income;
- Increased efficiency of banking sector; and
- Increased macroeconomic discipline.

<u>Benefits of Foreign Capital Inflows</u>

- Limited effect if misallocated (used for consumptive purposes);
- In practice limited as lack of access in bad times or only at prohibitive cost;
- Pro-cyclicity and volatility of capital Inflows;
- Loss of macroeconomic stability: (i) in case of fixed exchange rate can lead to rapid monetary expansion if not appropriately sterilized, resulting in inflationary pressure in domestic economy; (ii) real exchange rate could appre-

ciate and existing current account deficit could widen

Thailand: measures taken to develop bond market

- Building a benchmark yield curve: Primary dealers are assigned to submit end of the day indicative quotes for Government Bonds for yield curve construction.
- Announcing government debt issuance calendar, in order to enhance continuity, predictability, and transparency of bond issuance.
- Developing and electronic bidding process: online bidding instead of receiving bids on paper (since 2003).
- Introducing non-competitive bidding system: Since 2007 for certain investors – their effective yield curve will be equal to the weighted average accepted yield of the competitive bids resulting in wider investor base.
- Allowing foreign entities to issue bath bonds (Asian Development Bank first issuer).
- Broadening investor base: Education of retail investors and Ministry of Finance's issuance of savings bonds as an alternative investment instrument for retail investors, while non-resident investors are tax-exempt for returns.
- Developing hedging instruments: Derivatives Market Act in 2004 (Futures Exchange Market).
- Centralizing the securities depository and clearing and settlement system:
  - Since 14 May 2006, the depository of public debt securities has been migrated from the BOT to the Thailand Securities Depository (TSD).
  - Prior to that, the clearing of government bonds has been at BOT and corporate bonds at TSD.
  - Centralization will help efficiency and reduce costs.
- Encouraging corporate bond issuance:
  - Securities and Exchange Commission (SEC) as capital market regulator has been making efforts in pushing through regulations for securitization and streamlining the process for corporate debt securities issuance.
  - E.g. the SEC filing and credit rating have been waived for debt issues with an offer amount not exceeding 100 million baht and with transfer limit of not more than 10 holders.
  - Expand shelf-filing to include investment grade long-term bonds.

The Asian Development Bank as guarantor in securitizations: full credit wrap

- The Asian Development Bank's triple-A rated guarantee benefits both issuers and investors by lowering overall financing costs, improving marketability and liquidity, diversifying portfolios, and adding credit strength to assets, structures and countries.
- The Asian Development Bank's financial guarantee is an unconditional and irrevocable promise to investors that they are paid the full amounts due to them under bonds, should the issuer fail to pay.
- Principal and interest repayments will be made by the issuer according to the original schedule when the securities were issued.
- An Asian Development Bank's wrap provides the ultimate structural protection.
- When a bond is guaranteed (or insured/wrapped) by the Asian Development Bank, it automatically receives a triple-A rating regardless of its true, underlying transaction (shadow) rating.
- The Asian Development Bank typically requires the underlying transaction rating to be investment grade by one or two rating agencies (S&P, Fitch and Moody's).
- Alternatively provision of principal only guarantees or political risk insurance (Four point insurance: Expropriation, Transfer and Convertibility, Political Violence, Breach of Contract).

Case Study: Kazkommertsbank


This announcement appears as a matter of record only

KAZKOMMERTSBANK

Originator of the Diversified Payment Rights and Servicer

JSC Kazkommertsbank

USD 150,000,000 Series 2007A Notes due 2017

USD 250,000,000 Series 2007B Notes due 2017

USD 100,000,000 Series 2007C Notes due 2017

Merrill Lynch

Merrill Lynch & Co.

WestLB

WestLB AG, London Branch

Joint Lead Arrangers and Bookrunners

FGIC

2007A Financial Guaranty Insurance Policy Provider

Financial Guaranty Insurance Company

MBIA

2007B Financial Guaranty Insurance Policy Provider

MBIA Insurance Corporation

ADB

2007C Financial Guaranty Provider

Asian Development Bank

April 2007

New features:

- Reg 144A Program;
- Third deal of KKB;
- Largest DPR securitization at that time in Kazakhstan;
- First time ever reached maturity for ten years for this type of transaction; and
- Several times over subscribed.

Panel 9

The use of capital market financing – country case studies

The use of capital market financing – country case studies: summary of panel discussion

Moderator: Mr. Chris. Itsede, Director General, West African Institute of Financial and Economic Management (WAIFEM).

Panelists: Mr. William Ortiz Linares, Chief, Domestic Capital Markets Group, Public Credit and Treasury, Colombia
Mr. Zouhair Chorfi, Directeur du Trésor, Ministère des Finances et de la Privatisation, Morocco
Mr. Jose Franco Medeiros de Morais, Head, External Debt Operations, Head , External Debt Operations, Treasury, Ministry of Finance, Brazil

In this panel debt managers from the countries themselves described their experiences with capital market financing. How they developed the markets, how they undertake risk management, how they target the market by using retail bonds and how they managed to extend the duration of their instruments.

Mr. William Ortiz Linares' presentation started with a short historic overview of the situation since the beginning of the decade. He stated that efforts to improve the debt structure were paying off while exposure to currency risk had been reduced.

He then spoke on the relationship between capital markets, derivatives and money markets. He said that the development of the money market was the base for the development of the capital market via instruments and indicators. He added that the development of the derivatives market (which may or may not be listed on the stock exchange) complements the development of the capital market. He also mentioned that Colombia currently was undertaking, a project with the World Bank in the area of money market instruments. To illustrate the development in Colombia Mr. Linares presented the figures for the evolution in the issuance of fixed-rate TES bonds which are Class B Treasury bonds and illustrated the consolidated yield curve.

In the area of foreign investment, Mr. Linares presented figures showing the evolution of foreign investors in the TES B bonds. He said that discussions between the Government and the Central Bank were held which focused on the volatility of prices in the local market and the impact on the currency exchange market as well as the diversification in the investors.

Mr. Zouhair Chorfi first summarized the development of the domestic market and then explained the use of the international financial market. At the end of the rescheduling cycle in 1993, Morocco faced a situation where public external debt service absorbed more than 30% of budget revenues and structural negative net flow of external financings which absorbed a significant part of its internal resources

Consequently, Morocco has engaged in a vast program aimed at modernizing the Treasury domestic financing in order to obtain favorable conditions in terms of cost and risk as well as stable financing in both domestic and external markets. At the end of 2006, government debt outstanding amounted to $40 billion, equivalent to 57 per cent of the gross domestic product, of which 80 per cent was in domestic debt. Interest charges, which amounted to $2.4 billion, absorbed 14 per cent of budget revenues.

Created in 1989, the auction market for Treasury instruments was improved through numerous reforms and measures in order to respond to investor requirements and create more transparency. The Central Bank, which supervises the auction process, submits the bids to the Treasury Department and informs the bidding institutions of the status of their bids. The Treasury Department then selects the interest rate or limit price according to the Dutch auction method and reports it to the Central Bank. Submissions are served at the prices of the bidding institutions beginning with the highest price until completion of the total amount needed. The Treasury instruments (bons du Trésor) have three standard maturities:

- Short-term: every Tuesday of the month;
- Medium- to long-term: less than or equal to 15 years; the 2nd and last Tuesday of the month;
- Long-term: 20- to 30-year bonds: the last Tuesday of the month.

The development of an auction market for treasury securities involved the creation of a secondary market, the designation of Treasury securities dealers, the dematerialization of certificates of indebtedness and the securing of transactions and the introduction of issues by assimilation. The financial community is kept abreast of any intervention in the market. To this end, periodic meetings are held between the various participants: the Treasury Department, the Central Bank, the Treasury securities dealers and the secondary market transactors (mutual funds, brokerage firms, etc.) for more effective communication.

With respect to the international financial market as a supplementary source of financing, Mr. Chorfi stated that the objectives were to alleviate the negative net flows of the external debt, to finance active external debt management operations, and to enable internal and external resources. He added that access to the international market under favorable conditions depends on the perception that investors have of the Moroccan risk.

In terms of objectives of external debt management, Mr. Chorfi mentioned the reduction of the burden and cost of the existing debt, the minimization of currency and interest rate risks, the conversion of debts into investments, the treatment of odious debt and risk management.

Mr. Chorfi concluded his presentation with a series of figures summarizing the trends in Treasury securities. For example, subscriptions and volumes of transactions increased by 100 per cent and 359 per cent, respectively. Morocco also achieved success with issues on the international financial market. Thus, the "investment grade" from Standard & Poors and Fitch ratings was doubled and the issues were 3.5 times oversubscribed. Furthermore, the issues attracted geographically diverse investors with more than 70 investors, in particular, from Europe, the United States and the Middle East.

Mr. Jose Franco Medeiros de Morais′ presentation covered public debt management including external debt and domestic debt as well as Brazil's performance during the recent crisis. He started by presenting the guidelines from the Annual Borrowing Plan for 2007. These were to lengthen the average maturity, primarily by increasing the average term of the securities issued in auctions, reduce the share of debt due in 12 months, thus reducing the refinancing risk, gradually replace Selic-linked and FX-linked bonds by fixed rate and price index bonds, thus reducing the market risk, issue foreign currency bonds based on qualitative aspects, observing market conditions, stimulate the development of the yield curves for federal public securities on domestic and external markets, and to broaden the investor base

Overall, the improvement of the public debt composition has reduced the risks relating to exchange rates and floating rates. In the area of external debt, the Federal Government achieved an improved profile from 2005 to 2007. Furthermore, the redemption program and new issuances since 2006 have had a favorable impact on the payment flow to external debt.

In the area of domestic debt, Mr. Medeiros indicated that major opportunities had emerged with respect to both long-term fixed rate bonds and inflation-linked bonds. The average daily trade value also increased substantially during the same period. He stated that the solid foundation of the Brazilian economy has succeeded in attracting foreign investors to domestic debt but that there was still room for further growth.

In view of the above guidelines, in particular in the development of the secondary market, the lengthening of the fixed rate and inflation-linked bonds and the broadening of the investor base, Mr. Medeiros said that foreign investors have an important role to play in helping the Government to reach its targets as they usually participate more extensively in fixed rate and inflation-linked bonds.

Finally, Mr. Medeiros discussed Brazil's performance during the recent subprime crisis which had little impact on the FX flow, which demonstrates a better risk perception on the Brazilian economic fundamentals.

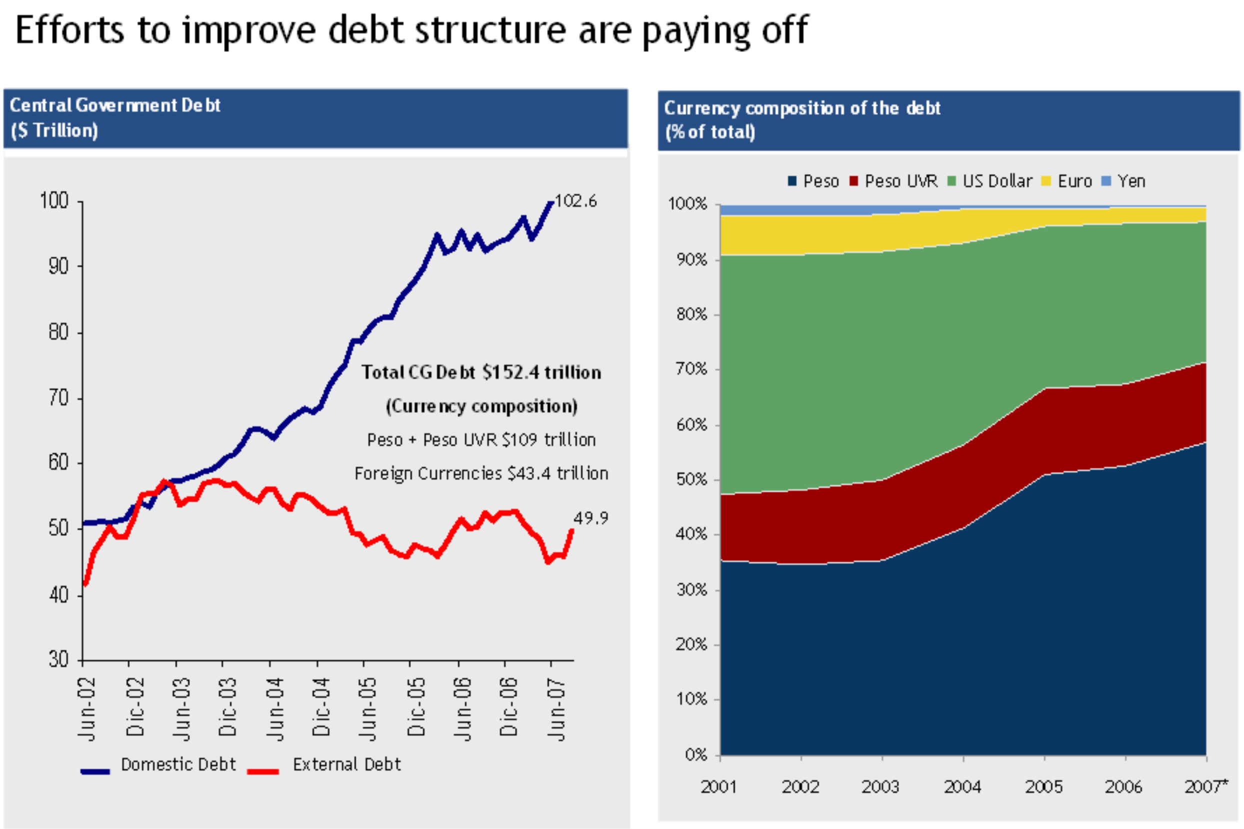
The use of capital market financing: Colombia

William Ortiz Linares
Chief, Domestic Capital Markets Group, Public Credit and Treasury, Colombia

Agenda

1. De donde venimos
2. Mercado de Capitales vs otros Mercados
3. Deuda pública y desarrollo del mercado de capitales
4. Inversionistas extranjeros, estructurales y/o oportunistas
5. La estrategia de emisión y el desarrollo de los mercados
6. Estructura de tenedores

1. De donde venimos

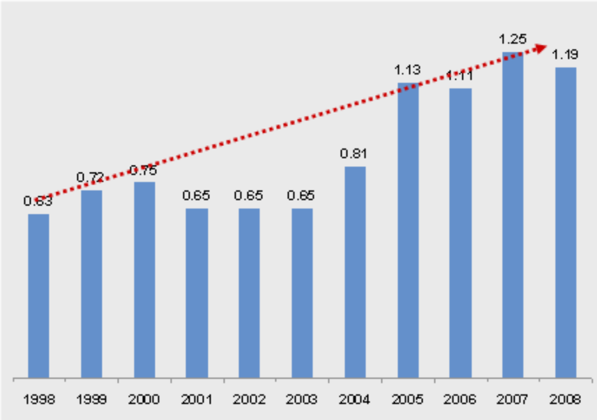


Source: Ministerio de Hacienda y Crédito Público- Aug 31, 2007

Source: Ministerio de Hacienda y Crédito Público- Aug 31, 2007

Reduction of exposure to currency risk

Ratio for fiscal sustainability of debt

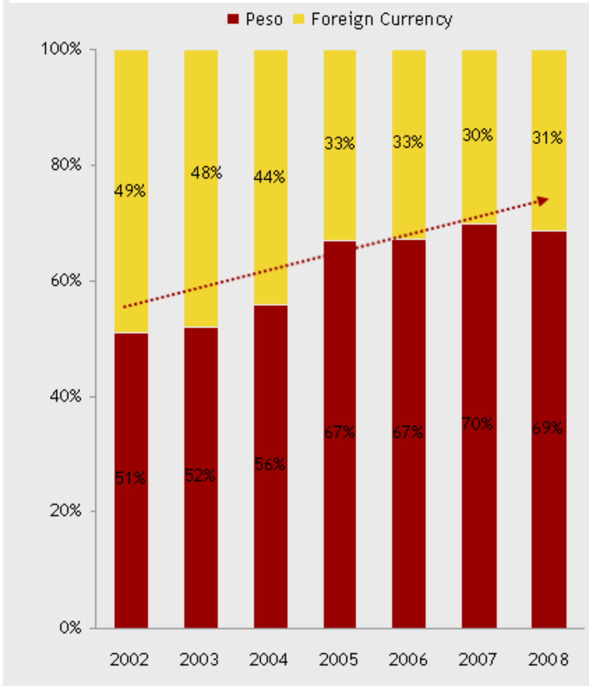


$$\frac{D_L / D_F}{Y / Y^*} = 1$$

DL: Debt in local currency
DF: Debt in foreign currency
Y: Non-tradable GDP
Y*: Tradable GDP

Source: "Sudden Stops, the Real Exchange Rate and Fiscal Sustainability", Guillermo Calvo, Alejandro Izquierdo y Ernesto Talvi, March 2002. Calculations: Ministerio de Hacienda y Crédito Público

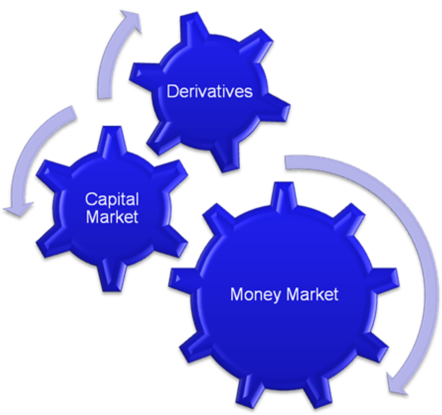
Central Government debt by currency (% of total)



Source: Ministerio de Hacienda y Crédito Público

2. Mercado de Capitales vs otros Mercado

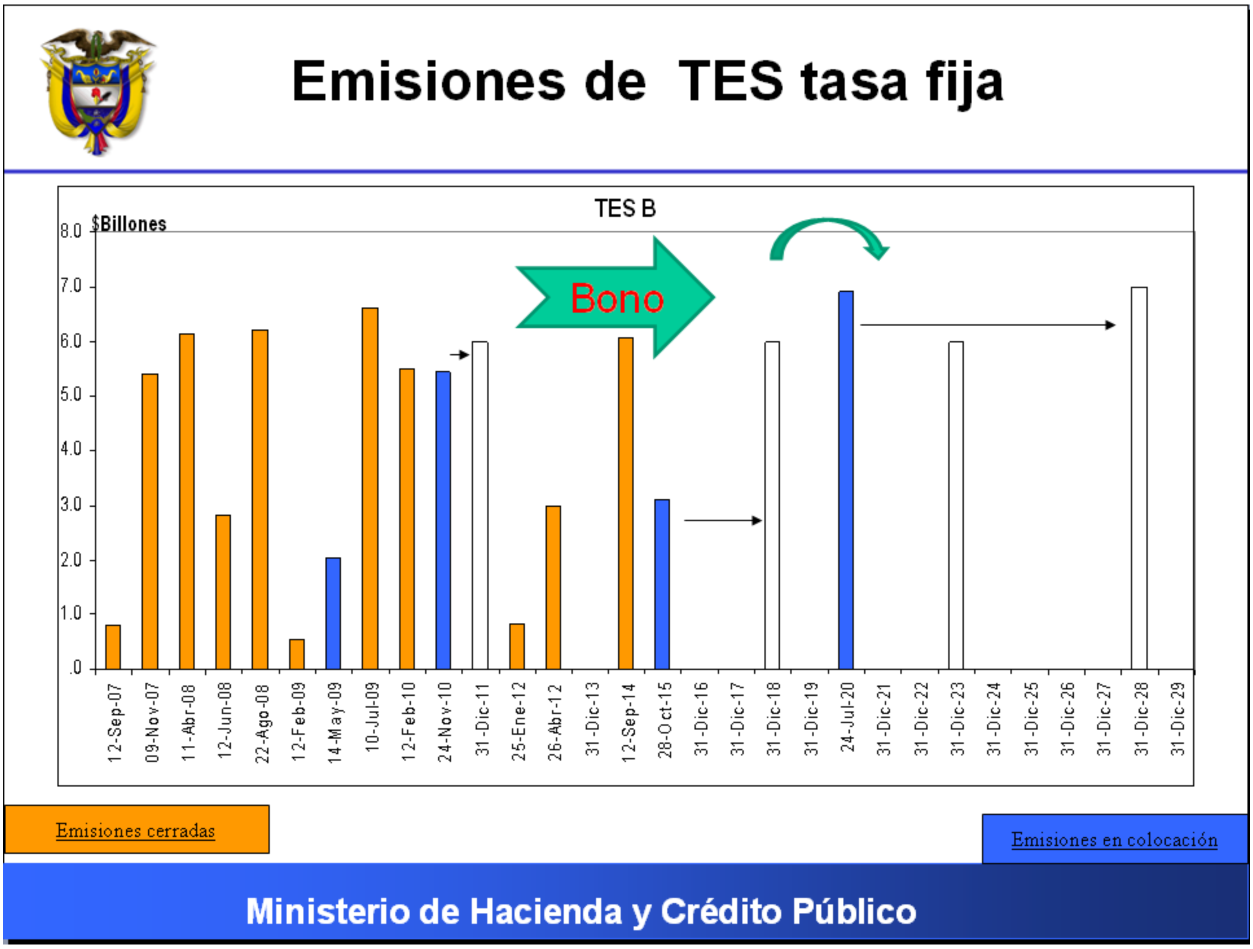
Engranaje



Ministerio de Hacienda y Crédito Público

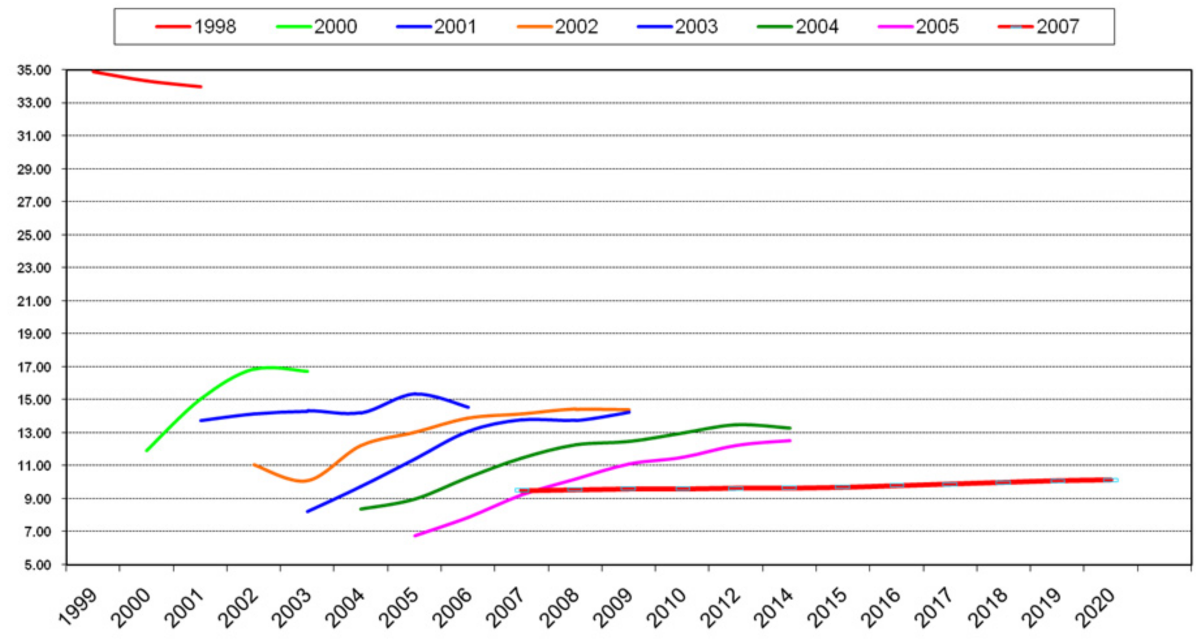
1. Desarrollo del mercado monetario como base del desarrollo del mercado de capitales
   - Instrumentos de Mercado Monetario, Proyecto con Banco Mundial: repos, simultaneas y préstamo de valores
   - Indicadores de corto plazo: IBR indicador privado a 1 día y 28 días, a partir de enero de 2008.

2. Desarrollo del mercado de derivados como complemento del desarrollo del mercado de capitales
   - Derivados listados en Bolsa de Valores
     - Sobre la curva de rendimientos
     - Sobre una referencia definida
     - Bono Nocional 10 años – 5 años
   - No listados, nueva regulación (FMI)

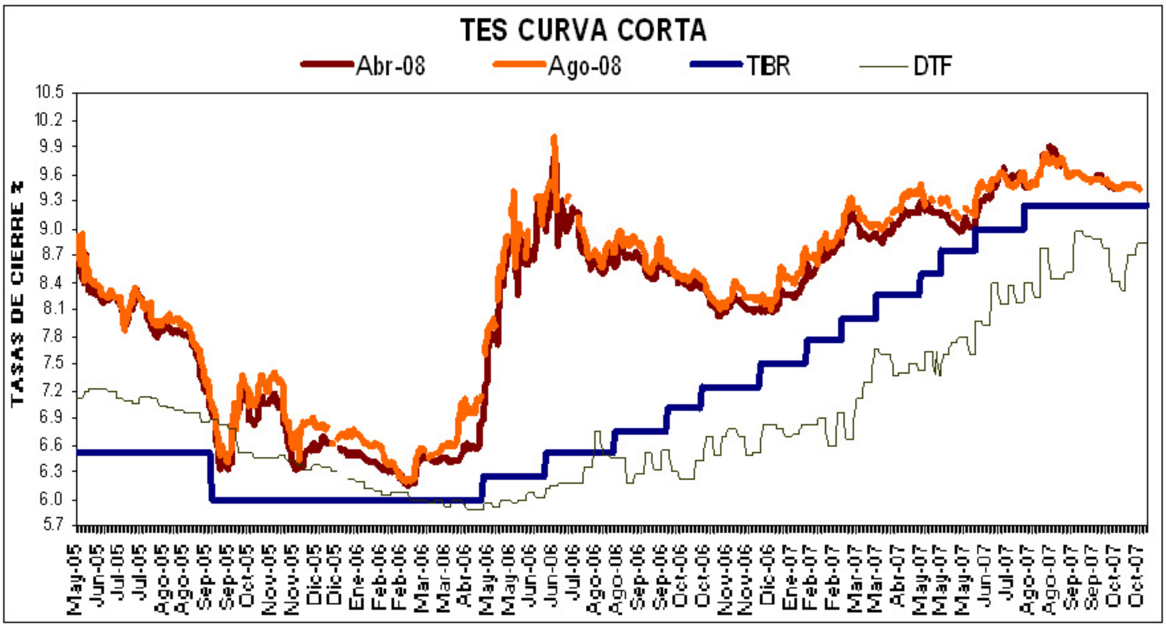


3. Deuda pública y desarrollo del mercado de capitales

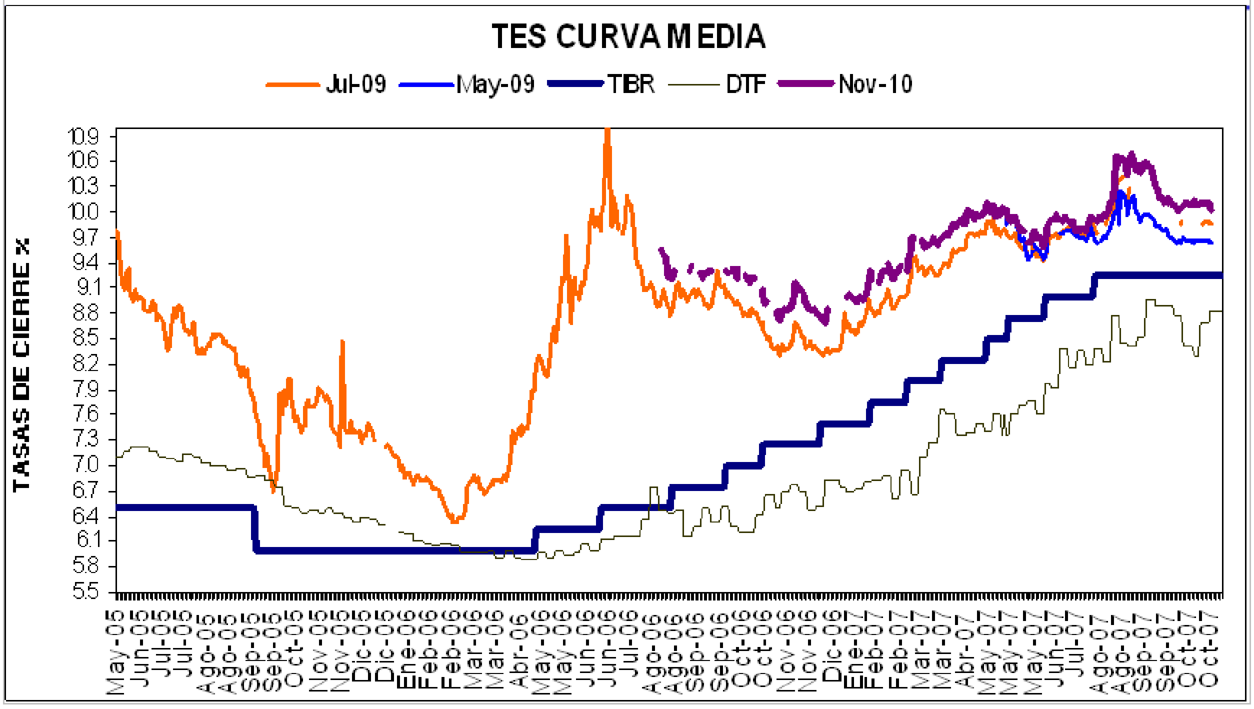
Consolidación curva de rendimientos



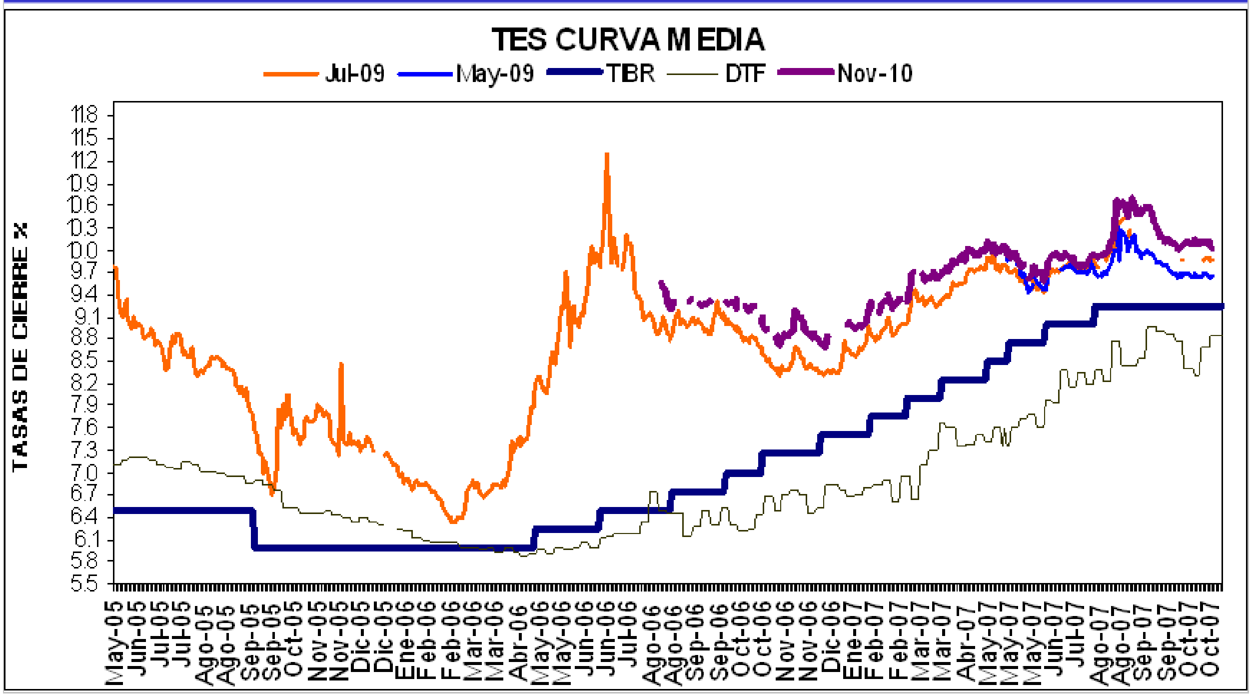
Tasa BanRep e impacto Curva TES corto plazo



Tasa BanRep e impacto Curva TES Mediano Plazo

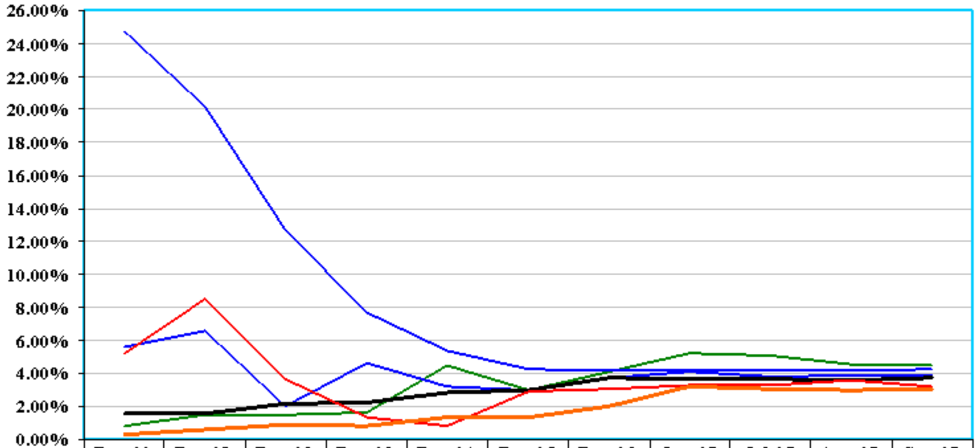


Tasa BanRep e impacto Curva TES Largo Plazo



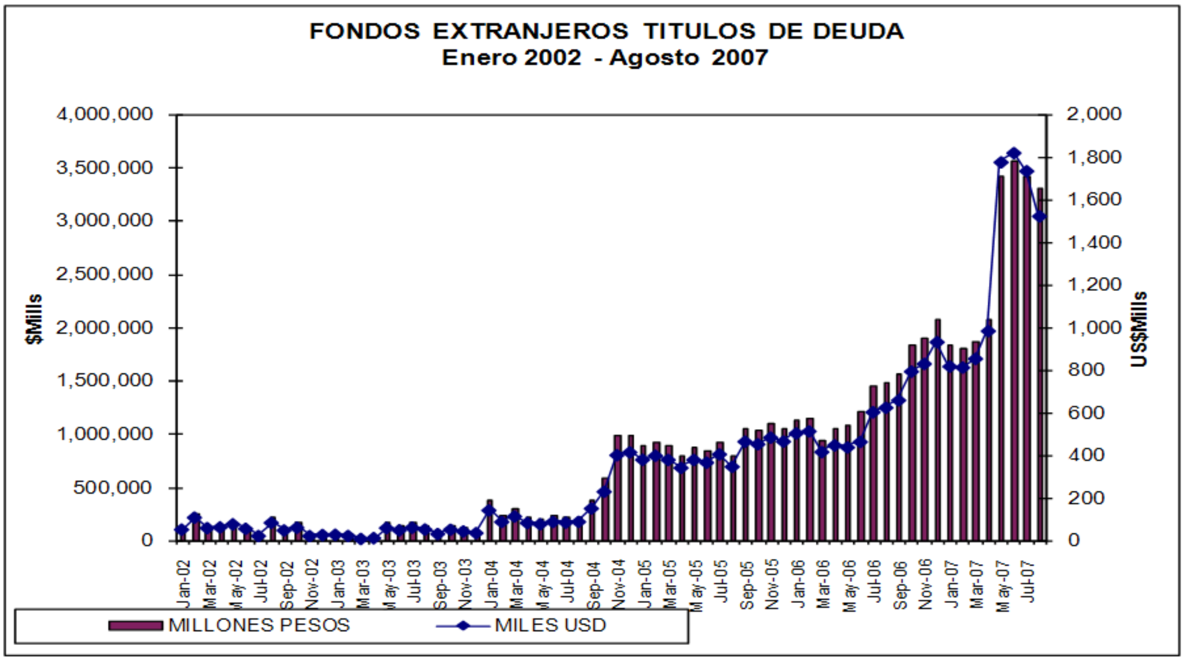
4. Inversionistas extranjeros, estructurales y/o oportunistas

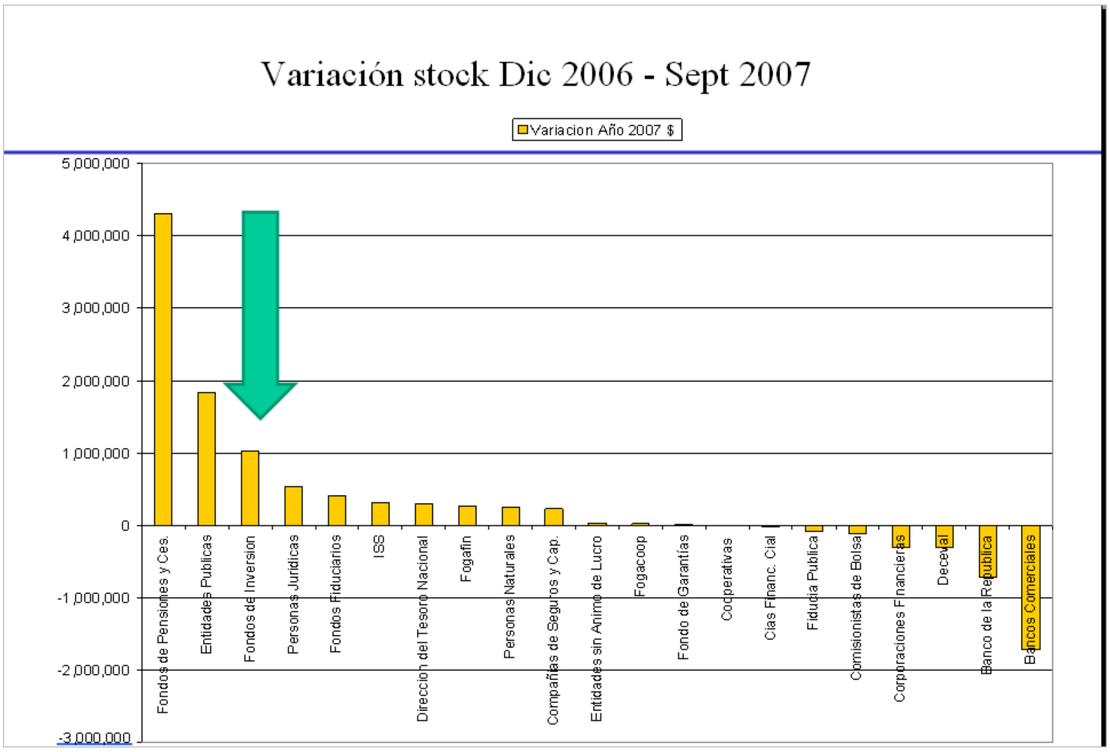
Inversionistas entre 3.0 y 10 % en TES



	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04	Dec-05	Dec-06	Jun-07	Jul-07	Aug-07	Sep-07
Personas Juridicas	0.84%	1.53%	1.51%	1.68%	4.48%	2.97%	4.14%	5.20%	5.07%	4.58%	4.45%
ISS	24.75%	20.15%	12.73%	7.68%	5.40%	4.24%	4.18%	4.19%	4.21%	4.17%	4.23%
Fondos Fiduciarios	5.59%	6.54%	2.03%	4.60%	3.19%	2.99%	3.70%	4.09%	3.80%	3.87%	3.90%
Compañías de Seguros y Cap.	1.58%	1.55%	2.15%	2.22%	2.85%	2.98%	3.77%	3.66%	3.64%	3.61%	3.77%
Direccion del Tesoro Nacional	5.24%	8.55%	3.69%	1.35%	0.79%	2.91%	3.09%	3.30%	3.28%	3.60%	3.21%
Fondos de Inversion	0.31%	0.59%	0.86%	0.79%	1.35%	1.33%	2.03%	3.18%	3.09%	2.97%	3.05%

Inversionistas extranjeros.... Evolución





Inversion Extranjera

1. Discusiones de Gobierno y Banco Central
    1. Volatilidad de los precios en el mercado local
    2. Impacto en el Mercado Cambiario
    3. Diversificación de tenedores
2. Control de Capitales (40% de deposito a inversión directa en portafolio) actual

5. La estrategia de emisión y el desarrollo de los mercados

COLOCACIONES DE TES Octubre 2007

MERCADO DE CAPITALES INTERNO

SITUACION ACTUAL COLOCACION TES 2007

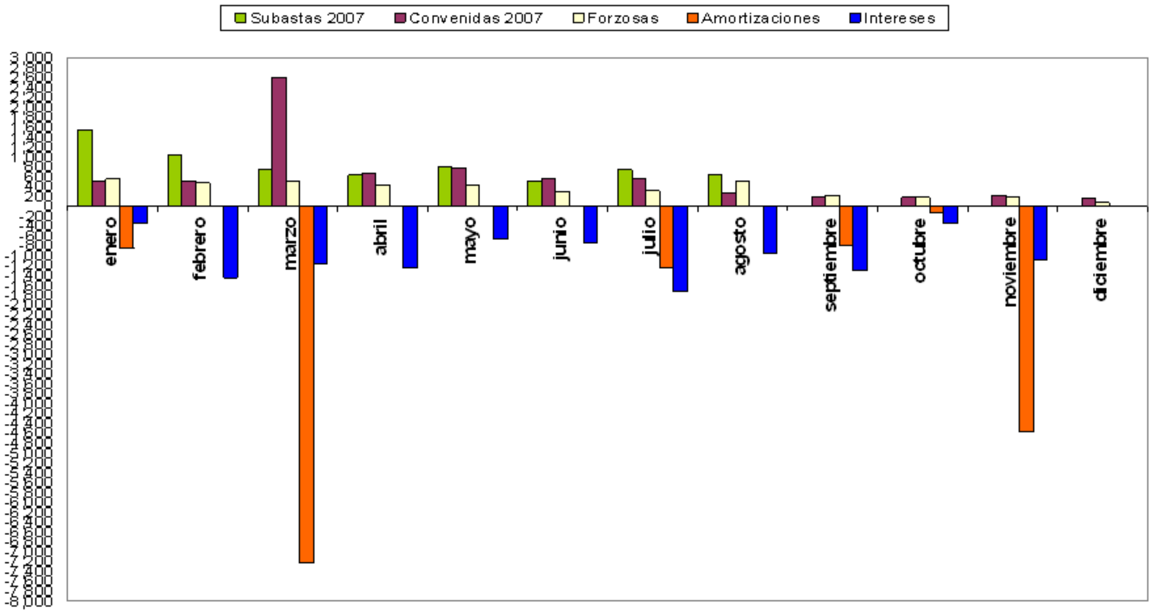
Fecha 11-Oct-07

COLOCACION TES	Meta Financiamiento 2007	Enero	febrero	marzo	Abril	Mayo	Junio	Julio	Agost	Sept	Octubre	Octubre Ejecutado	Diferencia contra mes	Colocado total año	Por Colocar
SUBASTA	6,529	1,522	1,027	734	619	791	493	725	619	0	0	0.0	-	6,528.8	0.1
CONVENIDA	7,046	484	498	2,596	653	765	558	537	248	204	175	1.0	(174)	6,542.9	503.4
FORZOSA	4,000	537	462	487	423	419	282	301	481	550	60	205.9	146	4,148.5	-148.0
TOTAL	17,575.6	2,543	1,987	3,816	1,695	1,975	1,333	1,563	1,348	754	235	206.9	(28)	17,220.2	355.5

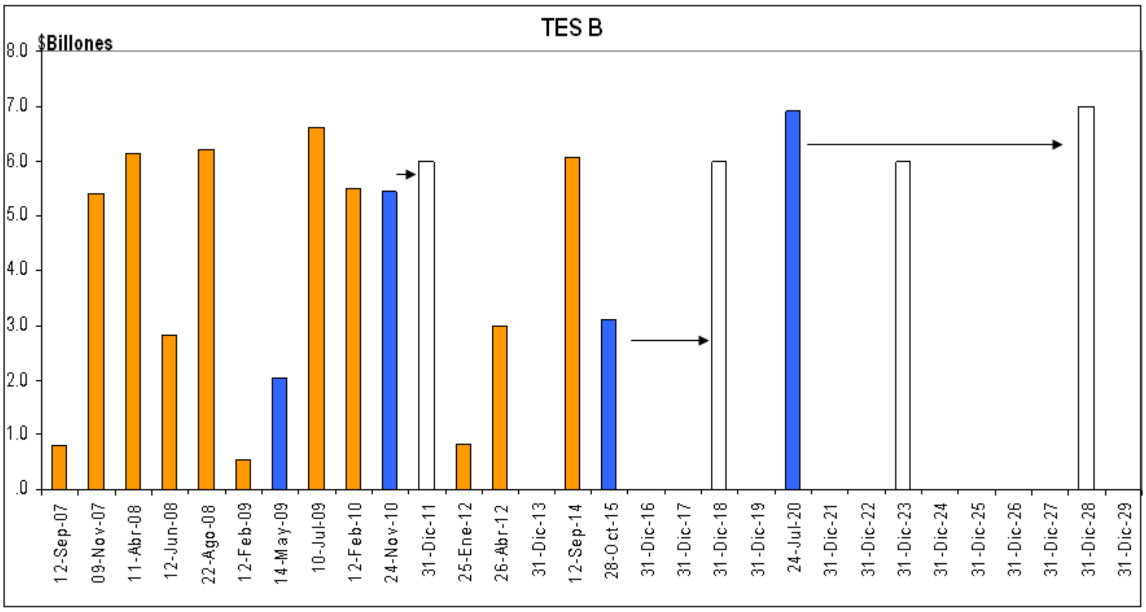
SUBASTA	37.1%	23.3%	15.7%	11.2%	9.5%	12.1%	7.5%	11.1%	9.5%	0.0%	0.0%	0.0%	100.00%	100.00%	0.00%
CONVENIDA	40.1%	6.9%	7.1%	36.8%	9.3%	10.9%	7.9%	7.6%	3.5%	2.9%	2.5%	0.2%	99.82%	92.86%	7.14%
FORZOSA	22.8%	13.4%	11.6%	12.2%	10.6%	10.5%	7.1%	7.5%	12.0%	13.8%	1.5%	72.9%	27.06%	103.70%	-3.70%
TOTAL	100.0%	14.5%	11.3%	21.7%	9.6%	11.2%	7.6%	8.9%	7.7%	4.3%	1.3%	15.5%	84.47%	97.98%	2.02%

FLUJO DE COLOCACIONES Y VENCIMIENTOS

Flujo Vto deuda Interna



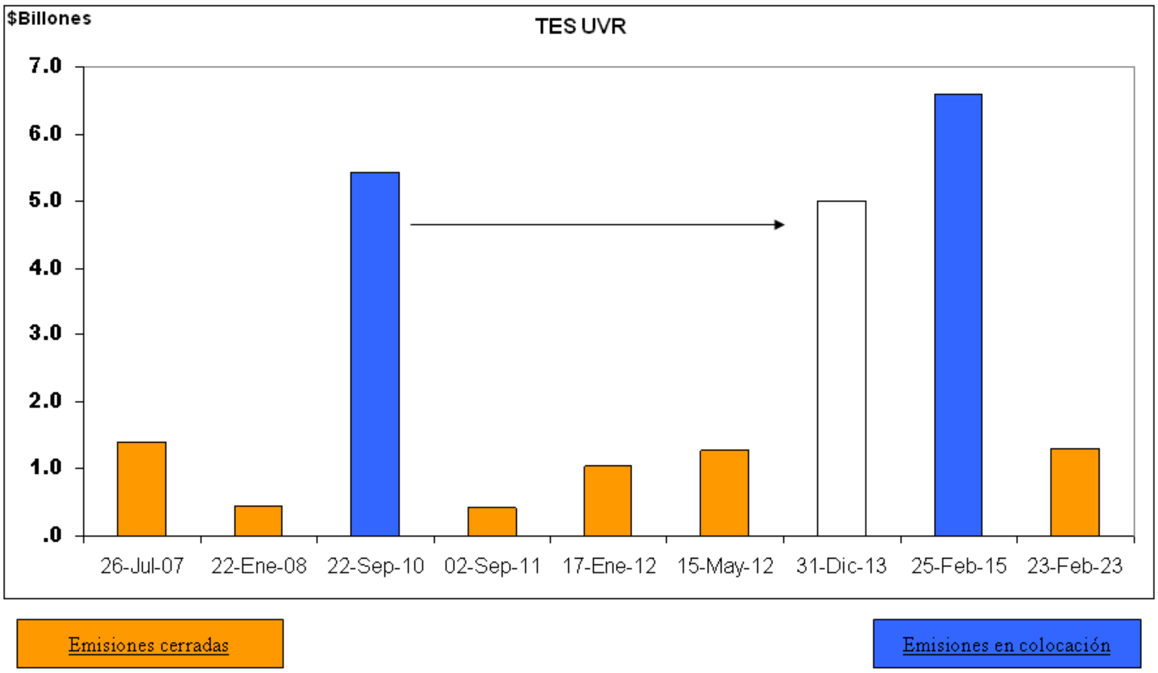
Emisiones de TES tasa fija



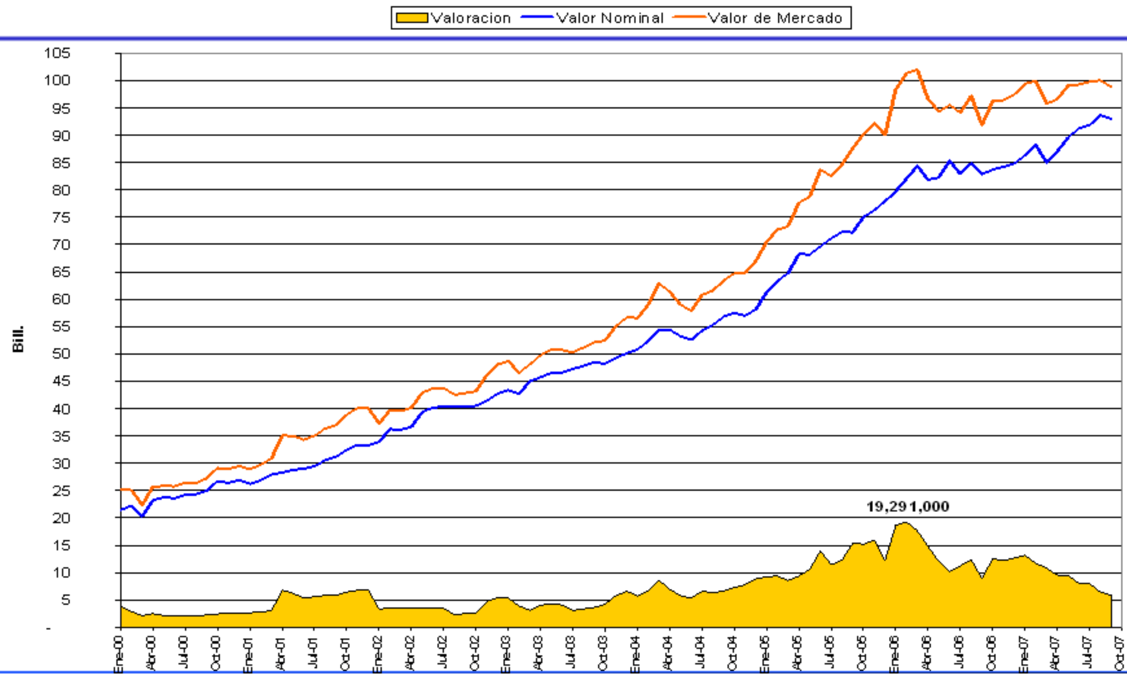
Emisiones cerradas

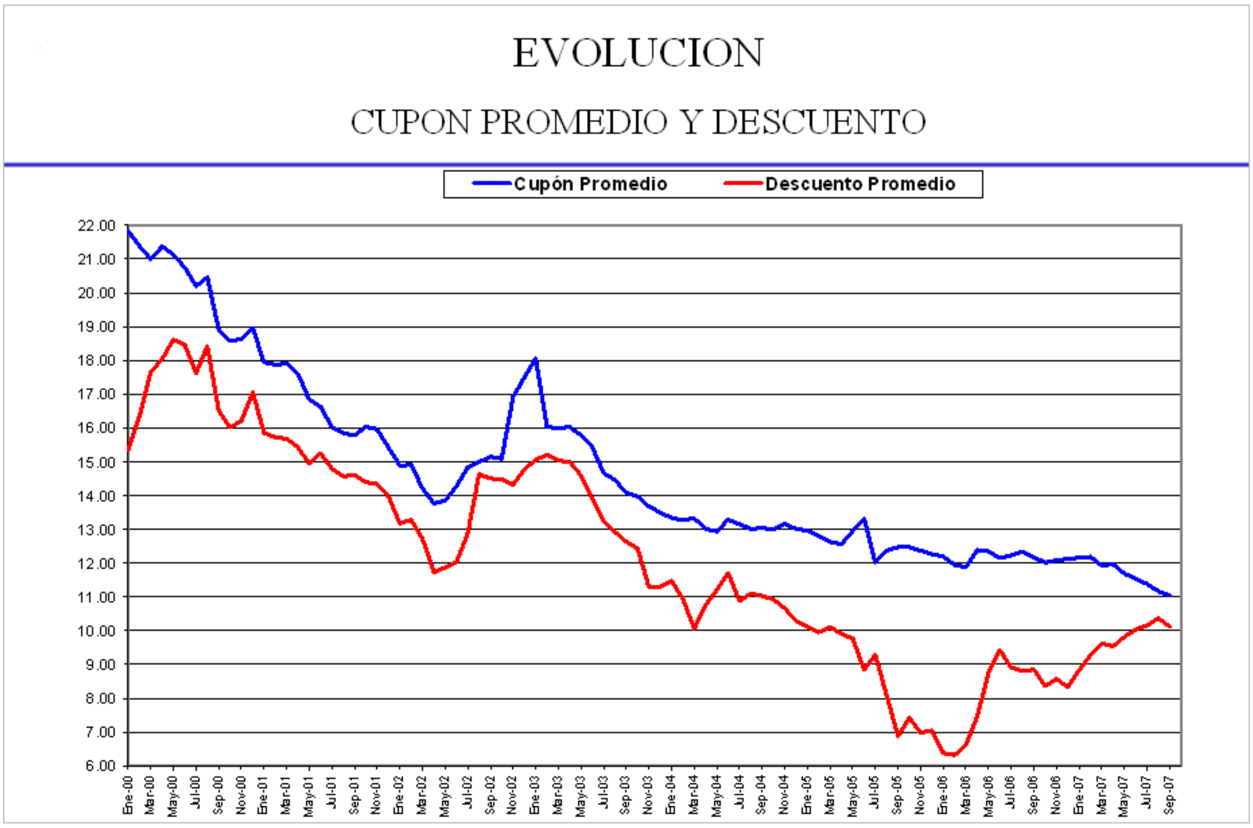
Emisiones en colocación

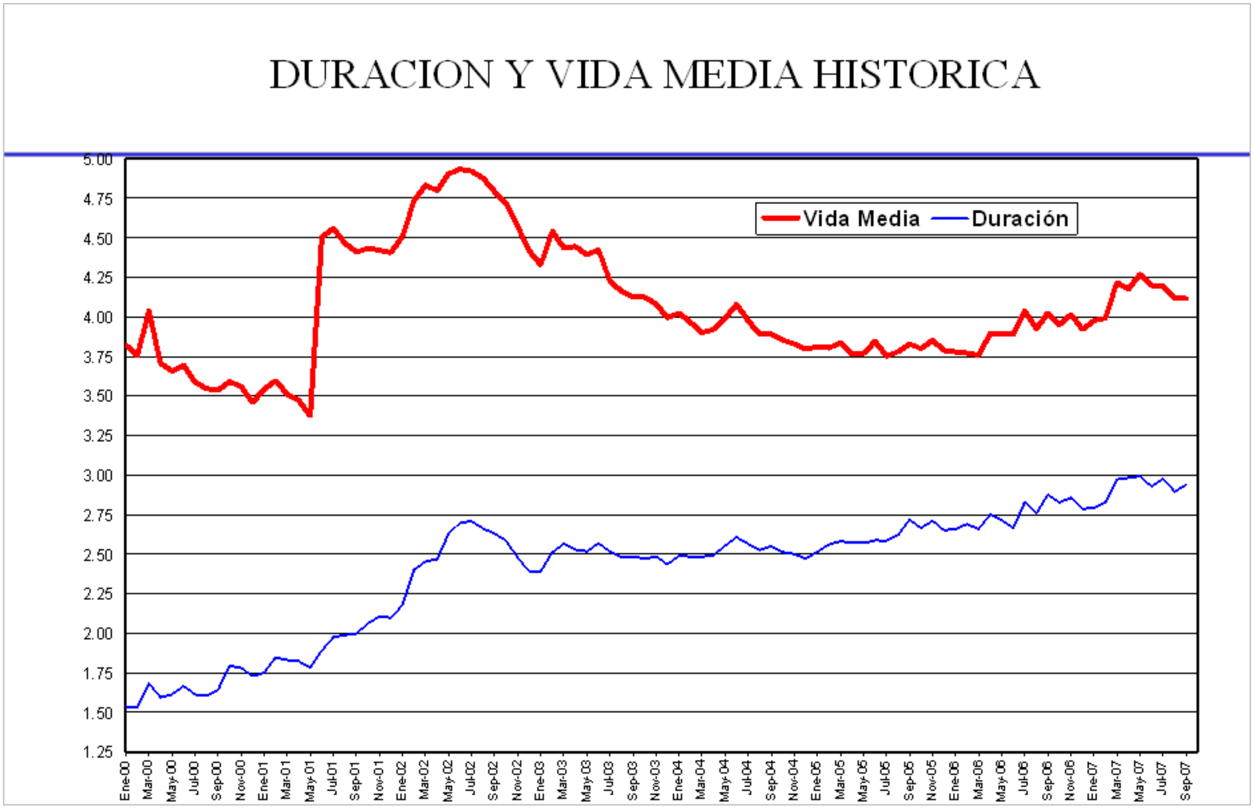
Perfil de vencimientos por emisiones TES UVR



EVOLUCION HISTORICA DE TES EN EL MERCADO

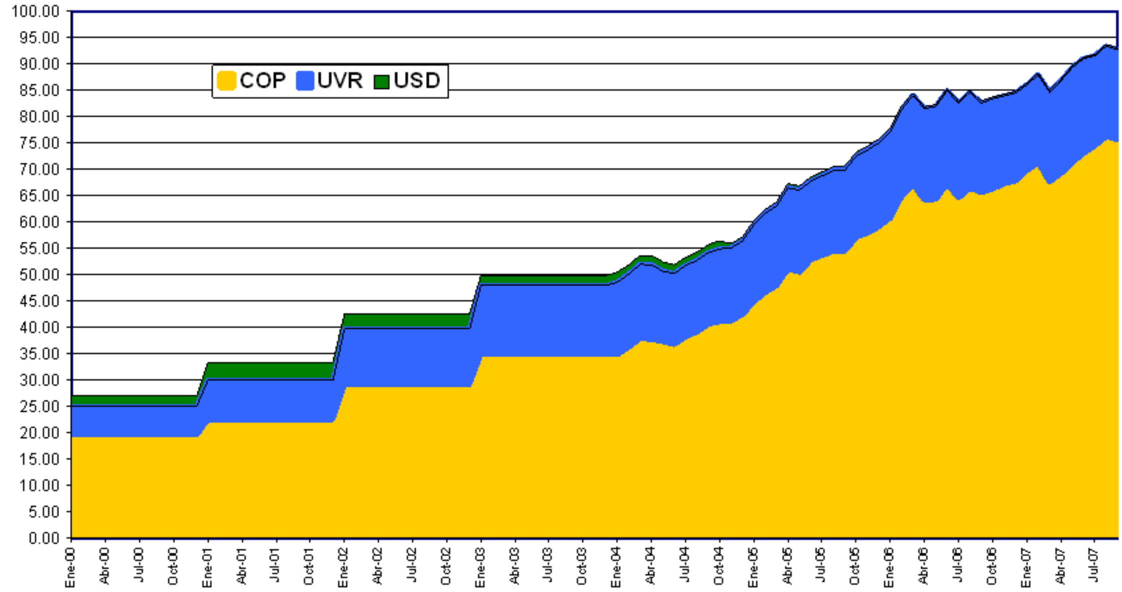



EVOLUCION
CUPON PROMEDIO Y DESCUENTO
Cupón Promedio
Descuento Promedio

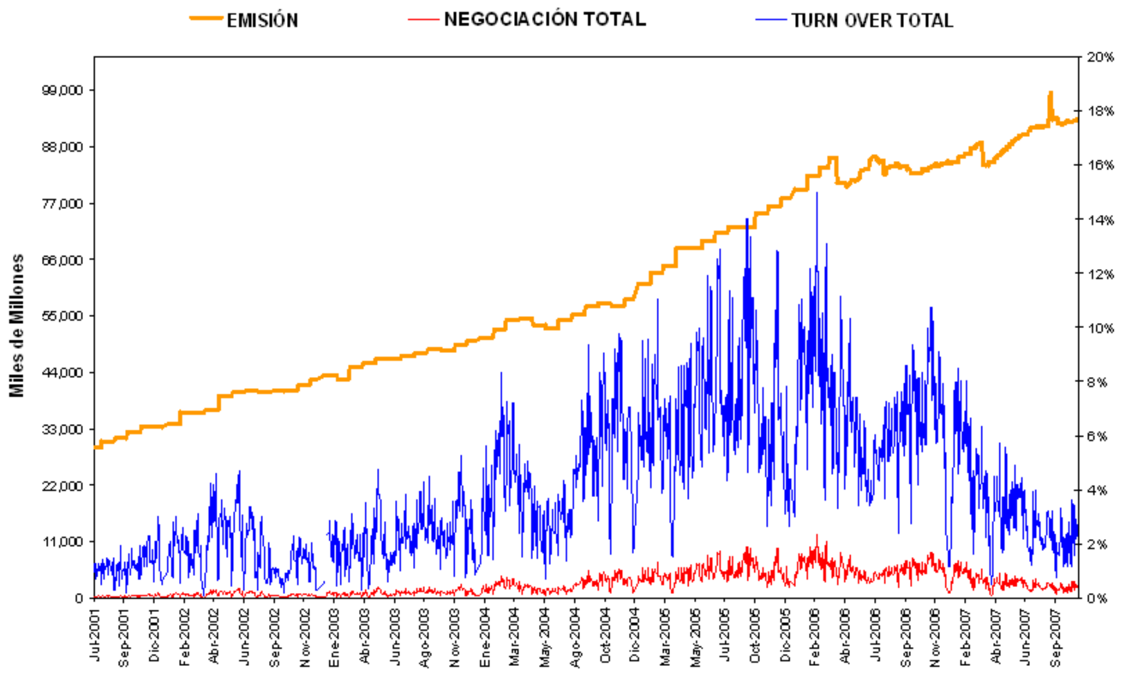

DURACION Y VIDA MEDIA HISTORICA
Vida Media
Duración

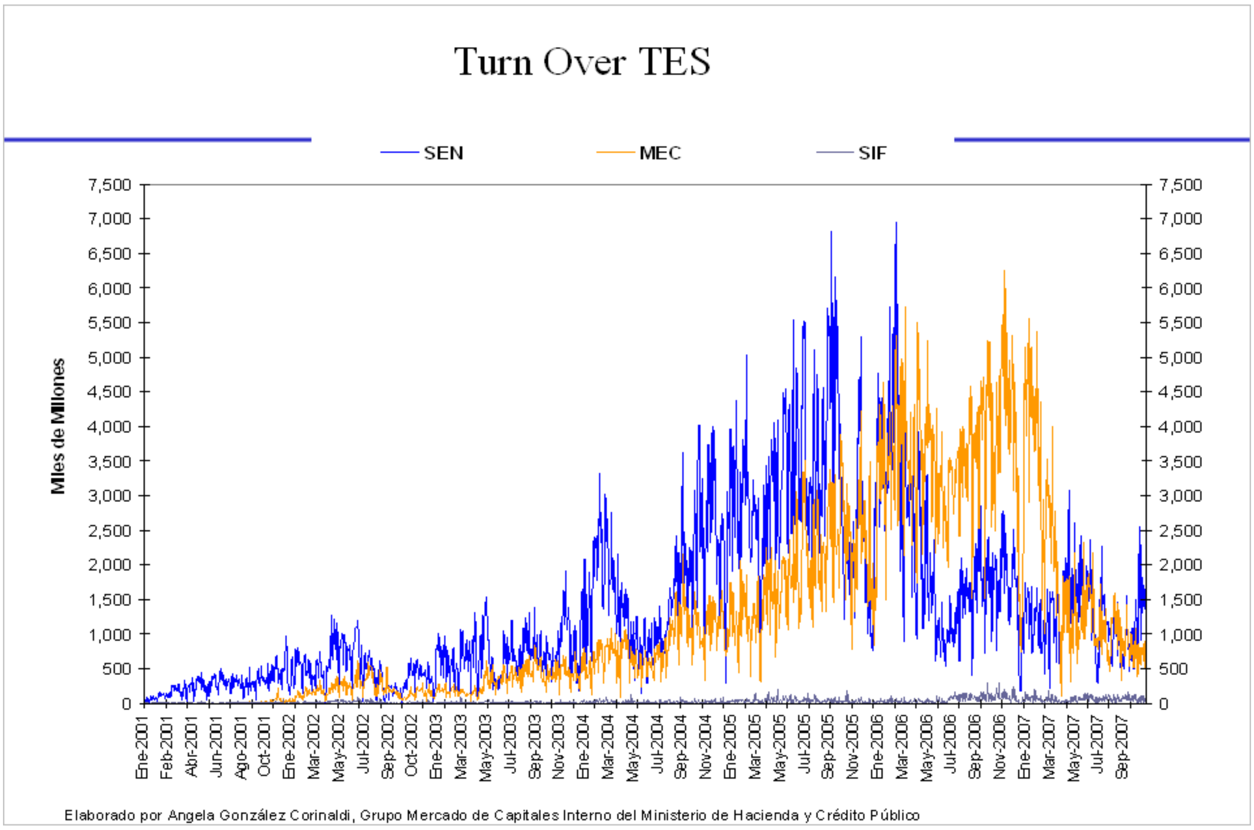
Composición por denominación

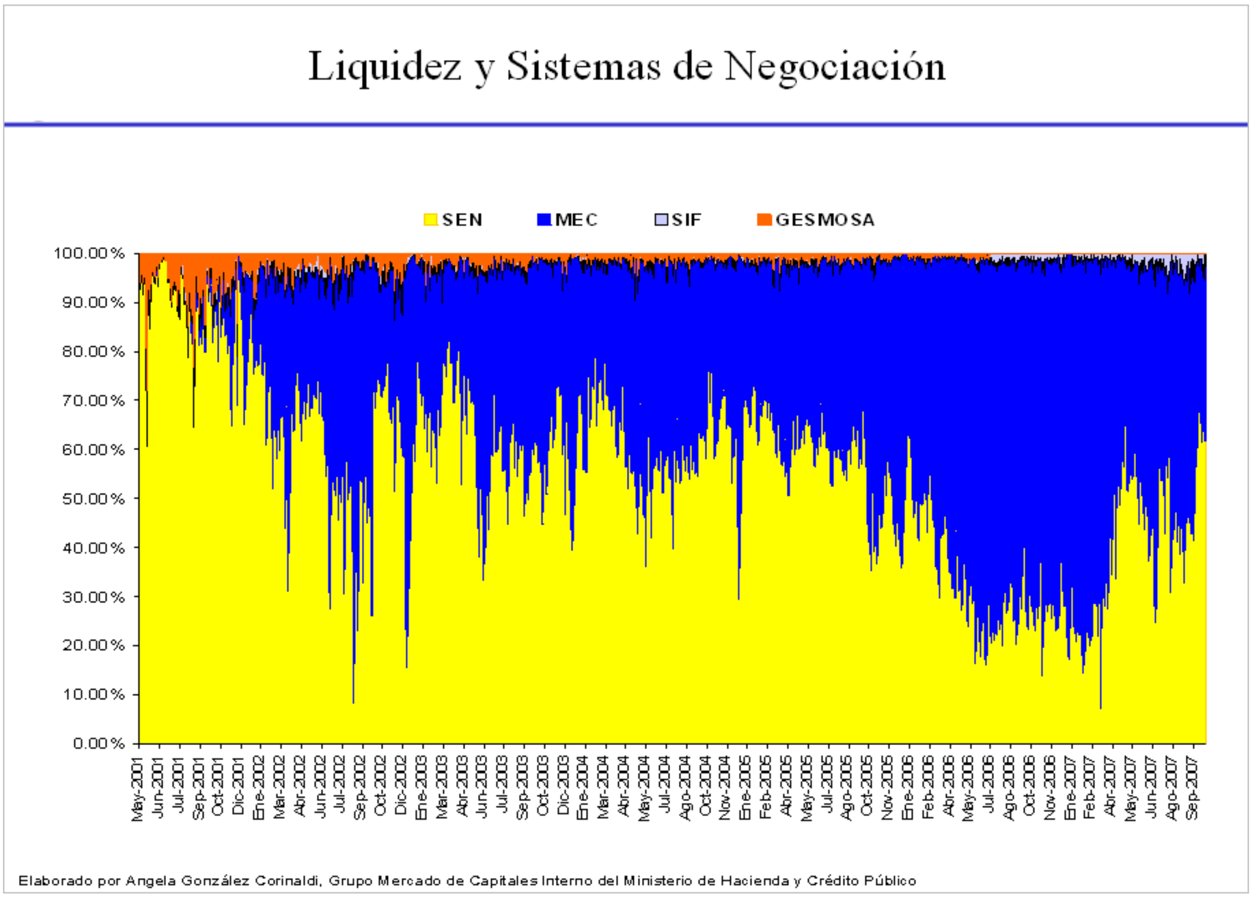
PARTICIPACION POR TASA DE EMISION



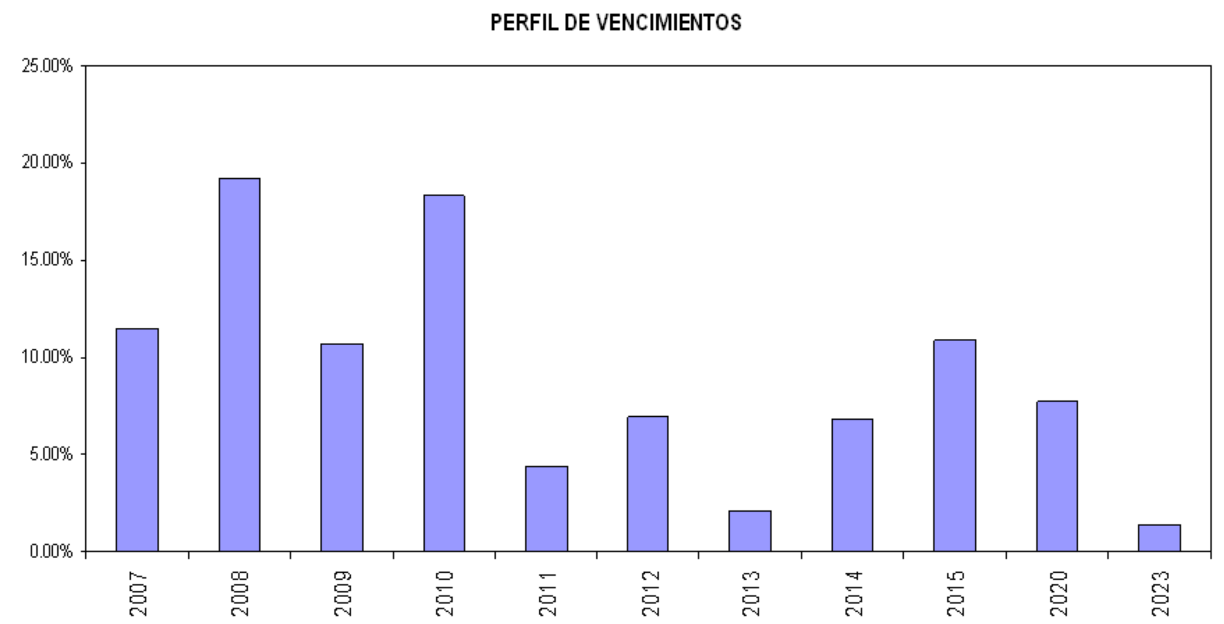
Turn Over TES



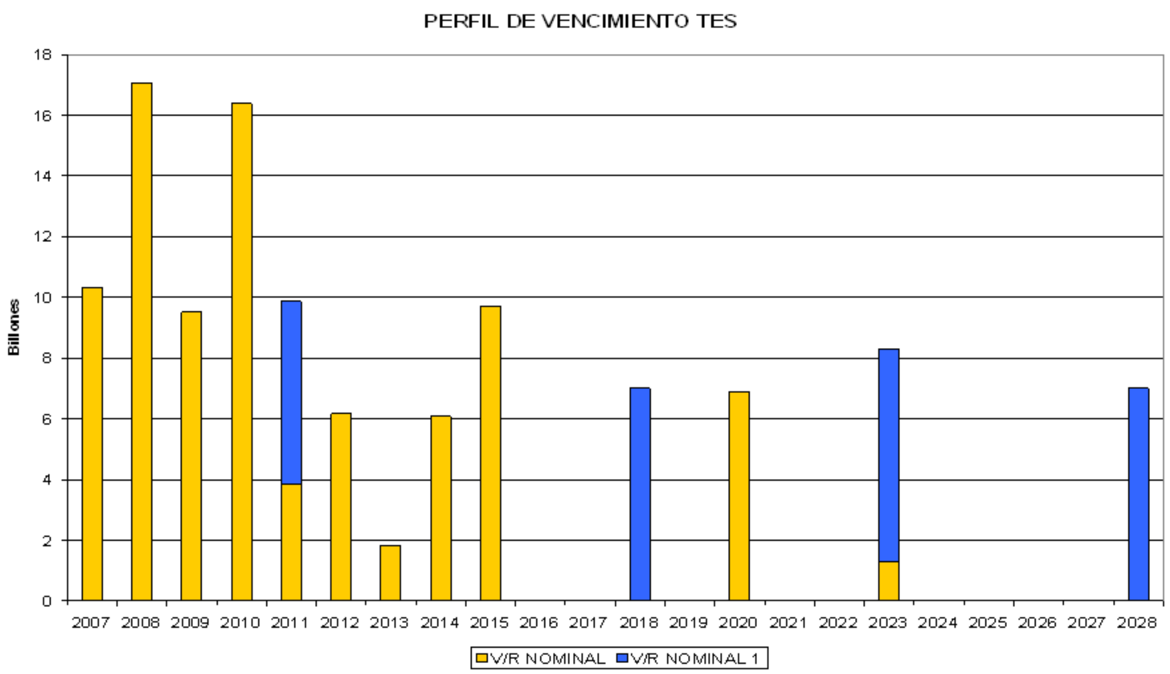

Turn Over TES
SEN
MEC
SIF
Miles de Millones
Elaborado por Angela González Corinaldi, Grupo Mercado de Capitales Interno del Ministerio de Hacienda y Crédito Público


Liquidez y Sistemas de Negociación
SEN
MEC
SIF
GESMOSA
Elaborado por Angela González Corinaldi, Grupo Mercado de Capitales Interno del Ministerio de Hacienda y Crédito Público

Perfil de vencimientos



Perfil de vencimientos



MARKET MAKER y desarrollo de Mercado de Capitales

No.	Entidad	Puntaje Total
1	BANCOLOMBIA	1,00000
2	INTERBOLSA S.A.	0,81384
3	BANCO DAVIVIENDA	0,73839
4	ABN AMRO BANK	0,58263
5	BBVA	0,46651
6	BANCO SANTANDER	0,38770
7	CITIBANK	0,36957
8	CORFICOLOMBIANA	0,34506
9	SUDAMERIS	0,32712
10	CORREVAL	0,31157
11	JPMORGAN CO	0,22998
12	BANCO AGRARIO	0,12587
13	BANCO DE BOGOTA	0,09262

Creadores de Mercado

Aspirantes a C de M

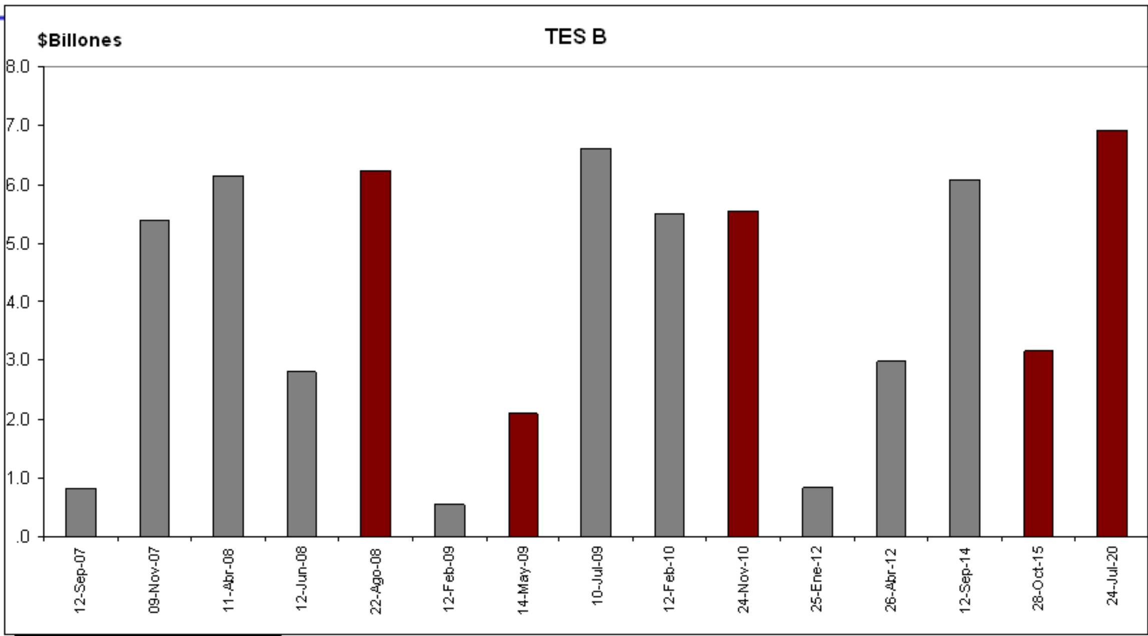
Ranking Market Maker durante 2007

No.	Entidad	mp	Entidad	ms	Entidad	pp
1	BANCOLOMBIA	0,3500	INTERBOLSA S.A.	0,3300	BANCOLOMBIA	0,3200
2	INTERBOLSA S.A.	0,2767	ABN AMRO BANK	0,2739	BANCO DAVIVIENDA	0,3127
3	BBVA	0,2493	BANCOLOMBIA	0,2046	ABN AMRO BANK	0,1313
4	SUDAMERIS	0,2159	BANCO DAVIVIENDA	0,1285	BANCO SANTANDER	0,1239
5	BANCO DAVIVIENDA	0,2046	CITIBANK	0,1063	INTERBOLSA S.A.	0,1051
6	CORFICOLOMBIANA	0,1808	BANCO SANTANDER	0,0903	BBVA	0,1034
7	CORREVAL	0,1624	CORREVAL	0,0692	CITIBANK	0,0788
8	CITIBANK	0,1382	CORFICOLOMBIANA	0,06	CORFICOLOMBIANA	0,061
9	BANCO SANTANDER	0,1249	JPMORGAN CO	0,0593	SUDAMERIS	0,0491
10	ABN AMRO BANK	0,1044	BBVA	0,0554	JPMORGAN CO	0,0431
11	JPMORGAN CO	0,0988	BANCO DE BOGOTA	0,0275	CORREVAL	0,0409
12	BANCO AGRARIO	0,0665	SUDAMERIS	0,0212	BANCO DE BOGOTA	0,0245
13	BANCO DE BOGOTA	0,0290	BANCO AGRARIO	0,0211	BANCO AGRARIO	0,0225

Creadores

Aspirantes

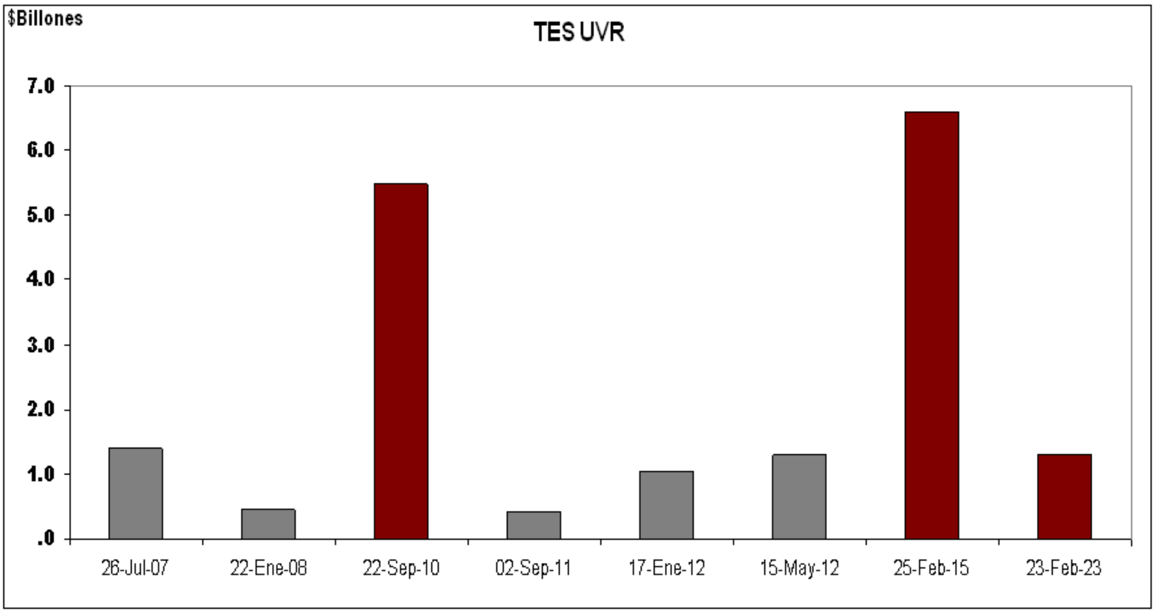
Cotización Obligatoria … Propuesta



Cotización Obligatoria

Otras emisiones

Cotización Obligatoria … TES UVR Propuesta



Cotización Obligatoria

Otras emisiones

Emisiones y cotización obligatoria A partir del 1 julio de 2007

Emisiones abiertas durante el Segundo Semestre

14 mayo 2009
24 Nov 2010
2011
28 Oct 2015
2018
24 Julio 2020
2028

UVR 22 Septiembre 2010
2013
UVR 23 febrero 2023

Emisiones de Cotización Obligatoria

22 Agosto 2008
14 Mayo 2009
24 Nov 2010
28 Oct 2015
24 jul. 2020

UVR 22 Septiembre 2010
UVR 25 Febrero 2015
UVR 23 Febrero 2023

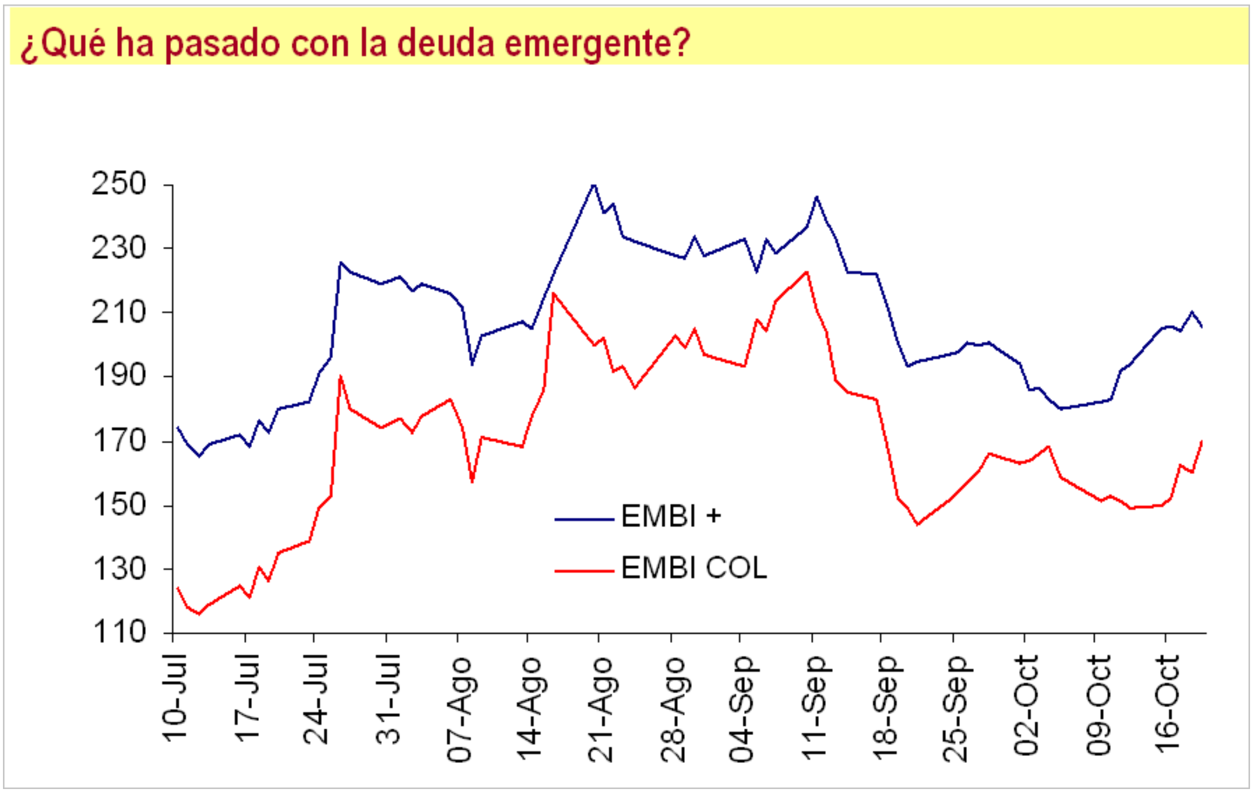
Ministerio de Hacienda y Crédito Público

Financiamiento 2008

Fuentes		$ MM	36.664
Desembolsos			**26.111**
Externos	**(USD 2.308 mill)**		**5.189**
Internos			**20.922**
TES			22.304
Convenidas			9.001
Subastas			9.302
Forzosas			4.002
Sentencias			-
Otros			(1.382)
Ajustes por Causación			**1.176**
Utilidades Banco República			**1.310**
Disponibilidad inicial			**3.793**
En dólares	(USD 800 mill)		1.799
En pesos			1.994
Otros			**4.274**
Optimización de activos			1.500
Tes Corto Plazo			1.274
Privatizaciones			1.500
Electrificadoras			1.000
Otras			500

Usos		$ MM	36.664
Deficit			**13.863**
Del cual, pago de intereses externos (USD 2.014 mill)			4.528
Amortizaciones			**22.043**
Externas	(US $ mill 1.643)		3.693
Internas			18.350
Disponibilidad Final			**758**

Fuente: CONFIS- MHCP.

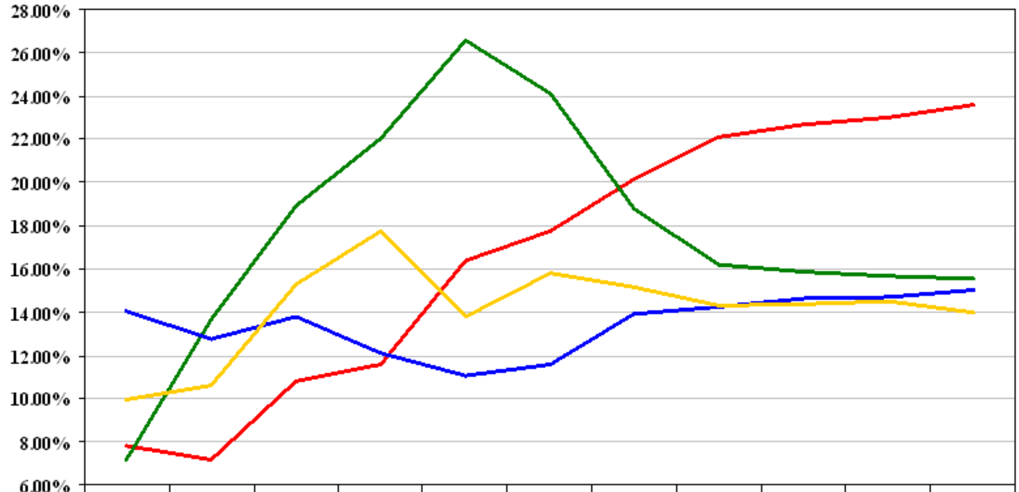


Fuente: Bloomberg, cálculos Subdirección de Riesgo – DGCPTN, 30 de octubre de 2007

Fuente: Bloomberg, cálculos Subdirección de Riesgo – DGCPTN, 30 de octubre de 2007

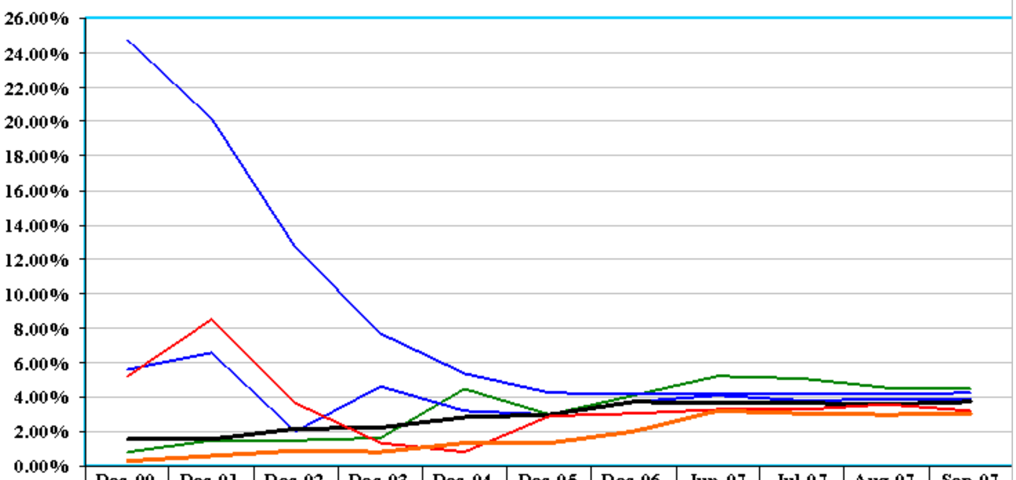
6. Estructura de Tenedores

Inversionistas con más del 10% en TES



	Dic-00	Dic-01	Dic-02	Dic-03	Dic-04	Dic-05	Dic-06	Jun-07	Jul-07	Ago-07	Sep-07
Fondos de Pensiones y Ces.	7.80%	7.17%	10.80%	11.60%	16.38%	17.75%	20.16%	22.08%	22.69%	22.99%	23.58%
Bancos Comerciales	7.15%	13.64%	18.89%	22.00%	26.59%	24.12%	18.77%	16.20%	15.89%	15.69%	15.51%
Entidades Publicas	14.02%	12.72%	13.78%	12.12%	11.07%	11.55%	13.91%	14.26%	14.63%	14.71%	14.99%
Fiducia Publica	9.94%	10.62%	15.27%	17.73%	13.79%	15.79%	15.18%	14.30%	14.39%	14.52%	14.01%

Inversionistas entre 3.0 y 10 % en TES



	Dec-00	Dec-01	Dec-02	Dec-03	Dec-04	Dec-05	Dec-06	Jun-07	Jul-07	Aug-07	Sep-07
Personas Juridicas	0.84%	1.53%	1.51%	1.68%	4.48%	2.97%	4.14%	5.20%	5.07%	4.58%	4.45%
ISS	24.75%	20.15%	12.73%	7.68%	5.40%	4.24%	4.18%	4.19%	4.21%	4.17%	4.23%
Fondos Fiduciarios	5.59%	6.54%	2.03%	4.60%	3.19%	2.99%	3.70%	4.09%	3.80%	3.87%	3.90%
Compañias de Seguros y Cap.	1.58%	1.55%	2.15%	2.22%	2.85%	2.98%	3.77%	3.66%	3.64%	3.61%	3.77%
Direccion del Tesoro Nacional	5.24%	8.55%	3.69%	1.35%	0.79%	2.91%	3.09%	3.30%	3.28%	3.60%	3.21%
Fondos de Inversion	0.31%	0.59%	0.86%	0.79%	1.35%	1.33%	2.03%	3.18%	3.09%	2.97%	3.05%

Conclusiones

1. Estructura de emisiones y organización ayudan y soportan desarrollo del mercado de deuda Pública y del mercado de capitales.
2. Engranaje de mercados (monetario, derivados y de capitales deben ir de la mano)
3. Estructura de tenedores es vital para el desarrollo de los mercados (diversidad de riesgo)
4. Propender por mantener un mercado con liquidez (sabia del desarrollo).
5. Proveer de información al inversionista.

The use of capital market financing – case of Morocco

Ahmed Zoubaine
Head, External Debt Management Division, Ministry of Finance and Privatization of Morocco

Note: The paper was prepared by Mr.Zoubaine but presented by Mr. Chorfi, Director of the Treasury, Ministry of Finance and Privatization of Morocco.

I. Introduction

At the end of the rescheduling cycle in 1993, Morocco faced:

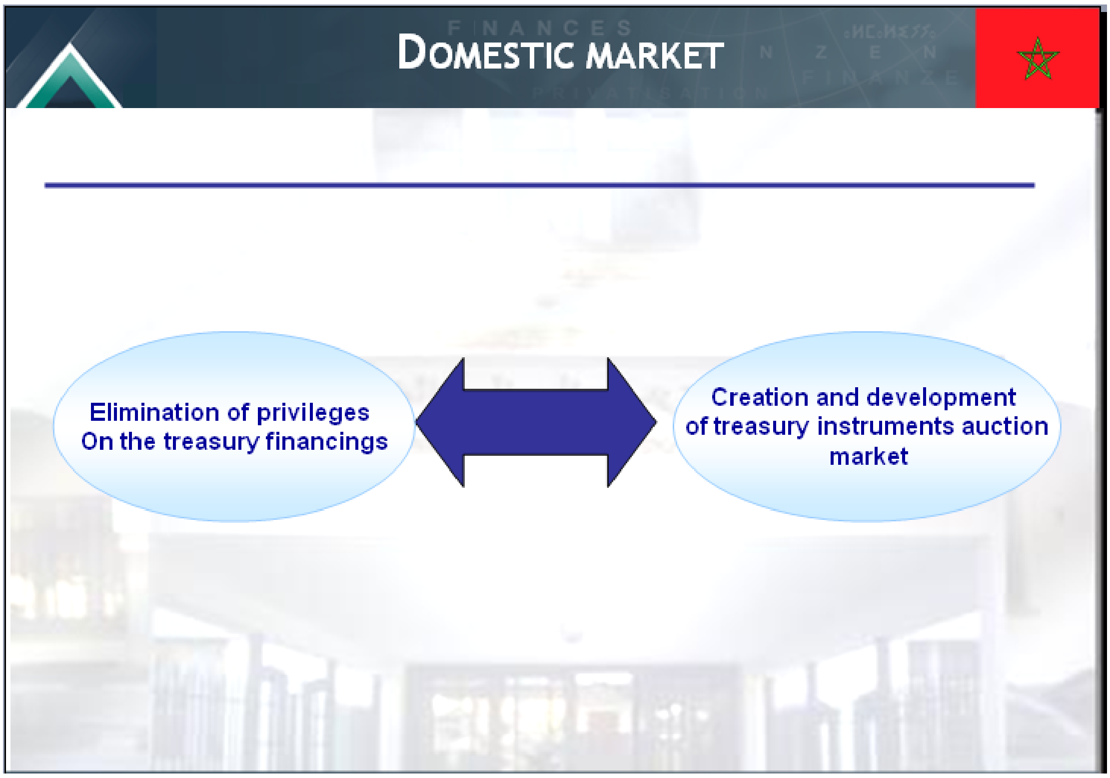
- Public external debt service which absorbed more than 30 per cent of budget revenues.
- Structural negative net flow of external financings which absorbed a significant part of its internal resources.

Thus, Morocco has engaged a vast program aiming at modernizing the Treasury domestic financing mode in order to obtain favorable conditions in terms of cost and risk and stable financing on both the internal and external markets.

Some current figures:

- At the end of 2006, government debt outstanding amounted to $40 billion equivalent to 57 per cent of GDP, of which 80 per cent is domestic debt.
- Interest charges, which amounted to $2,4 billion, absorbed 14 per cent of budget revenues.

II. Domestic market



Elimination of privileges on the Treasury financings:

- Elimination of the total exemption of interest accrued on the treasury instruments subscribed by individuals;
- Elimination of mandatory holdings in form of a floor on government instruments that the banking system was required to subscribe;
- Unification of the securities market by the abandonment of different types of issues (bond issues at attractive rates, national borrowing…);
- Elimination of recourse to the BAM for additional financings and reimbursement of the existing advances.

Treasury instruments auction market:

This market, created in 1989, has been improved through many reforms and measures in order to respond to investors requirements and create more transparency.

- The Central Bank (BAM), which supervise the auction process submits the bids to the Treasury Department and informs the bidding institutions of the status of their bids.
- Treasury Department selects the interest rate or limit price according to Dutch auction method and reports it to BAM. Submissions are served at prices of bidding institutions beginning with the highest price until completion of the total amount needed.

Treasury instruments auction market:

The Treasury instruments (Treasury bonds: BDT) are standardized with three maturities:

- Short term: every Tuesday of the month;
- Medium and long terms (<=15 year) : the 2nd and last Tuesday of the month;
- Long term (20 and 30 year bonds): the last Tuesday of the month.

Treasury instruments auction market:

Investors are informed by statements, via the Central Bank, about the schedule of auctions to be held and the lines to be served:

- A monthly statement about the amount to be mobilized on the auction market;
- A weekly statement about the lines to be served.

Development of the treasury auction market securities:

- Creation of a secondary market;
- Designation of treasury securities dealers;
- Dematerialization of certificates of indebtedness and securing transactions;
- Introduction of issues by assimilation.

Development of the treasury auction market securities:

Enhanced communication is introduced with the financial community to keep it abreast of any intervention in the market. To this end, periodic meetings are held between the various participants - the Treasury Department, the BAM, Treasury securities dealers and secondary market transactors (mutual funds, brokerage firms…) for more effective communication.

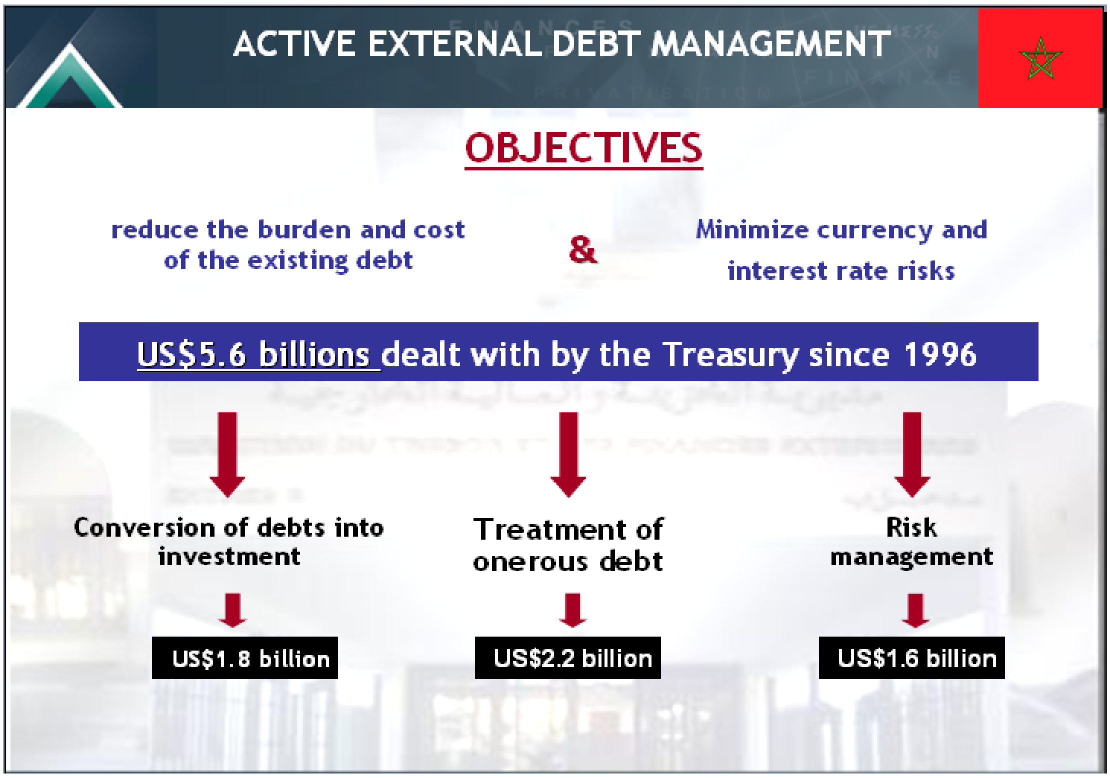
Objectives:

To have a supplementary source besides the traditional external financings in order to:

- To alleviate negative net flows of the external debt;
- To finance the active external debt management operations;
- To be able to arbitrate between internal and external resources.

The access to the international financial market with favorable conditions depends on the perception that investors have of the Moroccan risk.

- Minister annual meeting with the media;
- SDDS;
- Rating.



III. International financial market

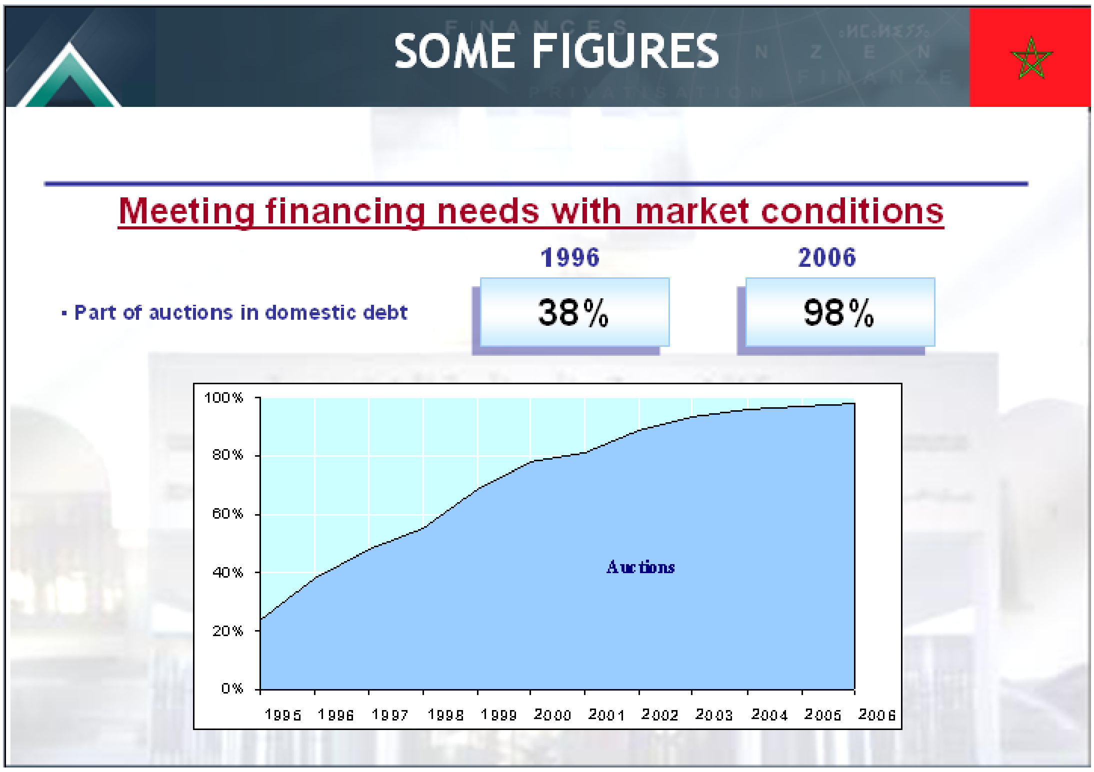
Special issues

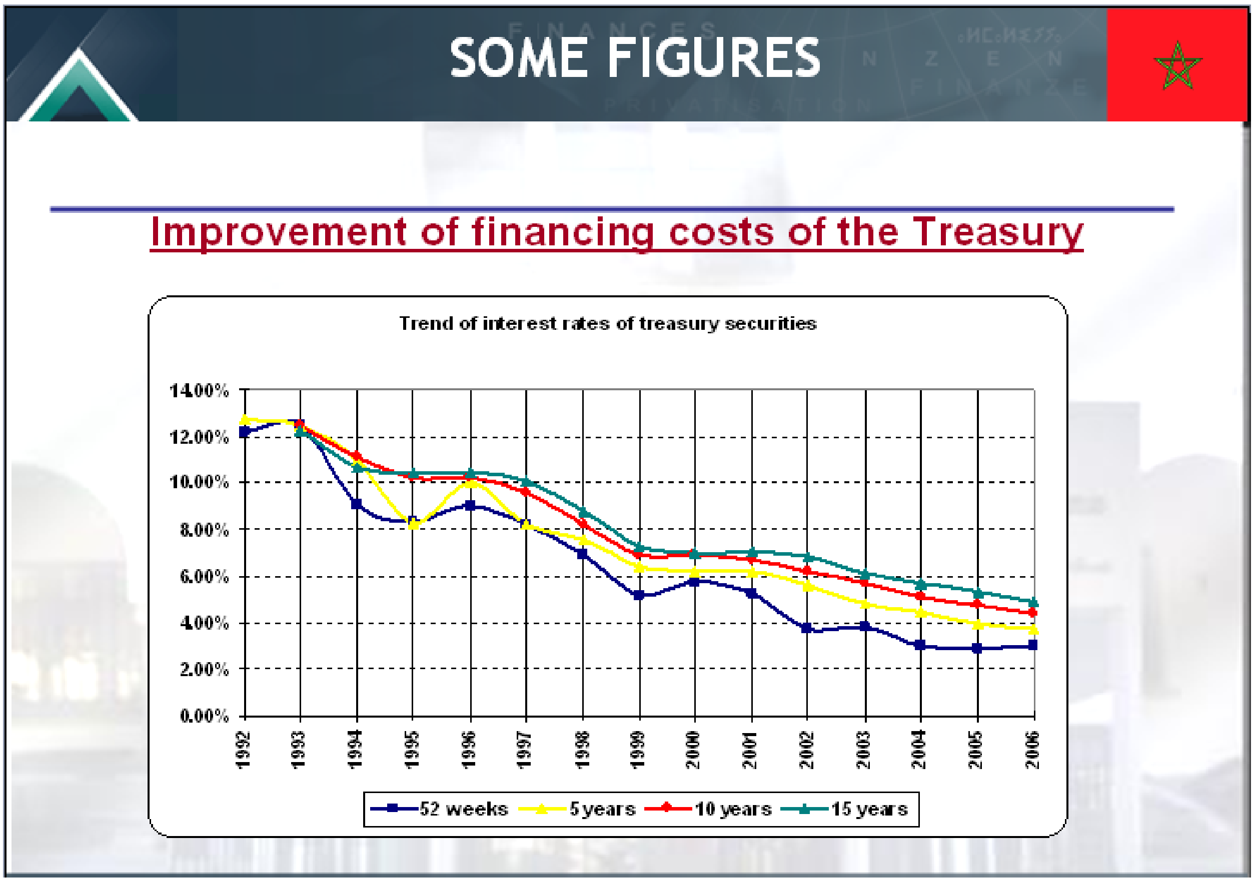
- July 1996: FRF 1.5 billion, guaranteed by AFD, with 5 years maturity and 48 bp spread.
- February 1998: syndicated credit of US$200 million with spread of 45 bp and 5 years maturity.
- April 1999: €138.7 million garanteed by AFD, with 7 years maturity and 55 bp spread.

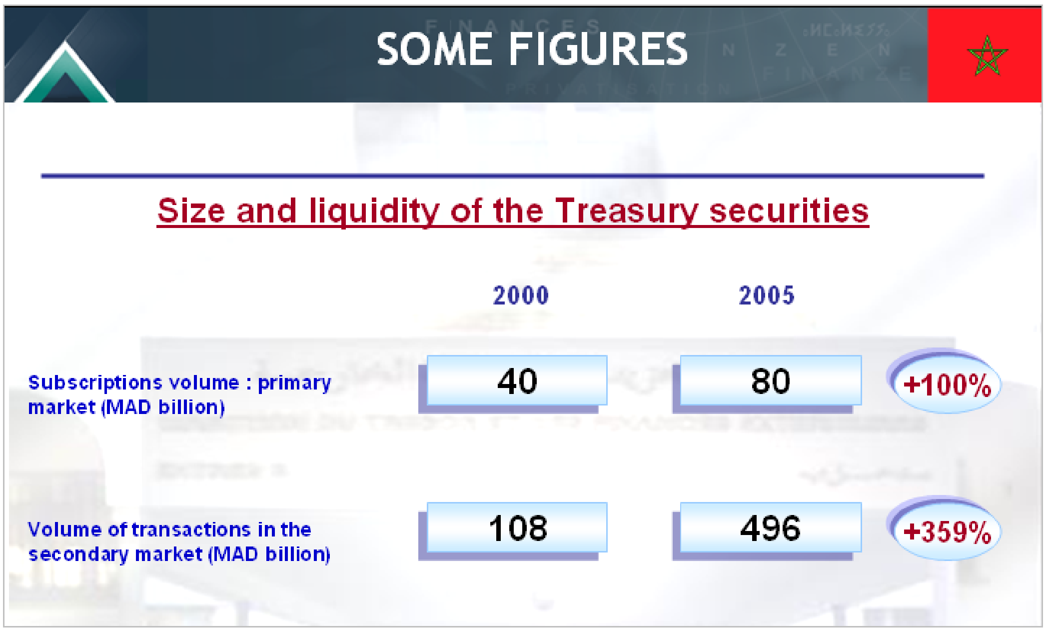
Re-access to the international financial markets

- July 2003: €400 million, 1st issue without external guarantee, spread of 215 bp for 5 years maturity.
- July 2007: €500 million, spread of 55 bp and 10 years maturity.

IV. Some figures



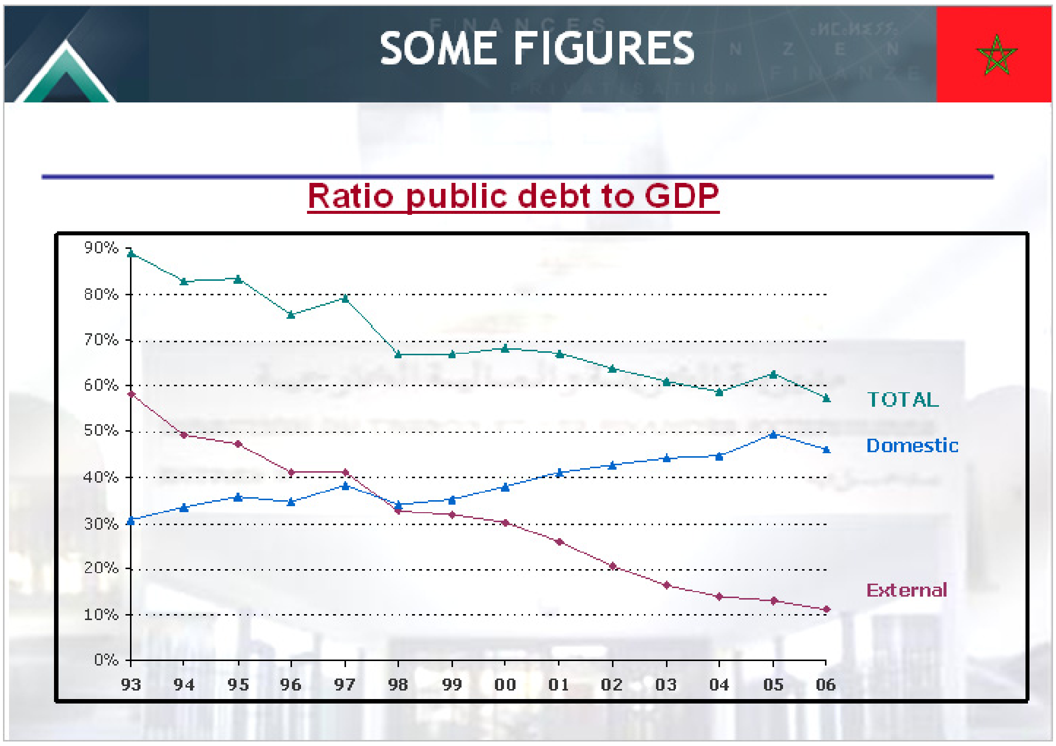


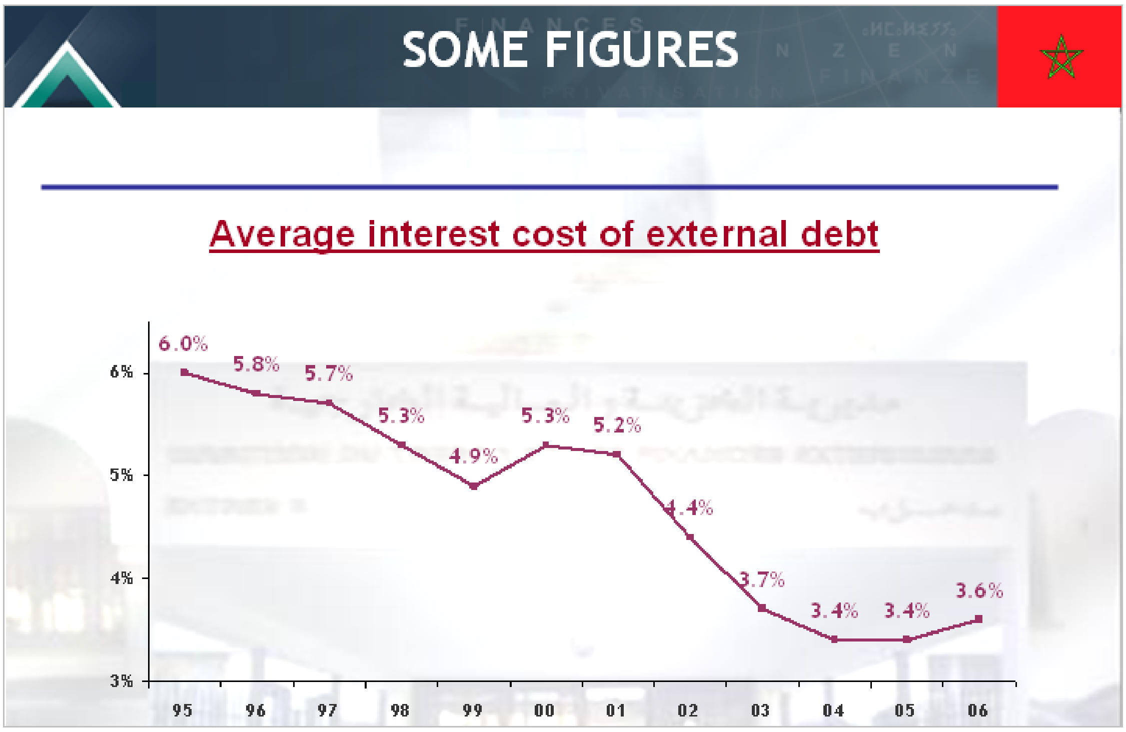


Morocco re-access to the international financial market

Great success of the issue on the international financial market:

- double « Investment grade » rating from Standard & Poor's and Fitch Ratings;
- Risk premium of 55 bp over 10 years maturity swap;
- 3.5 times over-subscribed;
- Geographically diversified investors (more than 70 investors particularly from Europe, United States and the Middle East).




SOME FIGURES
Average interest cost of external debt
6.0%
5.8%
5.7%
5.3%
4.9%
5.3%
5.2%
4.4%
3.7%
3.4%
3.4%
3.6%
6%
5%
4%
3%
95
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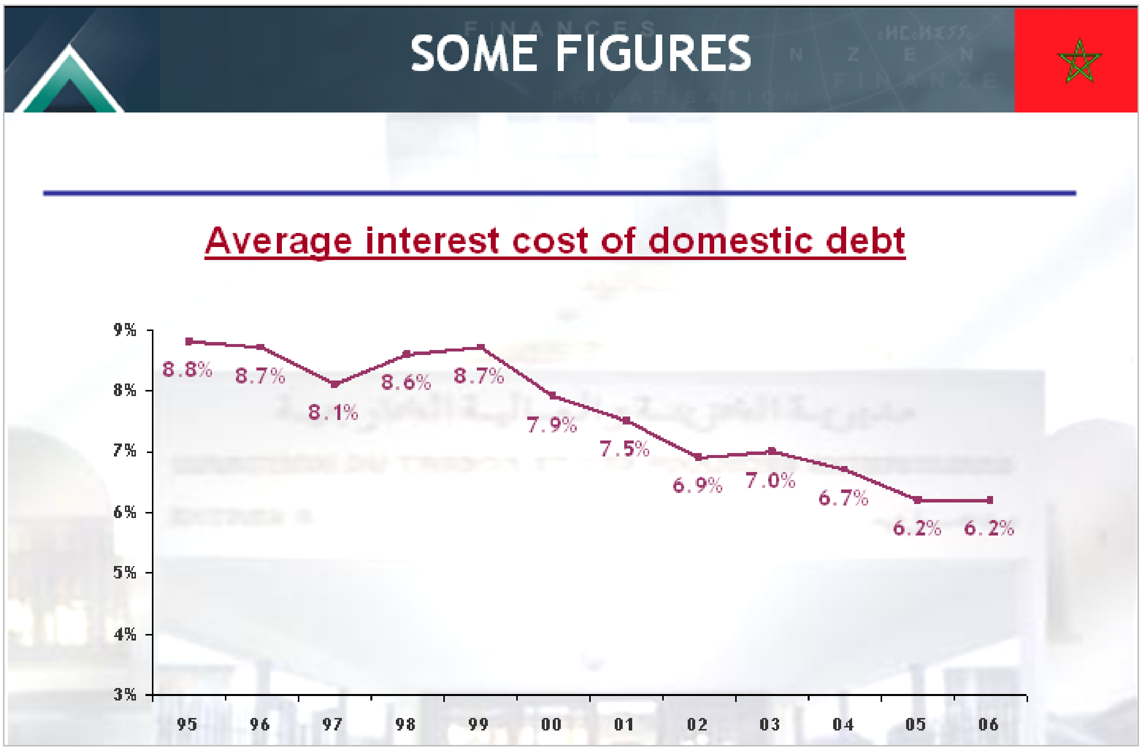
SOME FIGURES
Average interest cost of domestic debt
8.8%
8.7%
8.1%
8.6%
8.7%
7.9%
7.5%
6.9%
7.0%
6.7%
6.2%
6.2%
9%
8%
7%
6%
5%
4%
3%
95
96
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98
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06

Public debt management in Brazil

José Franco de Morais

Note: The author wrote this paper based on analysis conducted by the Back, Middle and Front offices of the Public Debt Department, which belongs to the National Treasury of Brazil.

1- Introduction

This paper aims to present the experience of the National Treasury of Brazil as a public debt manager. Brazilian public debt is as large as U$ 1.3 trillion, managed according to a strategy which contemplates short, medium and long term objectives. The debt management policy complies with the best international practices and has been achieving important results. The experience of Brazil could be an interesting case study for other debt managers that share similar challenges.

The paper is structured as follows. Section 2 presents the institutional framework and explains how the Debt Management Office (DMO) is structured. Section 3 presents the Annual Borrowing Plan, which states general guidelines and defines specific targets to be achieved at the end of the year. A risk management analysis is conducted in section 4 and the strategy to be implemented in accordance with the Annual Borrowing Plan is presented in section 5. Final remarks are done in Section 6.

2- Institutional framework

Brazilian public debt management has achieved important results in the recent past. In 2001 the DMO, which is part of the National Treasury of Brazil, was restructured to meet international standards. The DMO was segmented into three different units, with a clear definition of the role of each unit. The back office is responsible for, among other activities, managing the payment system and generating the statistics related to the public debt. The middle office is responsible for research, macroeconomic analysis, risk management and institutional relationship. Finally, the front office is in charge of defining the short and medium term strategic planning and executing all the transactions in the domestic and international markets, including bond issuance, bond repurchases and liability management transactions.

The Government Bonds Dealer System for the domestic debt was officially created in 2003. Dealers are financial intermediaries selected to perform a specialized role in the market for government securities. In general dealers agree to perform specific obligations or services in the operation of primary or secondary markets for government securities. In exchange, they have specific benefits. An overview on this topic can be found in Mu (2007). There are different structures of primary dealer systems implemented by many DMOs around the world. In the specific case of Brazil there are two types of dealers, named Primary and Specialist. The role of primary dealers is focused on the primary market, while specialist dealers have responsibilities more related to secondary market development.

Another important step towards best practices in public debt management was the creation of the Investor Relation Office in 2001. An institutional relations area is key in the process of opening and maintaining a communication channel with rating agencies, the press and the investors community in general. The maintenance of an open dialogue with agents enhances transparency and improves the flow of information. The main communication channels are electronic newsletters, meetings and conference calls, which are scheduled on a frequent basis. Besides, the National Treasury publishes the Federal Debt Monthly Report, which unifies statistics and other relevant data, providing greater transparency, timing, easiness of access and objectivity.

The National Treasury of Brazil created the Tesouro Direto (Treasury Direct) Program in 2002, allowing individuals to buy domestic government bonds through the web. The minimum amount required is as low as R$ 200 and the main objective of this program is to make public bonds accessible to individuals, regardless their income. Although the high number of individuals registered in the program (over 100.000), it represents only a small fraction of the outstanding amount of the public debt.

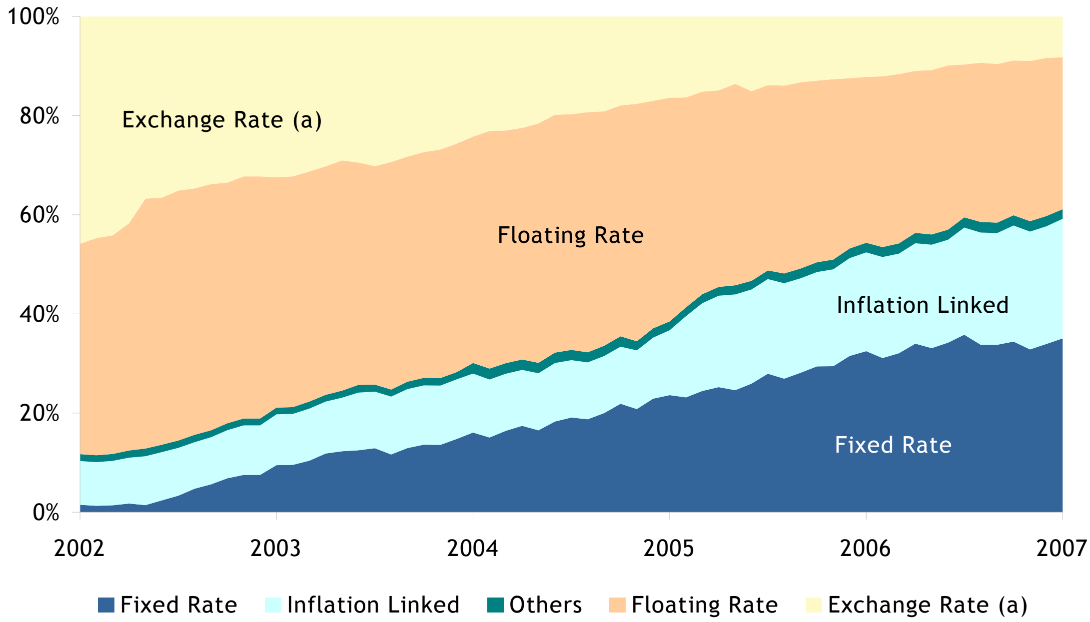
One important aspect of public debt management is the availability of human and capital resources. Public debt managers are usually civil servants, who should have a high educational level in order to deal with complex tasks in a dynamic economy. In the case of Brazilian DMO most of the employees hold a master degree and some of them hold a doctoral degree. In terms of capital resources it is fundamental to have up to date information technology (IT) available, including financial information systems and risk management and economic analysis tools. Another key aspect is the availability of an efficient payment system. In Brazilian DMO IT resources are quite satisfactory and a brand new integrated payment system is currently being implemented.

3- The annual borrowing plan

The objective of public debt management is to minimize long-term financing costs, while ensuring the maintenance of prudent levels of risk. Besides, the National Treasury is committed to contributing to a smooth operation of the government bonds market. As strategy to achieve this objective, the National Treasury has adopted an active policy of improving the composition and lengthening the average life of the debt. The combination of these two factors tends to reduce investor's perception of risk and therefore lowering the financing costs.

In terms of composition there has been a massive reduction of exchange rate and floating rate exposure, which was compensated by an increase in the fraction of fixed rate and inflation linked bonds. Besides average life extension, there is also an explicit policy of lowering short term refinancing risk through the reduction of the percentage of bonds with maturity of less than 12 months. These goals have been achieved as well, although there is room for further enhancement. Figure 3.1 presents data on the composition and the short term maturity.

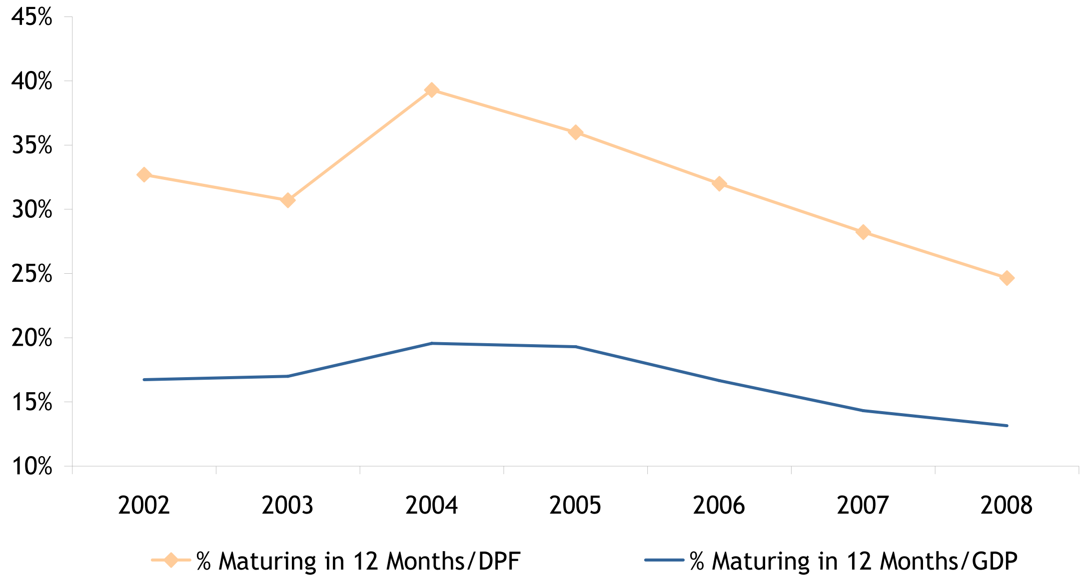
Figure 3.1a: Composition



	Dec-02	Dec-07
Exchange Rate	45.80%	8.20%
Floating Rate	42.40%	30.70%
Inflation Linked	8.80%	24.10%
Fixed Rate	1.50%	35.10%
Others	1.50%	1.90%

Source: National Treasury of Brazil

Figure 3.1b: Short Term Maturity Structure



Source: National Treasury of Brazil
Note: It considers 2008 ABP targets

Since 2000 the National Treasury publishes its Annual Borrowing Plan (ABP), which contains the guidelines for the public debt management policy, defines explicit ranges for target variables to be achieved at the end of the year and sets up the strategy to be adopted. The guidelines for 2008 are as follows: (i) lengthening of average maturities and reducing the percentage of public debt maturing in 12 months; (ii) gradual replacement of floating-rate bonds for fixed-rate or inflation-linked bonds; (iii) improvement of the external liability profile through the issuance of benchmark bonds, early redemption program and liability management operations; (iv) incentives to the development of the interest rate term structures for government bonds on domestic and external markets; and (v) investors base expansion.

Besides these general guidelines, the ABP defines also the target ranges for some statistics to be achieved at the end of the year. As shown in Figure 3.2, composition enhancement and average maturity lengthening continue to be the focus of the public debt management in 2008.

Figure 3.2: 2008 Annual Borrowing Plan

Indicators	2007	PAF-2008	
		Minimum	Maximum
Outstanding ***(R$ Billion)***			
	1,333.8	1,480.0	1,540.0
Profile (%)			
Fixed Rate	35.1%	35.0%	40.0%
Inflation Linked	24.1%	25.0%	29.0%
Floating Rate	30.7%	25.0%	30.0%
Exchange Rate	8.2%	7.0%	9.0%
Others	1.9%	1.0%	3.0%
Maturity Structure			
Average Maturity (Months)	39.2	42.0	46.0
Percentage Maturing in 12 Months	28.2%	24.0%	27.0%

Source: National Treasury of Brazil

4- Risk Assessment

The National Treasury of Brazil has developed an Asset Liability Management (ALM) model in order to optimize its debt structure. The output of the joint analysis of assets and liabilities is the benchmark debt structure, which is used as a reference to set up the ranges presented on the ABP.

The high exposure to exchange rate and interest rate has always represented the greatest source of risk for the public debt in Brazil. As shown in Figure 3.1a, in 2002 it represented 88% of the total debt. One interesting risk management exercise is to calculate the sensitivity of the public debt to a shock on either interest rate or exchange rate. Figure 4.1 presents the sensitivity analysis considering the impact on the net public sector debt (NPSD)/GDP ratio provoked by a 1% shock in either interest rate or exchange rate. It can be seen that risk mitigation has been considerable. The negative impact of an FX shock can be explained by the fact that international reserves have been growing consistently to U$ 185 billion, which is higher than the external debt outstanding amount of U$ 60 billion.

Figure 4.1a: Impact of 1% SELIC change on NPSD/GDP

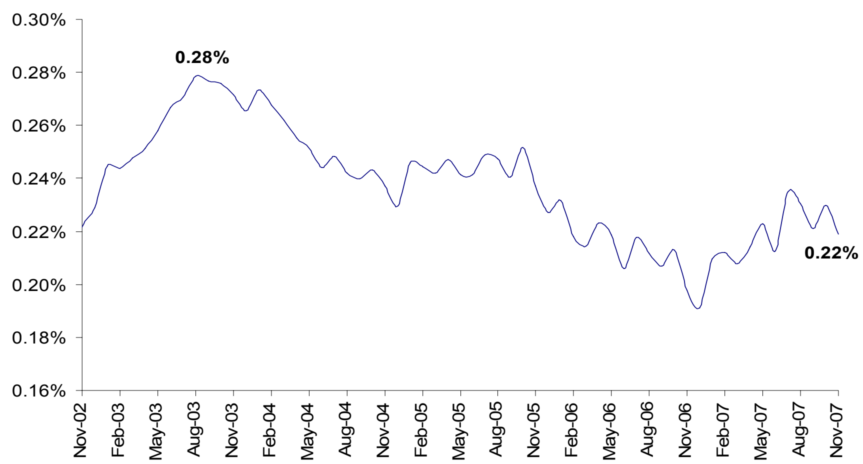
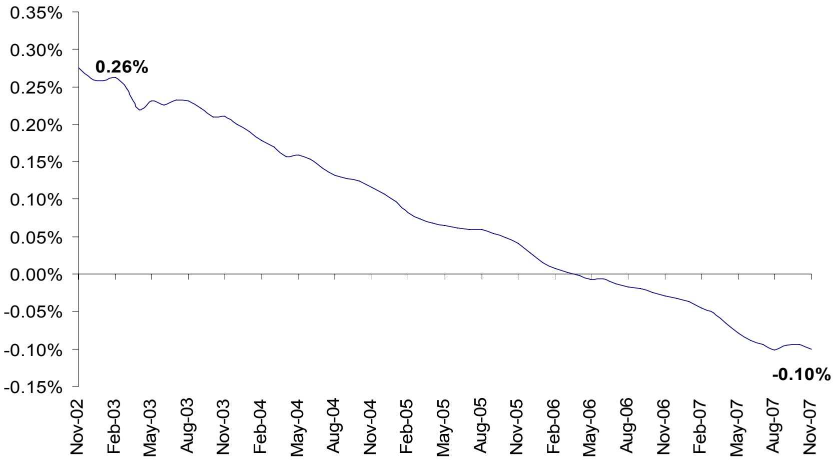


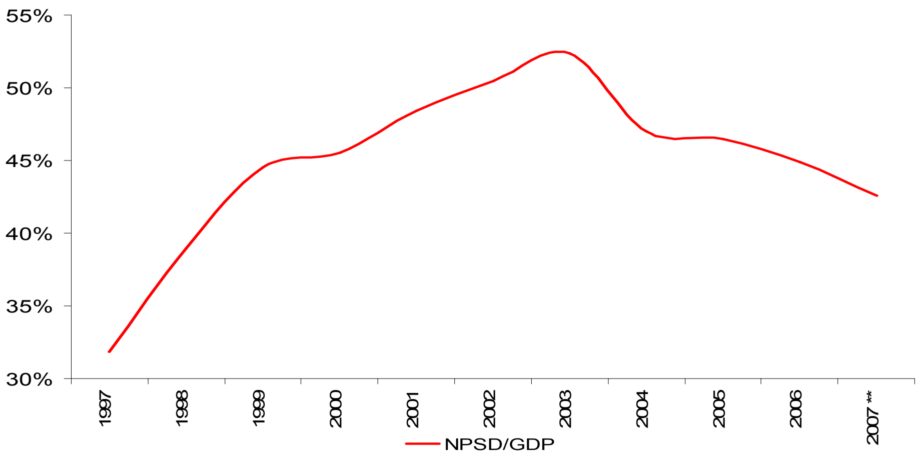
Figure 4.1b: Impact of 1% FX devaluation on NPSD/GDP



Source: National Treasury of Brazil

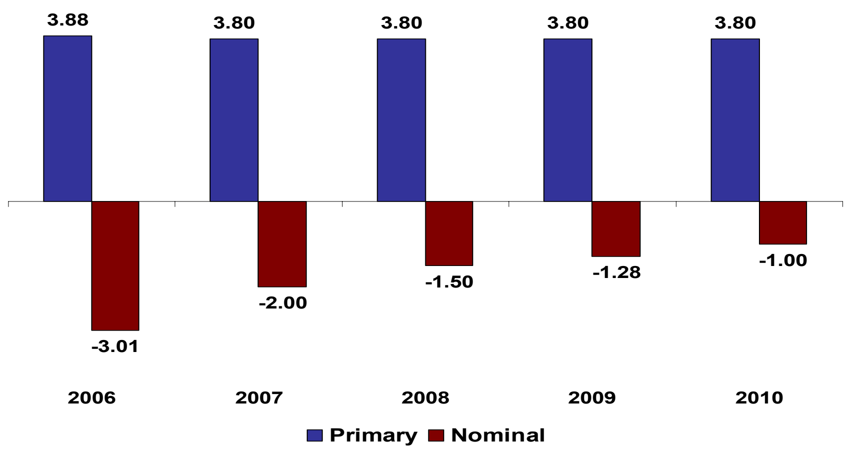
Another important variable closed watched by rating agencies and the analyst community in general is the Public Debt/GDP ratio. After reaching a peak in 2003, this relation has taken a clear downward trend, as shown in Figure 4.2. One of the reasons of this positive outcome is the fiscal commitment. The primary surplus target is currently at 3.8% of GDP and the nominal deficit has been decreasing over time and is expected to reach zero over the next few years, as shown in Figure 4.3.

Figure 4.2: Net Public Sector Debt/GDP



Source: Central Bank of Brazil

Figure 4.3: Fiscal Balance/GDP



Source: Central Bank of Brazil

5- Strategy

The ABP contains also the general strategy to be adopted for both domestic and international markets, in order to meet the targets. The main financial instruments offered by the National Treasury in the domestic market and their respective strategy are as follows:

(i) LTN (*Letras do Tesouro Nacional*): bills with maturities up to 24 months. On the run tenors are 6, 12 and 24 months;

(ii) NTN-F (*Notas do Tesouro Nacional* – series F): plain vanilla bonds and notes with semiannual coupon payments. Current benchmark tenors are 3, 5 and 10 years, but there is a possibility of extending the curve and issuing longer term instruments, depending on market conditions.

(iii) NTN-B (*Notas do Tesouro Nacional* – series B): inflation linked bonds with semiannual coupon payments. Current benchmark tenors are 3, 5, 10, 20, 30 and 40 years.

(iv) LFT (*Letras Financeiras do Tesouro*): Floating rate instrument linked to the SELIC rate. The average issuance term in 2008 is expected to be greater than the average 2007 term of the federal public debt, which is around 40 months. There will be net redemption of this instrument in 2008.

In order to reduce refinancing risk, especially in the short term, the National Treasury adopts an active debt management policy through the Early Redemption Program. It consists of repurchase auctions and exchange auctions on a frequent and organized basis. This program aims to smooth the maturity profile, enhance liquidity and benchmark both fixed rate and real rate curves215. Eligible instruments are short term bonds or off the run instruments that are no longer issued for financing purposes. The domestic debt maturity profile is shown in Figure 5.1a, while the balance between issuance and redemption is shown in Figure 5.1b.

The National Treasury is strongly committed to the secondary market development. Having a well defined curve formed by liquid instruments and clear benchmarks is extremely important and contributes to lower the financing costs. Figure 5.2 presents the daily turnover rate for the most important financing instruments in the domestic market[216]

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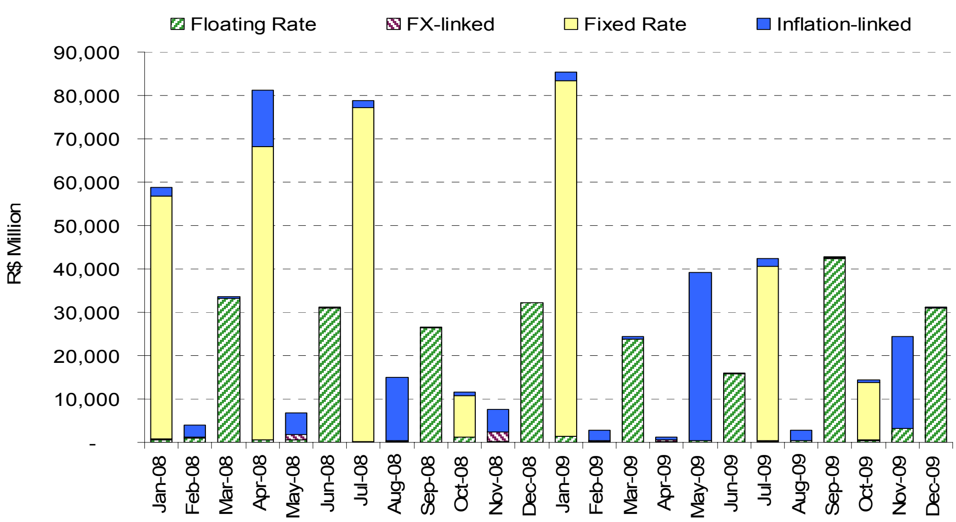
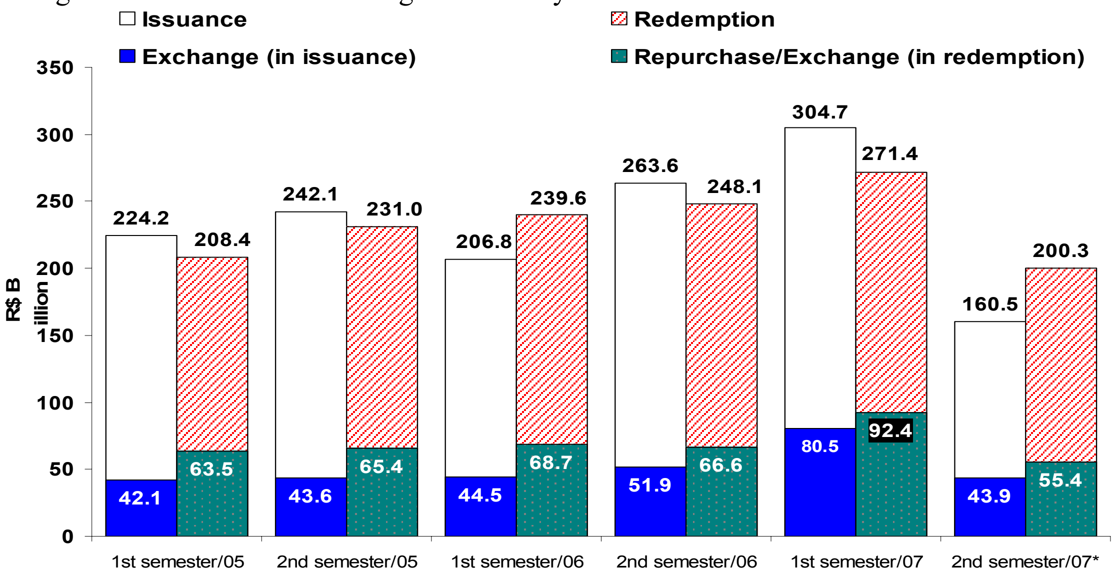
(v)

Figure 5.1a: Domestic Debt Maturity Profile



[215] The real rate curve is formed by inflation linked bonds.
[216] The turnover rate is given by the Traded Amount/Outstanding Amount ratio.

Figure 5.1b: Active Debt Management Policy



Source: National Treasury of Brazil

Figure 5.2a: Fixed Rate Bonds Liquidity Indicator

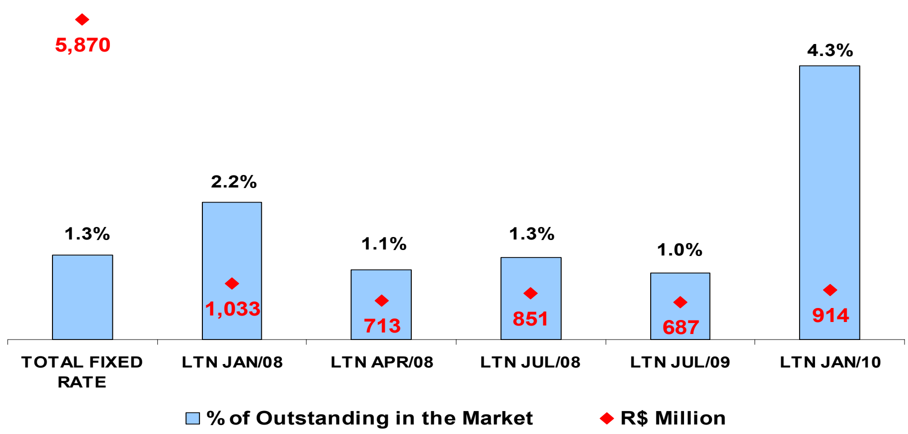
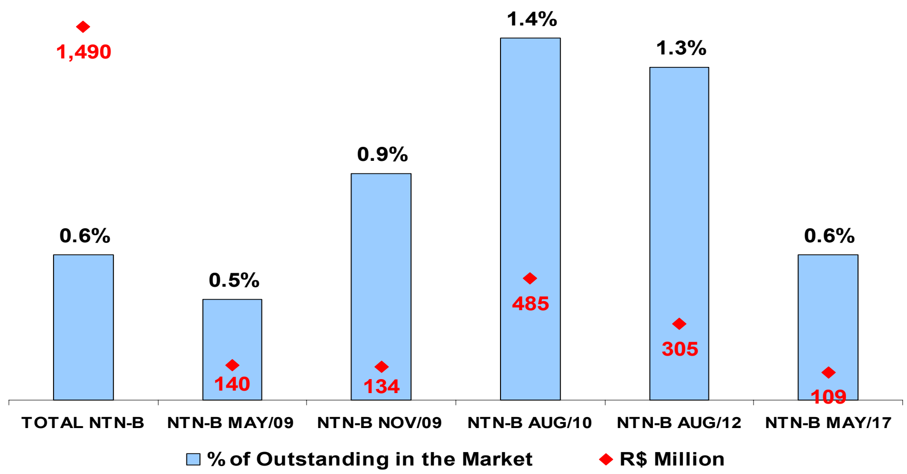


Figure 5.2b: Inflation Linked Bonds Liquidity Indicator



Source: National Treasury – as of November 2007

On the external front the National Treasury has taken several measures to smooth the maturity profile. After exercising the Brady bonds call option and executing early payments of the entire IMF and Paris Club debt in 2006, the DMO announced two public liability management transactions in 2007. The first one was a tender offer for most of the external bonds, while the second one was an exchange offer in which eligible bonds were long term ones and the bond to be issued was the 30-year benchmark.

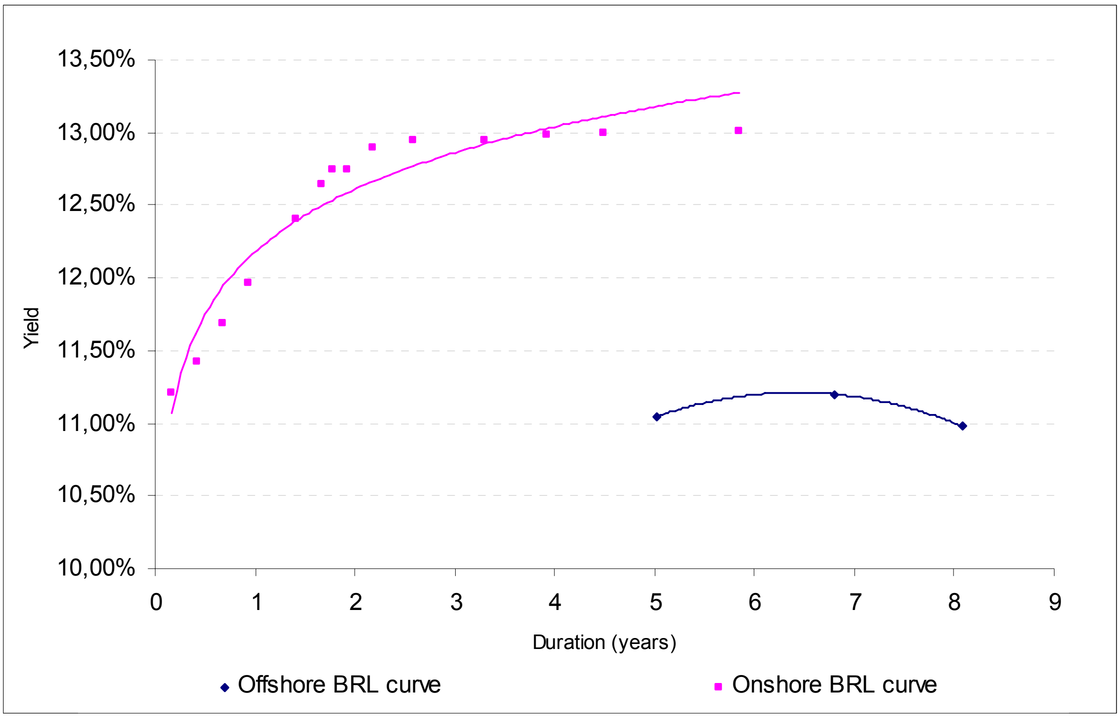
Along the lines of reducing FX exposure and benchmarking the external curve, another important action taken was the implementation of the Repurchase Program in 2006. The rationale behind this strategy is to buy back off the run bonds through secondary market regular trades and, at the same time, keep issuing on the run benchmark bonds, which for the USD denominated curve are basically the 10-year and 30-year tenor. The outcome is a more efficient curve with clear and liquid benchmarks, instead of having a curve with many illiquid bonds. The total amount repurchased in 2006 and 2007 was, in nominal terms, $6.0 billion and $5.4 billion respectively.

In general the Repurchase Program is perceived to be more cost efficient than traditional liability management transactions for several reasons. First of all the issuer can take a more opportunistic approach and buy into the dips. Secondly it is possible to buy back bonds at levels below the market ask side (often at mid-market level), while in a traditional tender offer the issuer is asked to pay an extra premium above the ask side of the market. Another important point to be mentioned is the exposure to the announcement effect in traditional liability management transactions, when the price action runs against the issuer once the deal is announced. As a potential drawback, it is fair to say that secondary market repurchases are a gradual process and it takes time to build a considerable amount. Besides, it has less appeal in terms of being a marketing event.

The external debt strategy contemplates also the creation and maintenance of a BRL denominated off shore curve, which plays an important role as a reference in the long part of the fixed rate curve, since foreign investors are in general more willing to take duration than local investors. The first issuance in the off shore market occurred in 2005, with a 10-year tenor (BRL 2016). At that time the longest fixed rate tenor in the domestic market was 5 years. Since then the off shore curve was extended to 15 and 20 years (BRL 2022 and BRL 2028), and it worked as a catalyst factor for extending the on shore curve and creating the 10-year benchmark in 2007 (NTN-F 2017).

In terms of financing costs, it is worth mentioning that the off shore curve is tighter than the on shore curve. The spread differential has been fluctuating between 90 bps and 200 bps, depending on market conditions. On February 2006 the withholding tax exemption for foreign investors was approved and since then foreign investors participation in the local market has increased. The higher yield is an incentive for international investors to buy domestic bonds. On the other hand, if an investor has preference for an off shore instrument, denominated in BRL, settled in USD and cleared through the usual international clearing systems, she must be willing to take a lower yield. Figure 5.1 presents both on shore and off shore BRL fixed rate curves.

Figure 5.1: BRL on shore and off shore curves



Source: National Treasury of Brazil

6- Concluding remarks

Public debt management in Brazil is done in accordance with the best international practices and has achieved important results. A clear communication with investors, analysts, rating agencies and the press is kept though the Institutional Relations Office.

The Annual Borrowing Plan disclosures general guidelines and determines specific targets to be met at the end of the year. Moreover, it defines the strategy to be adopted during the year in order to achieve the targets.

The strategy adopted in the recent past has been successful and the public debt management has achieved important results such as composition improvement, duration extension and the construction of liquid curves with well defined benchmarks. Nonetheless there is room for further achievements.

References

Mu, Yibin, 2007. Issuing Mechanisms for Government Securities. The World Bank/IFC Capital Markets Advisory Group.

Panel 10

International support for debt strategy formulation and implementation

International support for strategy implementation: summary of panel discussion

Moderator: Mr. Raja Khalidi, Officer-in-Charge, Debt and Development Finance Branch, GDS, UNCTAD

Panelists: Mr. Gerry Teeling, Chief, DMFAS Programme, UNCTAD
Mr. Tomas Magnusson, Lead Financial Officer, World Bank
Ms. Lucy Laliberté**,** Deputy-Director, Statistics Department**,** IMF

Mr. Gerry Teeling gave an outlook on international (public and publicly founded) technical support on debt management. He proposed a 3-level pyramidal structure. At the bottom of the pyramid there are recording & operations activities whose aim is to obtain a reliable debt database. There two main tools are at disposition: the one developed by UNCTAD (DMFAS) and the one by the Commonwealth (COMSEC). At the second level the information is compiled into statistics to give a clearer picture of the debt situation. Together with the previous mentioned Organizations also IMF and some regional institutions are active in this field. At the third level, there is debt analysis: basic with the DMFAS & COMSEC tools; advanced, including risk analysis, with the WB/IMF & MEFMI models. At the top of all this, debt analysis is pooled with other economic information and processed into debt sustainability analysis (here Debt Relief International operates with DebtPro; and WB/IMF, together with UNCTAD, with DSM+), which can finally led to a Medium Term Debt Strategy.

Besides, other specific debt training providers are: the US Treasury for institutional support, the IMF Technical Assistance Centre (TAC), IDI/INTOSAI for training debt audits, UNITAR, UN ESCWA, UN ESCAP and IDB/LAC Debt Group.

The described structure, which implies a holistic approach, has however some gaps. The debt environment is getting complex and demanding, and many grey areas (like risk-analysis) can still be pointed out, as well as, in many cases, lack of coordination and overlapping. At the same time, example of good coordination can also be found (among them: the debt guide on external debt statistics, DeMPA and MTDS). These should be seen as the right benchmark for the future debt management which will necessarily imply a directory of service providers, plans at country level and standard criteria and language.

Mr. Tomas Magnusson described the Debt Management Performance Assessment Tool (DeMPA), a methodology launched by WB for assessing performance through a set of indicators spanning the full rang of government debt management functions. The indicators are 14 with 35 dimensions, evaluated through a scoring methodology. The aspects covered are basically six: governance, coordination with macroeconomic policies, borrowing, cash flow forecasting and cash balance management, operational risk management, debt records and reporting. In many developing, he explained, debt management performance is very weak. Hence the need for a universally accepted and standardized metric, that could also monitor progress over time and help in designing reform programs and enhance donor harmonization based on common understanding of priorities.

Mr. Magnusson also briefly presented the Medium Term Debt Strategy, a joint WB-IMF project aimed to support debt management strategy in low income Countries through a "step by step" guide and a scenario analysis model based on a spreadsheet-based analytical tool.

Ms. Lucie Laliberté presented the Interagency Task Force on Finance Statistics which coordinates work among the participating organizations (UNCTAD, Paris Club Secretariat, WB, Bank of International Settlement, IMF, European Central Bank, COMSEC) to improve the methodological soundness, transparency, timeliness and availability of debt-statistics. Every two years it reports to the UN Statistical Commission.

Its main achievements are the External Debt Guide (which is to be updated taking in order to be harmonized with the balance of payment recent accounting changes), as well as Public sector debt guide, External Debt Data Quality Framework and IIP/External Debt Comparison.

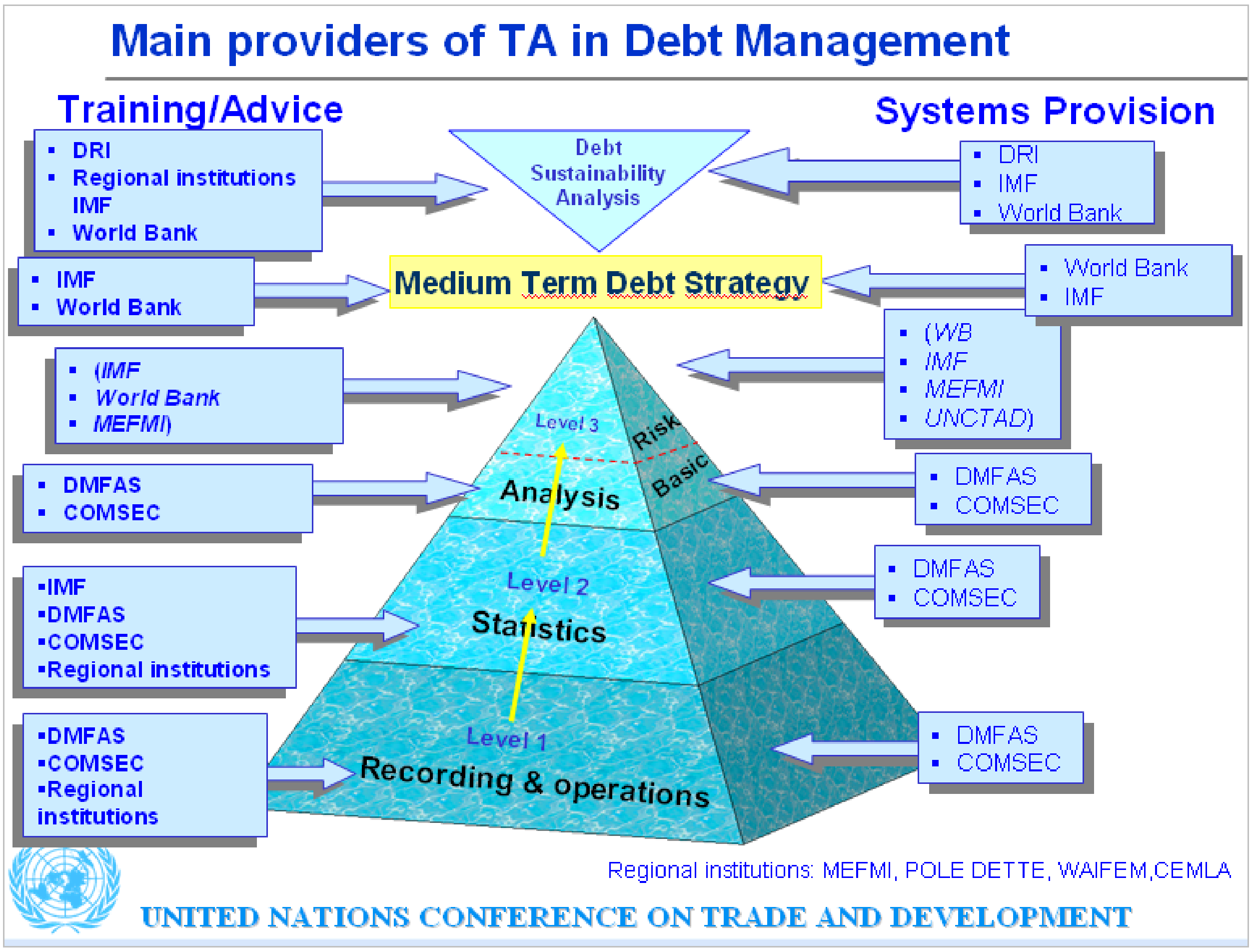
International support for formulating and implementing debt strategies in developing countries

Gerry Teeling
Debt management – DMFAS Programme

Content

- Summary of the international (public & publicly funded) technical support available
- Observations
- Lessons learnt
- Questions we need to ask ourselves

Main providers of technical assistance in debt management



Audio transcript

In this presentation I will first give a summary of the international technical support available. By international support I mean public and publicly funded. Secondly, I will make some observations about what is available. Then we take some lessons that we have learnt from the 25 years we have been involved in debt management support.

The pyramid that you see here (slide) is the capacity-building pyramid which basically has 3 layers. You see on the right hand side that we have the Systems Provision and there we see recording and operations. It is clearly defined that the main providers out there in the public domaine are the Commonwealth Secretariat and the DMFAS Programme of UNCTAD, which provide computerized debt management systems for the recording and operations – particularly at the back office level. On the left hand side we have the Training and Advice. Here again, you have the COMSEC, the DMFAS, in collaboration with the regional institutions.

Moving to level 2: debt statistics – we have heard so much about how important debt statistics are during this Conference. Here you have the COMSEC and DMFAS being the main public goods which are available, which are out there for debt management offices to assist them in producing debt statistics on the basis of the timely, reliable data that they would get from level 1. After good recording, good operations, then to be able to use that data to produce high quality debt statistics.

On the left hand side, in the area of training and advice, we have the IMF, DMFAS, the COMSEC, and the regional institutions. There are many other organizations that have contributed in this arena but I would just like to point out that these are the main providers of technical assistance. And I am very happy to say that all of those four entities that are there have been collaborating very, very consistently in this area.

Moving now to the area of analysis, we see that this panorama is not so clear. What we have actually done is to cut the top layer into two. What we have in the bottom part of the layer where you see analysis (and on the right hand side is basic. Well this is very basic debt analysis: basic risk indicators, basic debt indicators, basic debt portfolio analysis. We see that DMFAS and the COMSEC systems do provide a certain amount of support in that area and we know that both systems are being improved in order to provide even further support in basic analysis. Similarly, on the left hand side, the same goes for training and advice. At the top level of that layer where we see risk, this is the area where the situation is still evolving and this is the reason why on the Systems Provision, we have placed all of the emphasis there in italics and parenthesis. The reason being – and as we heard earlier today, from Mr. Das –that there is a lot of work going on in this area by the World Bank and the IMF. The work is on the way in order to produce and provide public goods in the form of cost risk modules.

We understand also that MEFMI has done some work in this area and has supported at least one country in building such a module for their own needs. UNCTAD is there primarily because we have been asked by many of the beneficiaries with whom we are working to support them in this area. We haven't yet gone to the level of building such a module. What we would like to do is rather to cooperate with the other partners to be able to find a global solution in this area. On the right hand side, on the Training/Advice, you see that the main providers of assistance in these areas are the IMF, the World Bank and we understand also MEFMI.

Debt sustainability analysis. We have superimposed this on top. It could easily have become part of the third level of the pyramid but we would prefer to separate it because so much work has gone on in this area which is quite distinct. We believe that it deserves to have its distinct area on this diagram. On the Systems Provision, we have Debt Relief International – who are basically the main operators of the HIPC capacity building initiative working together with the regional institutions. The reason that we put them there is that they were using the DebtPro system for debt sustainability analysis and they were also providing training and advice in its use to beneficiary countries undergoing the HIPC initiative.

In the Systems provision we also have the IMF and the World Bank and as we heard earlier during previous sessions, both these institutions have collaborated on the production of the debt sustainability analysis templates and have made them available as public goods on their websites. So those are the main systems which are available now. The World Bank did work at one point on another module which is the Debt Sustainability Model (the DSM+). Both UNCTAD and the Commonwealth Secretariat have a partnership with the World Bank to disseminate it. We are doing it on the basis of demand, simply providing the system and some basic training as how to use it but neither ourselves nor the Commonwealth Secretariat engage in debt sustainability analysis. The Training/Advice on the left hand side is DRI together with the regional institutions, the IMF and the World Bank.

And finally medium term debt strategies, the ultimate goal of all of this: to enable countries to be able to produce effective and medium-term debt strategies. In this area the main providers of support and advice are the World Bank and the IMF. Also, we heard earlier that the World Bank and the IMF are working to produce tools which will make this job easier.

Other providers

- US Treasury – institutional support
- IMF Technical Assistance Centres (TAC)
- IDI/INTOSAI – training, debt audits
- UNITAR – training
- UN ESCWA
- UN ESCAP - training
- IDB/LAC Debt Group – facilitator
- Other…..

Audio transcript

I have to say that in putting that diagram up, we knew that we were not going to be able to cover every provider. We really wanted to include those that were providing technical assistance. We know and we are very grateful to all of the donors, all of the sponsors, all of the regional banks, all of the development banks and agencies that are supporting the work in this area and the aim of this is just to have a summary of those that are providing technical assistance.

Now with regard to other providers, we have the United States Treasury that also has the goal of assisting countries in formulating effective debt strategies. They are working in a number of countries and have advisors placed in a number of countries. I know from the UNCTAD perspective, we have had the pleasure to coordinate with them in those countries.

Similarly for the IMF, the technical assistance centres, or the TACs, also place debt experts in a number of their centres and those advisors provide a level of advice and support also to those countries in which they are working.

IDI – INTOSAI. We had the pleasure of having presentations here from INTOSAI members and we are working within UNCTAD with IDI/INTOSAI because we see that debt audit is a very important area. It is all part of having an effective debt management strategy. I will just name the others.

UNITAR Training, UN-ESCWA training, UN-ESCAP training, the IDB or the LAC Debt Group who facilitate training. There has been a lot of coordination with them also and the other actors. And my apologies to others out there.

Observations

- Holistic approach to debt strategies is crucial
- Lot of support available, but still gaps in key areas
- Many providers & new entrants
- Lot of coordination – lot of room for improvement
- Not always clear who is doing what, when, where
- Risk of duplication/overlapping
- Risk of confusion for beneficiaries & donors

Audio transcript

The holistic approach to debt strategies is crucial. And I am just going to jump back: All of these layers are necessary. You can not have an effective medium-term debt strategy unless you have quality at all of the other levels. That is why we believe firmly that a holistic approach to this is crucial. There is a lot of support available as we have seen. But there are still gaps in key areas. And one of the key areas in which it seems that now that there is work ongoing in order to fill the gap is in the area of risk analysis. There are many providers, there are many new entrants. If we had compiled this list even a year ago we probably wouldn't have had so many names there. There is a lot of coordination but there is a lot of room for improvement.

It is not always clear who is doing what, when, where. And in that situation, there is a risk of duplication, overlapping. There is a risk of confusion both for beneficiaries and for donors.

Challenges shared by all stakeholders

- Growing need & demand for debt management TA
- Changing nature of the demand
- Design & implementation of debt strategies a complex task
- High staff turnover at country-level
- Infrequency of some debt functions
- Coordination faces many constraints
- Limited resources
- Ensuring continuous improvement while ensuring today's needs are met

Audio transcript

Moving on to challenges, these are challenges that we believe are shared by all stakeholders, whether it is the beneficiary country, the provider of a system, the donors, the sponsors who are funding the activities. First of all, the growing need and demand for debt management technical assistance, and linked to that the changing nature of that demand. I am not going to dwell on that. We have heard enough during this Conference.

Design and implementation of debt strategies is a complex task. We saw that you need many, many elements to fit in. And that was only part of the picture. That was shown on the pyramid. That only showed the debt management side; we have to add the whole exogenous data. Also the macroeconomic data which needs to be added to that whole picture in order to have an effective debt management strategy. Challenges – high staff turnover at the country level. Capacity building can build a lot of competence in the debt management area but that may be temporary. We hear from debt managers all the time, that one of the main problems is high staff turnover. The infrequency of some debt functions. Some of the functions like those at the lower end of the pyramid are performed much more frequently than those at the upper end of the pyramid. Which means that some skills that are learned and that are not used very frequently may be lost and that give rise to a repetition of training. Coordination faces many constraints. Despite a high will to coordinate and as I said there is a lot of coordination ongoing, there are many constraints. Not least issues of privacy, of sharing between providers on what is happening in countries and also the issue of limited resources. Ensuring continuous improvement. Well, ensuring that today's needs are met. That is a big challenge for us.

Coordination among technical assistance providers – some global examples

- *Debt Guide* (on External Debt Statistics)
  - Partnership in Conception
  - Partnership in Dissemination
  - Partnership in Implementation
- New initiatives:
  - Debt Management Performance Assessment (DeMPA)

Audio transcript

We just want to give here examples of what we believe have been some excellent examples of coordination.
First of all, the Debt Guide on External Debt Statistics. This coordination happened at all three levels: conception, dissemination and implementation. Which meant that this issue of ownership was very strong amongst all partners. Coordination is also in place and we are looking very positively at this in the area of the two initiatives which we heard about earlier and about which we will hear more during this panel: the DEMPA (debt management performance assessment) and the Medium term strategies.

Lessons learnt
Prerequisites for effective, efficient support

1. Definition of support available – *'Directory of debt management service providers'*
2. Clear definition of which organisations best suited to provide different types of support
3. Comprehensive plan at country level (5 W's) based on comprehensive capacity-building framework; kept updated – 'TA calendar'
4. Plans to be shared amongst all actors
5. Efforts driven by the beneficiary
6. Flexibility to adapt to changing needs
7. Coordination between actors based on shared ownership and competitive advantage – 'harmonization'
8. Support must be sustainable
9. Measurement of impact using standard criteria & language
10. Regular evaluation of debt management TA on a global level

Audio transcript

Lessons learnt. First of all we believe that there is a need for a directory of debt management service providers. What we have shown today is what UNCTAD has put together. But we believe that this needs to be shared and that it needs to be kept up to date so that all stakeholders have this information available. This would help to have a clear definition of which organizations are best suited to different types of support. It would also help us to build comprehensive plans at the country level. The five Ws based on a comprehensive capacity-building framework. Plans need to be shared. Efforts need to be driven by the beneficiary and that is a key point. The beneficiary should be the one who decides what is going to happen. Flexibility to adapt to the changing needs. Coordination between actors based on shared ownership and comparative advantage. Harmonization of this coordination. Support must be sustainable for the reasons that I just named. For example – the high turnover of staff.

Measurement of impact using standard criteria and language between the different providers and stakeholders. We are all working very hard to provide good service. However, we are not always talking the same language. We do not always use the same criteria for measuring the impact of what we are doing. We believe that there should be standards. And that is where new initiatives such as the DeMPA can be very valuable.

Questions for evaluating debt management technical assistance

- Are there gaps between supply and demand for TA?
- Are the beneficiary countries satisfied with the support?
- How to best address any gaps?
- Is there 'duplication'? Is that duplication useful?
- Is there enough information available about what support is available?

- Is the particular TA initiative sustainable?
- Are we maximising opportunities for coordination and cost-effectiveness?

Audio transcript

There should be regular evaluations of debt management TA on a global level. How we evaluate. We see that these are the types of questions that we should all be asking ourselves. Are there gaps between supply and demand? Are the beneficiary countries satisfied with the support? How do we address any gaps between supply and demand or levels of satisfaction. Is there duplication. Is it useful. We should make sure that there is enough information available. We should make sure that it is sustainable. Are we maximizing opportunities for coordination or harmonization as I had mentioned and cost effectiveness. Are our efforts driven by the countries themselves and finally and this is to borrow a phrase from the total? Quality management arena: "are we doing the right thing right"

DeMPA and MTDS: two new tools

Tomas Magnusson

Debt Management Performance Assessment Tool (DeMPA)

Rationale

- Changing context:
  - Debt cancellation under the Multilateral Debt Relief Initiative (MDRI);
  - Newly creditworthy low income countries are now attracting non-concessional creditors and issuing domestic debt.
- In many low income countries, debt management performance is still weak.
- How does one focus policy attention on the issue?
  - Measure debt management performance, using a universally accepted, comprehensive, and standardized metric.

Objectives

- World Bank, in collaboration with partners (including IMF), launched DeMPA to:
- Assess debt management performance and monitor it over time;
- Enable design of reform programs; and
- Enhance donor harmonization based on common understanding of priorities.

Holistic approach

- 35 dimensions covering:
  - Governance and strategy development;
  - Coordination with macroeconomic policies;
  - Borrowing and related financing activities
  - Cash flow forecasting and cash balance management;
  - Operational risk management;
  - Debt records and reporting.
- The DeMPA tool and accompanying Guide can be found on the website: http://go.worldbank.org/W7V1F1A6S0

Medium-Term Debt Management Strategy Toolkit (MTDS)

Joint Bank-Fund Project.

- Joint Bank-Fund work to:
  - Develop a toolkit to support the design of medium-term debt management strategies (MTDS) in low income countries;
  - Strengthen the overall debt management framework;
- Background
  - Both Boards have asked for countries to have a MTDS;
  - Not many LICs have a formal debt management strategy;
  - Following MDRI borrowing space has increased, and many LICs now have access to different financing choices.

Toolkit

- Toolkit consists of:
  - Guidance Note: a step-by-step "how-to" guide on the process of developing a MTDS. Also stresses the importance of addressing constraints arising from governance, coordination with other macroeconomic policies, and domestic debt market development.
  - Scenario Analysis Model (spreadsheet-based analytical tool) to help comparing alternative strategies under different scenarios for future market rates, accompanied by a User's Guide.
- Joint Bank-Fund TA delivery in 6 countries during calendar year 2008.

Inter-agency Task Force on Finance Statistics (TFFS)

Lucie Laliberté
Chair of the TFFS Statistics Department, International Monetary Fund

Mandate and composition of the Inter-agency Task Force on Finance Statistics (TFFS):

- A valuable forum that promotes inter-agency cooperation in the field of debt statistics, both domestic and external.
- Composed of UNCTAD DMFAS Group, Comsec, Paris Club Secretariat, World Bank, Bank of International Settlements, European Central Bank, and International Monetary Fund, *chair*.
- Focus on methodology, quality, availability, and coordination among agencies on financial positions statistics, both domestic and external—notably on debt—and related issues, and is responsive to emerging policy makers' concerns.
- Reports to the UN Statistical Commission

Selected achievements and tasks:

- Creditor/debt data in the Joint External Debt Hub (JEDH);
- Quarterly external debt statistics (QEDS);
- Public sector debt statistics;
- Training on external debt statistics;
- Survey on external sector data collection by agencies
- Update of the external debt guide on issues emerging from the Sixth Edition of the Balance of Payments and International Investment Position Manual (BPM6)
- Public Sector Debt Guide
- External Debt Data Quality Framework (External Debt DQAF)
- International Investment Position (IIP)/External Debt Comparison Work
- World Bank Government Debt Management Performance Measurement Framework

Quarterly External Debt Statistics (QEDS):

- As of March 2007, as many as 60 countries, all mostly SDDs countries.
- extending QEDS to GDDS participants, primarily to LICs
- Consistent with the External Debt Guide and the GDDS framework—public and publicly-guaranteed external debt stock data, broken down by maturity with quarterly periodicity and 3-to-6 months' timeliness.
- August 2007, a relatively small number of GDDS countries were invited to participate. The group includes 27 HIPC post-completion point (including a few other LICs) that are likely to meet minimum requirements of the project—several countries have already expressed their willingness to participate

Public sector debt statistics

- Framework set out as the public sector debt template (PDT)
- Based on recognized methodologies—Government Finance Statistics Manual (GFSM 2001) and the External Debt Guide—
- Promotes public debt statistics through international cooperation in debt reporting, technical assistance, and IMF surveillance work.
- Covers the nonfinancial public sector, comprising the central government, state and local governments, and nonfinancial public corporations, and
- Prescribes data broken down by residency, instrument, currency, maturity, and interest rate.

Update of the *External Debt Guide* on issues emerging from *BPM6*

- Reviewed the two appendices on exceptional financing and debt reorganization.
- Only an update (rather than rewrite) to start in 2011 for the update ready in 2013.
- Advice to countries on the appropriate methodological treatment (particularly relevant to the issue of arrears) would be provided in the meantime.

Other initiatives of interest to the TFFS

- Database on securities initiative:
  - Working Group on securities database reconvened in September 2007.
  - Outcome:
    - Stocktaking of BIS and ECB databases;
    - Handbook on debt securities to be developed, anchored in international statistical standards
  - Follow up:
    - "Challenges to improve global Comparison of Securities Statistics" led by BIS and hosted by IMF in Washington, March 2008
    - Conference by the Deutsche Bundesbank in close cooperation with the Federal Ministry of Finance, Frankfurt
    - Coordinated direct investment survey
    - As of year-end 2009

Sixth Debt Management Conference
Geneva, 19–21 November 2007

List of participants

Algeria

M. Mohand Ouali **Brahiti**
Directeur Général des Changes
Direction Générale des Changes
Banque d'Algérie
Alger, Algeria
🖷 Fax: +213 21 63 57 35
brahiti@bank-of-algeria.dz

M. Rabah **Boualit**
Sous directeur
Ministère des Finances
Alger, Algeria
🖷 Fax: +213 21 59 51 25
rabah.boualit@mf.gov.dz

Mlle Razika **Megateli**
Sous Directrice
Ministère des Finances
Alger, Algeria
🖷 Fax: +213 21 59 53 50
razikamegateli@hotmail.com

Angola

Mrs. Ana Paula **Coelho**
Head of Department
National Bank of Angola
Luanda, Angola
🖷 Fax: +244 222 33 60 69
acoelho@bna.ao

Mrs. Marilia **Pocas**
Head of Department
National Bank of Angola
Luanda, Angola
🖷 Fax: +244 222 33 91 46
mpocas@bna.ao

Mrs. Eunice Maria de **Vasconcelos**
Division Head
External Debt Division
National Bank of Angola
Luanda, Angola
🖷 Fax: +244 222 33 91 46
evasconcelos@ina.bna.ao

Argentina

Sr. Sebastián Javier **Cataldi**
Consultor SIGADE
Secretaria de Finanzas
Ministerio de Economía y Producción
Buenos Aires, Argentina
🖷 Fax: +54 11 43 49 62 39
scatal@mecon.gov.ar

Sr. Pedro Javier **Echaves**
Contador Público
Ministerio de Economía y Producción
Buenos Aires, Argentina
🖷 Fax: +54 11 43 49 68 25
pechav@mecon.gov.ar

Sr. Alejandro Gustavo **Granieri**
Ministerio de Economía y Producción
Buenos Aires, Argentina
🖷 Fax: +54 11 43 49 68 25
agrani@mecon.gov.ar

Sr. Emilio **Nastri**
Consultor SIGADE
Secretaria de Finanzas
Ministerio de Economía y Producción
Buenos Aires, Argentina
🖷 Fax: +54 11 43 49 87 09
enastr@mecon.gov.ar

Sra. Natalia Irene **Crociati**
Directora General de Financiamento
Ministerio de Economía de la Provincia de Río Negro
Viedma, Río Negro, Argentina
🖷 Fax: +54 2920 4250 30
ncrociati@economia.rionegro.gov.ar

Sr. Ricardo Enrique **Gutiérrez**
Secretario de Hacienda de la Provincia de Río Negro
Ministerio de Economía de la Provincia de Río Negro
Viedma, Río Negro, Argentina
🖷 Fax: +54 2920 42 50 30
rgutierrez@economia.rionegro.gov.ar

Austria

Ms. Elisabeth **Gruber**
Advisor
Ministry of Finance
Vienna, Austria
🖷 Fax: +43 1 514 33
elisabeth.gruber@bmf.gv.at

Bangladesh

Mr. Md.Azizul **Islam**
Joint Director
Statistics Department
Bangladesh Bank
Dhaka, Bangladesh
🖷 Fax: +880 2 712 29 67
azizjdbb@yahoo.com

Mr. Md. Abdul **Maleque Mian**
General Manager
Statistics Department
Bangladesh Bank
Dhaka, Bangladesh
🖷 Fax: +880 2 712 29 67
gmstat2@bangla.net

Ms. Mahmuda **Begum**
Deputy Secretary, FABA and National Project Director, CBMFAB Project
Economic Relations Division
Ministry of Finance
Dhaka, Bangladesh
🖷 Fax: +880 2 811 30 88
mahmuda_faba@yahoo.com

Mr. Mohd. Abdus **Sobhan**
Programmer & NPC
Economic Relations Division
Ministry of Finance
Dhaka, Bangladesh
🖷 Fax: +880 2 811 30 88
hirusobhan@yahoo.com

Belarus

Mr. Dmitri **Fomchenko**
Second Secretary
Permanent Mission of Belarus
Geneva, Switzerland
🖷 Fax: +41 22 748 24 51
mission.belarus@ties.itu.int

Benin

Mme Saodatou **De Medeiros-Dine**
Directrice générale adjointe
Caisse Autonome d'Amortissement
Cotonou, Benin
🖷 Fax: +229 21 31 53 56
dsaoda@yahoo.fr

Mme Jocelyne **Padonou-Bassa**
Directrice de la dette publique
Caisse Autonome d'Amortissement
Cotonou, Benin
🖷 Fax: +229 21 31 53 56
lynepadonou@yahoo.fr

M. Naïm **Akibou**
Premier conseiller
Mission permanente de la République du Bénin
Geneva, Switzerland
🖷 Fax: +41 22 906 84 61
info@missionbenin.ch

Bolivia

Sr. Roger Edwin **Rojas Ulo**
Director General de Crédito Público
Ministerio de Hacienda
La Paz, Bolivia
🖷 Fax: +591 2 22 01 12 62
erojas@hacienda.gov.bo

Bosnia and Herzegovina

Mrs. Verica **Božić**
Head of Public Debt Servicing Division
Central Bank of Bosnia and Herzegovina
Sarajevo, Bosnia and Herzegovina
🖷 Fax: +387 33 278 239
vbozic@cbbh.ba

Mrs. Jasenka **Žigić**
Head of Legal Department
Central Bank of Bosnia and Herzegovina
Sarajevo, Bosnia and Herzegovina
🖷 Fax: +387 33 278 239
jzigic@cbbh.ba

Brazil

Mr. Jose Franco **Morais**
Head of External Debt Operations
National Treasury Secretariat
Ministry of Finance
Brasília, Brazil
🖷 Fax: +55 61 3412 1534
josefranco.morais@fazenda.gov.br

Bulgaria

Mr. Vasil **Ivanov**
Head of Division
Ministry of Finance
Sofia, Bulgaria
🖷 Fax: +35 92 981 24 98
v.ivanov@minfin.bg

Mr. Latchezar **Stefanov**
Director
Ministry of Finance
Sofia, Bulgaria
🖷 Fax: +35 92 981 24 98
l.stefanov@minfin.bg

Burkina Faso

M. Gustave **Billa**
Chargé d'études
Direction de la dette publique
Direction Générale du Tresor et de la Comptabilité publique
Ministère des Finances et du Budget
Ouagadougou, Burkina Faso
🖷 Fax: +226 50 30 57 61
gustavebilla@yahoo.fr

M. Lin **Hien**
Chef de la Section de gestion de base de données de la dette
Direction Générale du Tresor et de la Comptabilité publique
Ministère des Finances et du Budget
Ouagadougou, Burkina Faso
🖷 Fax: +226 50 30 57 61
hdiopi_lin@yahoo.fr

Cambodia

Mrs. Khway **In**
Deputy Chief
Debt Management Division
Ministry of Economy and Finance
Phnom Penh, Cambodia
🖷 Fax: +855 23 430 241
kthida_in@yahoo.com

Mr. Thirong **Pen**
First Deputy Director
Department of Investment and Cooperation
Ministry of Economy and Finance
Phnom Penh, Cambodia
🖷 Fax: +855 23 427 798
penthirong@mef-adb.org

Ms. Naly **Sun**
Chief
Debt Management Division
Ministry of Economy and Finance
Phnom Penh, Cambodia
🖷 Fax: +855 23 428 521
naly_sun@yahoo.com

Ms. Sam Ath **Say**
Head of Front office
Exchange Management
National Bank of Cambodia
Phnom Penh, Cambodia
🖷 Fax: +855 23 428 105
say.samath@nbc.org.kh

Mrs. Siyout **Srey**
Director
Exchange Management
National Bank of Cambodia
Phnom Penh, Cambodia
🖷 Fax: +855 23 428 105
s.siyout@nbc.org.kh

Chad

M. Aziz **Mahamat-Saleh**
Directeur
Direction de la dette
Ministère des Finances
Ndjamena, Chad
🖷 Fax: +235 52 29 45
masa.aziz@gmail.com

China (People's Republic of)

Mr. Xuehao **Hu**
Deputy General Director
Ministry of Finance
Beijing, China (People's Republic of)
🖷 Fax: +86 10 6855 1240

Mr. Bin **Han**
Division Director
Ministry of Finance
Beijing, China (People's Republic of)
🖷 Fax: +86 10 6855 1240
hanbin@mof.gov.cn

Ms. Jingli **Wang**
Councellor
Permanent Mission of China
Geneva, Switzerland
🖷 +41 22 909 76 71
wjl302@yahoo.com.cn

Colombia

Mr. Jorge William **Ortiz Linares**
Subdirector Financiamiento interno
Grupo Mercado de Capitales Interno
Dirección General de Crédito Público y del Tesoro Nacional
Ministerio de Hacienda y Crédito Público
Bogotá, Colombia
🖷 Fax: +57 1 381 28 01
wortiz@minhacienda.gov.co

Congo (Republic of)

M. Duc **Elo-Dacy**
Chef de Section
Caisse Congolaise d'Amortissement
Brazzaville, Congo (Republic of)
🖷 Fax: +242 81 52 36
ducelodacy@yahoo.fr

M. Alphonse **Nkounkou**
Chef de Service Négociation
Caisse Congolaise d'Amortissement
Brazzaville, Congo (Republic of)
🖷 Fax: +242 81 52 36
nkounkoualphonse@yahoo.fr

M. André **Ollessongo**
Directeur des Investissements
Caisse Congolaise d'Amortissement
Brazzaville, Congo (Republic of)
🖷 Fax: +242 81 52 36
ollessongoandre@yahoo.fr

Croatia

Mr. Relja **Martić**
Vice Governor
Croatian National Bank
Zagreb, Croatia
🖷 Fax: +385 1 456 46 99
relja.martic@hnb.hr

Cyprus

Mr. Constantinos **Nikiforou**
Public Debt Management Department
Central Bank of Cyprus
Nicosia, Cyprus
🖷 Fax: +357 22 37 80 53
constantinosnikiforou@centralbank.gov.cy

Mr. Stelios **Leonidou**
Investments and Finance Division
Ministry of Finance
Nicosia, Cyprus
🖷 Fax: +357 22 60 27 48
sleonidou@mof.gov.cy

Djibouti

M. Mahdi Darar **Obsieh**
Chef du Service de la dette
Ministère de l'Economie, des Finances et de la Planification
Djibouti, Djibouti
🖷 Fax: +253 35 50 85
mahdi_darar@yahoo.fr

M. Almis Mohamed **Abdillahi**
Directeur du Financement Extérieur
Ministère de l'Economie, des Finances et de la Planification
Djibouti, Djibouti
🖷 Fax: +253 35 50 85
amalmis1@yahoo.fr

Dominican Republic

Sra. Rosanna **De Oleo**
Consultora
Secretaría de Estado de Finanzas
Santo Domingo, Dominican Republic
🖷 Fax: +1 809 688 88 38
rdeoleo@hacienda.gov.do

Sr. Angel **Ventura**
Encargado División Registro de la Deuda
Direccion general de crédito público
Secretaría de Estado de Finanzas
Santo Domingo, Dominican Republic
🖷 Fax: +1 809 688 88 38
aventura@hacienda.gov.do

Sr. Homero **Hernández-Sánchez**
Ambassador
Permanent Mission of the Dominican Republic
Geneva, Switzerland
🖷 Fax: +41 22 741 05 90

Ecuador

Sra. Katiuvshka **Yanez Segouia**
Economista
Banco Central del Ecuador
Quito, Ecuador
🖷 Fax: +593 2 2480 133
kyanez@bce.ec

Sr. Carlos **Pólit Faggioni**
Contralor
Contraloría General del Estado
Quito, Ecuador
🖷 Fax: +593 2 2900 825
coordinacion@contraloria.gov.ec

Egypt

Mr. Mohamed **Tamman**
Assistant Sub Governor
Foreign Relations Department
Central Bank of Egypt
Cairo, Egypt
🖷 Fax: +20 2 597 6065
tammam@cbe.org.eg

Ethiopia

Mr. Assefa **Moges Fanta**
Senior Economist
Credit Administration Department
Ministry of Finance and Economic Development
Addis Ababa, Ethiopia
🖷 Fax: +251 1 56 52 71
assefamoges@yahoo.com

Mr. Teklu **Tefera Negla**
Head / Controlers Team – External Debt
Credit Administration Department
Ministry of Finance and Economic Development
Addis Ababa, Ethiopia
🖷 Fax: +251 1 56 52 71
teklutn@yahoo.com

Ms. Yalemzewd **Tedla Behene**
Head
Credit Administration Department
Ministry of Finance and Economic Development
Addis Ababa, Ethiopia
🖷 Fax: +251 111 56 52 71
yalemzewdtb@yahoo.com

France

M. Michel **Cardona**
Directeur général adjoint
Etudes et des relations internationales
Banque de France
Paris, France
🖷 Fax: +33 1 42 92 44 11
michel.cardona@banque-france.com

M. Thomas **Courbe**
Secrétaire Général du Club de Paris
Direction du Trésor
Ministère de l'Economie, des Finances et de l'Emploi
Paris, France
🖷 Fax: +33 1 53 18 36 04
thomas.courbe@dgtpe.fr

M. Emmanuel **Farcot**
Premier Secrétaire
Mission permanente de la France
Geneva, Switzerland
🖷 Fax: +41 22 758 91 37
emmanuel.farcot@diplomatie.gouv.fr

Gabon

M. Edouard **Messan**
Conseiller
Direction Générale de la Comptabilité publique
Ministère de l'Economie, des Finances, du Budget et de la Privatisation
Libreville, Gabon
🖷 Fax: +241 76 67 90
elmess@rocketmail.com

M. Rufin **Mpouho Ondimba**
Directeur Général de la Comptabilité Publique
Ministère de l'Economie, des Finances, du Budget et de la Privatisation
Libreville, Gabon
🖷 Fax: +241 76 67 90
rufinmpouho@yahoo.fr

Georgia

Mr. George **Berishvili**
Head of External Debt Division
Ministry of Finance
Tbilisi, Georgia
🖷 Fax: +995 32 292 079
g.berishvili@mof.ge

Mr. Ioseb **Skhirtladze**
Head
External Relations Department
Ministry of Finance
Tbilisi, Georgia
🖷 Fax: +995 32 292 079
i.skhirtladze@mof.ge

Ms. Liana **Skhirtladze**
Ministry of Finance
Tbilisi, Georgia
🖷 Fax: +995 32 292 079
l.skhirtladze@mof.ge

Germany

Mr. Ronny **Bechmann**
Advisor
Federal Ministry for Economic Cooperation and Development
Berlin, Germany
🖷 Fax: +49 30 25 03 2632
ronny.bechmann@bmz.bund.de

Mr. Hendrik **Schmitz**
Federal Ministry for Economic Cooperation and Development
Berlin, Germany
🖷 Fax: +49 30 25 03 26 32
hendrik.schmitz@bmz.bund.de

Ms. Mechtild **Wesseler**
Counsellor
Federal Ministry of Finance
Berlin, Germany
🖷 Fax: +49 30 18 682 3092
mechtild.wesseler@bmf.bund.de

Mr. Reinhard **Schweppe**
Ambassador
Permanent Mission of Germany
Geneva, Switzerland
🖷 Fax: +41 22 734 30 43

Mr. Jan **Denter**
Permanent Mission of Germany
Geneva, Switzerland
🖷 Fax: +41 22 734 30 43

Guatemala

Sr. Hector Wilfredo **Martínez Mendez**
Subjefe Seccion de Finanzas Publicas
Finanzas Publicas
Banco de Guatemala
Ciudad de Guatemala, Guatemala
🖷 Fax: +502 22 38 1049
hwmm@banguat.gob.gt

Guinea

M. Ansoumane **Conde**
Directeur National de la Dette et des Investissements publics
Ministère de l'Economie, des Finances et du Plan
Conakry, Guinea
🖷 Fax: +224 30 45 54 22
condeansou@yahoo.fr

Mme Saoudatou **Sow**
Chef de la Division de la dette publique
Ministère de l'Economie, des Finances et du Plan
Conakry, Guinea
🖷 Fax: +224 60 45 54 22
saoudatousow2004@hotmail.com

Haïti

M. Délinois **Ducasse**
Chef du Service de la dette externe
Direction des affaires internationales
Banque de la République d'Haïti
Port-au-Prince, Haïti
🖷 Fax: +509 299 10 72
ducasse@ixp.net

M. Abel **Metellus**
Directeur Général Adjoint
Direction General du Budget
Ministère de l'Economie et des Finances
Port-au-Prince, Haïti
🖷 Fax: +509 299 17 05
ametellus22@yahoo.fr

Mme Guerda Mesilas **Pierre-Toussaint**
Chef de Service
Direction du Trésor
Ministère de l'Economie et des Finances
Port-au-Prince, Haïti
🖷 Fax: +509 299 17 33
guerdamesi@yahoo.fr

Honduras

Sra. Maritza Guadelupe **Molina Andino**
Jefe Sección de Presupuesto y Gestión de Pagos
Departamento Internacional
Banco Central
Tegucigalpa M.D.C., Honduras
🖷 Fax: +504 238 03 77
gmolina@bch.hn

India

Mr. B. K. **Mishra**
General Manager
Department of Government and Bank Accounts
Reserve Bank of India
Mumbai, India
🖷 Fax: +91 22 23 01 60 72
bkmishra@yahoo.com

Indonesia

Mr. Samasta **Pradhana**
Head of Division
Foreign Debt Management & Publication Division
Bank Indonesia
Jakarta, Indonesia
🖷 Fax: +62 21 350 20 02
samasta@bi.go.id

Mr. I Gede Yuddy **Hendranata**
Head of Sub Directorate Portfolio
Directorate of Portfolio and Debt Risk
Ministry of Finance
Jakarta, Indonesia
🖷 Fax: +62 21 38 46 516
yuddy_hendranata@dmo.or.id

Mr. Donny Lumban **Tobing**
Head of Sub Directorate of Monitoring and Evaluation
Directorate of Evaluation, Accounting and Settlement
Ministry of Finance
Jakarta, Indonesia
🖷 Fax: +62 21 38 43 712
donny_tobing@dmo.or.id

Iraq

Mr. Kassim **Abdulrasoul**
Assistant Director General
Central Bank of Iraq
Baghdad, Iraq
🖷 Fax:+ 964 1 816 68 02
hassanalhaidary@yahoo.com

Ms. Hiba G.A. **Al-Bak**
Manager
Debt Management Office
Ministry of Finance
Baghdad, Iraq
🖷 Fax:+ 964 1 416 80 30
mof_debtmanagementoffice@yahoo.com

Ms. Suha T. **Taha**
Chief Programmer
Debt Management Office
Ministry of Finance
Baghdad, Iraq
🖷 Fax:+ 964 1 416 80 30
mof_debtmanagementoffice@yahoo.com

Ireland

Mr. Keith **Gristock**
Senior Development Specialist
Development of Foreign Affairs
Irish AID
Dublin, Ireland
🖷 Fax: +353 1 408 2882
keith.gristock@dfa.ie

Italy

Mr. Giorgio **Novello**
First Counsellor
Ministry of Foreign Affairs
Rome, Italy
🖷 Fax: +39 06 323 58 89
giorgio.novella@esteri.it

Mr. Claudio **Spinedi**
Deputy Director General
Ministry of Foreign Affairs
Rome, Italy
🖷 Fax: +39 063 235 911
claudio.spinedi@esteri.it

Mr. Filippo **Montesi**
Stagiare
10, chemin de l'Imperatrice
Permanent Mission of Italy
Geneva, Italy
🖷 Fax: +41 22 734 67 02

Jordan

Mr. Muhammad **Alaloul**
Senior Financial Analyst
Central Bank of Jordan
Amman, Jordan
🖷 Fax: +962 6 461 62 65
aloulm@cbj.gov.jo

Mr. Mohammad **Alquntar**
Head of Division
Ministry of Finance
Amman, Jordan
🖷 Fax: +962 6 463 63 21
mohammad.q@mof.gov.jo

Mr. Ahmad **Hmaidat**
Head of Debt Restructuring Division
Ministry of Finance
Amman, Jordan
🖷 Fax: +962 6 465 07 24
ahmad.h@mof.gov.jo

Korea (Dem. People's Rep.)

Mr. Chol Man **Kim**
Manager
Foreign Trade Bank of the Democratic People's Republic of Korea
Pyongyang, Korea (Dem. People's Rep.)
ftb@chesin.com

Mr. Kwang Chol **O**
Chairman and President
Foreign Trade Bank of the Democratic People's Republic of Korea
Pyongyang, Korea (Dem. People's Rep.)
🖷 Fax: +850 2 381 4467
ftb@chesin.com

Mr. Song Chol **O**
Deputy Director
Foreign Trade Bank of the Democratic People's Republic of Korea
Pyongyang, Korea (Dem. People's Rep.)

Mr. Ryong Hwan **Han**
Head of Section
Ministry of Finance
Pyongyang, Korea (Dem. People's Rep.)

Latvia

Ms. Zane **Jaunslaviete**
Deputy Director
Financial Risk Management Department
Treasury of the Republic of Latvia
Riga, Latvia
🖷 Fax: +371 670 94 220
zane.jaunslaviete@kase.gov.lv

Lebanon

Mr. Youssef **Issa**
Senior Accountant and Controller
Directorate General of Finance
Ministry of Finance
Beyrouth, Lebanon
🖷 Fax: +961 1 642 769
youssefi@finance.gov.lb

Mrs. Amal Y. **Shebaro**
Head of Public Debt Department
Directorate General of Finance
Ministry of Finance
Beyrouth, Lebanon
🖷 Fax: +961 1 642 769
amals@finance.gov.lb

Madagascar

Mme Haingotiana Liliane **Rajemisa**
Chef de Service de la Gestion de la Dette Publique
Direction Générale du Trésor
Ministère de l'Economie, des Finances et du Budget
Antananarivo, Madagascar
🖷 Fax: +261 20 22 629 44
tresorsgdp@yahoo.fr

M. Jean-Noël **Ranaivoson**
Directeur de la Dette Publique
Direction Générale du Trésor
Ministère de l'Economie, des Finances et du Budget
Antananarivo, Madagascar
🖷 Fax: +261 20 22 629 44
tresorsddp@yahoo.fr

Mali

Mme Anna **Kone**
Chef Centre Informatique
Direction Générale de la Dette Publique
Ministère des Finances
Bamako, Mali
🖷 Fax: +223 222 07 93
akone velasova@yahoo.fr

Mauritius

M. Umesh Kumar **Sookmanee**
Deuxième secrétaire
Mission permanente de la République de Maurice
Geneva, Switzerland
🖷 Fax: +41 22 734 86 30

Mexico

Sr. Arturo **González de Aragón O.**
Auditor Superior de la Federación
Auditoría Superior de la Federación
México, D.F. Mexico
🖷 Fax: +52 55 55 34 18 91
agonzaleza@asf.gob.mx

Sr. Benjamin **Fuentes Castro**
Coordinador de Relaciones
Auditoría Superior de la Federación
México, D.F., Mexico
🖷 Fax: +52 55 55 34 47 99
bfuentes@asf.gob.mx

Ms. Graciela **Ramirez Cuevas**
Permanent Mission of Mexico
Geneva, Switzerland
🖷 Fax: +41 22 748 07 08
gramirez@delegamexoi.ch

Mr. José Luis **López**
Permanent Mission of Mexico
Geneva, Switzerland
🖷 Fax: +41 22 748 07 08
jlopez@wto-mex.com

Moldova

Mrs. Natalia **Agapii**
Deputy Head of Division
Ministry of Finance
Chisinau, Moldova
🖷 Fax: +373 22 21 20 77
nagapii@minfin.moldova.md

Mr. Oscar **Olortegui**
Advisor, Debt Management
Ministry of Finance
Chisinau, Moldova
🖷 Fax: +373 22 22 50 92
armolor@yahoo.com

Mrs. Oxana **Pui**
Economist
Ministry of Finance
Chisinau, Moldova
🖷 Fax: +373 22 22 50 92
oxana_pui@yahoo.com

Ms. Lilia **Razlog**
Director
Debt Department
Ministry of Finance
Chisinau, Moldova
🖷 Fax: +373 22 21 20 77
lili_razlog@yahoo.com

Morocco

M. Anis **El Youssoufi**
Responsable du Departement des Relations Internationales
Bank Al Maghrib
Rabat, Morocco
🖷 Fax: +212 37 20 67 68
a.elyoussoufi@bkam.ma

M. Ahmed **Zoubaine**
Chef de la Division de la gestion de la dette extérieure
Direction du Trésor et des Finances extérieures
Ministère des Finances et de la Privatisation
Rabat, Morocco
🖷 Fax: +212 37 67 74 09
a.zoubaine@dtfe.finances.gov.ma

Mozambique

Mrs. Piedade **Macamo Matavela**
Deputy National Director of Treasury
Ministry of Finance
Maputo, Mozambique
🖷 Fax: +258 21 310 493
piedade@tvcabo.co.mz

Ms. Anabela **Chambuca Pinho**
Head of Department
Public Debt Unit
National Directorate of Treasury
Ministry of Finance
Maputo, Mozambique
🖷 Fax: +258 21 310 493
achambuca@dntdivida.gov.mz

Netherlands

Mr. Herwin **Loman**
Policy Advisor
Ministry of Foreign Affairs
The Hague, Netherlands
herwin.loman@minbuza.nl

Norway

Mr. Henrik **Harboe**
Deputy Director General
Royal Ministry of Foreign Affairs
Oslo, Norway

Mr. Per Kristian **Roer**
Advisor
Royal Ministry of Foreign Affairs
Oslo, Norway
Fax: +47 22 24 37 90
pkr@mfa.no

Ms. Anja **Thomsen**
Advisor
Multilateral Bank and Finance Section
Royal Ministry of Foreign Affairs
Oslo, Norway
🖷 Fax: +47 22 24 37 90
anth@mfa.no

Oman

Mr. Rashid **Al-Maktoumi**
Director of Loans Department
Ministry of Finance
Muscat, Oman
🖷 Fax: +968 24 736 460
almaktoumi@hotmail.com

Pakistan

Mr. Malik Muhammad **Afaq**
Manager Computer Centre
Ministry of Economic Affairs and Statistics
Government of Pakistan
Islamabad, Pakistan
🖷 Fax: +92 51 92 05 975
malikafaq@ead.gov.pk

Mr. Muhammad Ali **Malik**
Director
Domestic Markets and Monetary Management
State Bank of Pakistan
Karachi, Pakistan
🖷 Fax: +92 21 92 12 416
muhammad.alimalik@sbp.org.pk

Panama

Sra. Enelda Clemencia **Medrano de González**
Viceministra de Economía
Ministerio de Economía y Finanzas
Panamá, Panamá
🖷 Fax: +507 507 70 53
egonzalez@mef.gob.pa

Licda. Aracelly **Mendez**
Directora de Crédito Público
Ministerio de Economía y Finanzas
Panamá, Panamá
🖷 Fax: +507 507 72 00
amendez@mef.gob.pa

Papua New Guinea

Mr. Aloysius **Hamou**
First Assistant Secretary
Department of Treasury
Ministry of Finance
Waigani, Papua New Guinea
🖷 Fax: +675 312 8808
aloysius_hamou@treasury.gov.pg

Paraguay

Sr. Modesto **Farina**
Jefe Departamento de la Deuda Pública
Ministerio de Hacienda
Asunción, Paraguay
🖷 Fax: +595 21 493 641
modesto_farina@hacienda.gov.py

Sr. Oscar Antonio **Martínez Bustamente**
Contador Público
Ministerio de Hacienda
Asunción, Paraguay
🖷 Fax: +595 21 493 641
oscar_martinez@hacienda.gov.py

Sra. Carmen Natividad **Martínez Wenninger**
Analista de Sistemas
Ministerio de Hacienda
Asunción, Paraguay
🖷 Fax: +595 21 492 599
carmen_martinez@hacienda.gov.py

Philippines

Ms. Patria B. **Angeles**
Deputy Director
International Department
Bangko Sentral ng Pilipinas
Manila, Philippines
🖷 Fax: +63 2 536 60 72
pangeles@bsp.gov.ph

Ms. Cynthia Rita **Cabbab**
Deputy Director
International Department
Bangko Sentral ng Pilipinas
Manila, Philippines
🖷 Fax: +63 2 536 60 72
ccabbab@bsp.gov.ph

Mr. Filemon **Condino**
Division Chief, Fiscal Planning
Bureau of the Treasury
Manila, Philippines
🖷 Fax: +63 2 527 31 14
fdcondino@treasury.gov.ph

Mr. Roberto **Tan**
Undersecretary and Acting Treasurer of the Philippines
Department of Finance
Manila, Philippines
🖷 Fax: +63 2 523 92 16
rbtan@dof.gov.ph

Qatar

Mr. Adel **Al Baker**
Assistant Director
Qatar Central Bank
Doha, Qatar
🖷 Fax: +974 443 0215
albakera@qcb.gov.qa

Mr. Adel **Al Ishaq**
Qatar Central Bank
Doha, Qatar
🖷 Fax: +974 443 0215
ishaqa@qcb.gov.qa

Romania

Mrs. Ecaterina **Anastase**
Counsellor
Ministry of Economy and Finance
Bucharest, Romania
🖷 Fax: +402 131 998 18
ecaterina.anastase@mfinante.ro

Ms. Mihaela Gabi **Ene**
Head of Division
General Directorate for External Finances
Ministry of Economy and Finance
Bucharest, Romania
🖷 Fax: +402 1 312 67 92
mihaela.ene@mfinante.ro

Mrs. Doina Liliana **Badea**
Economist
Statistics Department
National Bank of Romania
Bucharest, Romania
🖷 Fax: +402 131 271 93
doina.badea@bnro.ro

Mrs. Silvia Gabriela **Raileanu**
Expert
Statistics Department
National Bank of Romania
Chisinau, Romania
🖷 Fax: +402 131 271 93
silvia.raileanu@bnro.ro

Russian Federation

Mr. Sergey **Filippov**
Senior dealer
Bank of Russia
Moscow, Russian Federation
🖷 Fax: +7 495 771 43 98
Filipp84@mail.ru

Mr. Alexandre **Kovalenko**
First Deputy Chairman
State Debt Committee of the City of Moscow
Government of Moscow
Moscow, Russian Federation
🖷 Fax: +7 495 797 56 40
AKovalenko@moscowdebt.ru

Mr. Evgeny **Babenko**
Deputy Director General
Mosfinagency
Government of Moscow
Moscow, Russian Federation
🖷 Fax: +7 495 797 56 40
evb@moscowdebt.ru

Mr. Valery **Klykov**
Deputy Director General
Mosfinagency
Government of Moscow
Moscow, Russian Federation
🖷 Fax: +7 495 797 56 40
kvv@moscowdebt.ru

Mr. Dmitry **Godunov**
First Secretary
Permanent Mission of the Russian Federation in Geneva
Geneva, Russian Federation
🖷 Fax: +41 22 740 32 71
ruswto@bluewin.ch

Saudi Arabia

Mr. Abdulaziz **Alrashid**
Senior Specialist
Treasury Department
Saudi Fund for Development
Riyadh, Saudi Arabia
🖷 Fax: +966 1 464 74 50
rasho@sfd.gov.sa

Mr. Hamud Saad **Altowireb**
Senior Accounts Analyst
Treasury Department
Saudi Fund for Development
Riyadh, Saudi Arabia
🖷 Fax: +966 1 465 76 31
hamoudtowireb@hotmail.com

Serbia

Mrs. Ana **Gligorijevic**
Vice Governor
National Bank of Serbia
Belgrade, Serbia
🖷 Fax:+ 381 11 3291 172
ana.gligorijevic@nbs.yu

Spain

Sr. Jose Aitor **Erce Dominguez**
Economista
Banco de Espana
Madrid, Spain
🖷 Fax:+ 34 913 386 212
aerce@bde.es

Sr. D. Pere **Marzabal**
Counsellor
Permanent Mission of Spain
Geneva, Switzerland
🖷 Fax: +41 22 738 64 76
pmarzabal@mcx.es

Sudan

Dr. Sabir Mohammed **Hassan**
Governor
Central Bank of Sudan
Khartoum, Sudan
🖷 Fax: +249 183 780 273

Mr. Hazim **Ahmed**
Executive Director
Central Bank of Sudan
Khartoum, Sudan
🖷 Fax: +249 183 780 273

Mr. Ahmed Eltayeb **Hassan**
Senior Economist
Central Bank of Sudan
Khartoum, Sudan
🖷 Fax: +249 183 773 096
ahmedeltayeb2001@yahoo.com

Mr. Abdelhadi **Suliman**
Assistant Director
External Debt Unit
Central Bank of Sudan
Khartoum, Sudan
🖷 Fax: +249 183 773 096
hadsulim@hotmail.com

Dr. Nagmeldin Hassan **Yagoub**
Senior Economist
External Debt Unit
Central Bank of Sudan
Khartoum, Sudan
🖷 Fax: +249 183 773 096
nagmeldin@yahoo.com

Mr. Almansour Ibrahim **Bolad**
Minister plenipotentiary
Permanent Mission of Sudan
Geneva, Switzerland
🖷 Fax: +41 22 716 19 70
aebolad@yahoo.com

Sweden

Mrs. Hallgerd **Dyrssen**
Deputy Head of Division
Democratic Governance - Department for Democracy and Social Development
Swedish International Development Cooperation Agency (SIDA)
Stockholm, Sweden
🖷 Fax: +46 8 698 56 47
hallgerd.dyrssen@sida.se

Switzerland

Mr. Jerome **Duperrut**
Economist
Federal Finance Administration
Federal Department of Finance
Bern, Switzerland
🖷 Fax: +41 31 232 0833
jerome.duperrut@efv.admin.ch

Mr. Jean-Luc **Bernasconi**
Head of Division
Macroeconomic Assistance
State Secretariat for Economic Affairs
Bern, Switzerland
🖷 Fax: +41 31 324 09 62
jean-luc.bernasconi@seco.admin.ch

Mr. Lukas **Schneller**
Economist
State Secretariat for Economic Affairs
Bern, Switzerland
Lukas.schneller@seco.admin.ch

Syria

Mrs. Mahasen **Al Omary**
Foreign Loans Department
Central Bank of Syria
Damascus, Syria
🖷 Fax: +963 224 72 74
mahasenomari2@yahoo.com

Ms. Iman **Al Rabat**
Foreign Loans Department
Central Bank of Syria
Damascus, Syria
🖷 Fax: +963 224 72 74

Thailand

Mr. Paroche **Hutachareon**
Pulbic Debt Management Office
Ministry of Finance
Bangkok, Thailand
paroche@pdmo.mof.go.th

Tunisia

M. Mohamed Salah **Souilem**
Directeur du Financement extérieur et Opérations des marchés
Banque Centrale de Tunisie
Tunis, Tunisia
🖷 Fax: +216 71 340 615
mohamed.souilem@bct.gov.tn

Turkey

Mrs. Eylem **Vayvada Derya**
Division Chief
Undersecretariat of Turkish Treasury
Ankara, Turkey
🖷 Fax: +312 212 8786
eylem.vayvada@hazine.gov.tr

Uganda

Mr. Wasswa **Kajubi**
Director
Trade and External Debt Department
Bank of Uganda
Kampala, Uganda
🖷 Fax: +256 414 259 336
wkajubi@bou.or.ug

Mr. Stephen **Ndhaye**
Senior Principal Banking Officer
Bank of Uganda
Kampala, Uganda
🖷 Fax: +256 414 259 336
sndhaye@bou.or.ug

Mr. Fredrick **Matyama**
Priniciipal Economist
Ministry of Finance, Planning and Economic Development
Kampala, Uganda
🖷 Fax: +256 414 230 163
fredrick.matyama@finance.go.ug

Mr. Justin **Eriongu Ariku**
Senior Accountant
Ministry of Finance, Planning and Economic Development
Kampala, Uganda
🖷 Fax: +256 414 233 524
justin.eriongu@finance.go.ug

Mr. Joshua **Karamagi**
Assistant-Comissioner
Ministry of Finance, Planning and Economic Development
Kampala, Uganda
🖷 Fax: +256 0414 233 524
joshua.karamagi@finance.gov.ug

United States of America

Mr. Andrew B. **Haviland**
Deputy Director
Bureau of Economic and Business Affairs
U.S. Department of State
Washington, USA
havilandab@state.gov

Ms. Marlene **Sakaue**
Director, Office of Monetary Affairs
Bureau of Economic and Business Affairs
U.S. Department of State
Washington, USA
sakauemj@state.gov

Ms. Ann **Low**
First Secretary
Permanent Mission of the United States of America
Geneva, Switzerland
🖷 Fax: +41 22 749 48 80
lowam@state.gov

Ms. Dalynna **Moser**
Economics intern
Permanent Mission of the United States of America
Geneva, Switzerland
🖷 Fax: +41 22 749 48 80
moserdj@state.gov

Uzbekistan

M. Alisher **Mursaliyev**
Representative to the WTO
Permanent Mission of Uzbekistan
Geneva, Switzerland
🖷 Fax: +41 22 799 43 02

Viet Nam

Mr. Huy **Dang Quang**
Deputy Chief of General Affairs Division
External Finance Department
Ministry of Finance
Hanoi, Viet Nam
🖷 Fax: +84 4 220 80 20
DangQuangHuy@mof.gov.vn

Mrs. Mai Tuyet **Do**
Ministry of Finance
Hanoi, Viet Nam
🖷 Fax: +84 4 933 12 94
maidt@kbnn.vn

Mr. Duy Hien **Nguyen**
Ministry of Finance
Hanoi, Viet Nam
🖷 Fax: +84 4 220 80 53
ngduyhien@mof.gov.vn

Mrs. Thi Thu Huong **Tran**
External Finance Department
Ministry of Finance
Hanoi, Viet Nam
🖷 Fax: +84 4 220 80 20
tranthuhuong@mof.gov.vn

Zambia

Mr. Emmanuel Mulenga **Pamu**
Acting Assistant Director - BoP & Debt Economics Department
Bank of Zambia
Lusaka, Zambia
🖷 Fax: +260 1 221 722
epamu@boz.zm

Mr. Michael **Mwaanga**
Chief Economist
Ministry of Finance and National Planning
Lusaka, Zambia
🖷 Fax: +260 1 257 661
michael.mwaanga@mofnp.gov.zm

Mr. Joseph **Nkhoma**
Database Administrator
Ministry of Finance and National Planning
Lusaka, Zambia
🖷 Fax: +260 1 250 115
nkhoma_joe@yahoo.co.uk

Mr. Siforiano **Banda**
Head - Domestic Debt Unit
Investment and Debt Management Department
Ministry of Finance and National Planning
Lusaka, Zambia
🖷 Fax: +260 1 253 494
siforiano.banda@mofnp.gov.zm

Zimbabwe

Mr. Chenjerai **Chamunorwa**
Economist
Reserve Bank of Zimbabwe
Harare, Zimbabwe
🖷 Fax: +263 4 70 58 79
cchenjerai@rbz.co.zw

Mr. Ernest **Matiza**
Chief - Currency Exchange, Domestic Debt and ELCC
Reserve Bank of Zimbabwe
Harare, Zimbabwe
🖷 Fax: +263 4 703 128
ematiza@rbz.co.zw

M. Chameso **Mucheka**
Counsellor
Permanent Mission of Zimbabwe
Geneva, Switzerland
🖷 Fax: +41 22 758 30 44
cmucheka@yahoo.com

ORGANISATIONS

African Development Bank

Mr. Stefan **Nalletamby**
Advisor Vice President Finance
Tunis Belvedere, Tunisia
🖷 Fax: +216 7133 0598
s.nalletamby@afdb.org

Arab Bank for Economic Development in Africa (BADEA)

Mr. Zineddine **Belmahdi**
Chief
Loans and Disbursement Unit
Khartoum, Sudan
🖷 Fax: +249 11 770 600
touzalt@hotmail.com

Asian Development Bank (AsDB)

Ms. Amuerfina **Santos**
Strategy and Planning Officer
Manila, Philippines
🖷 Fax: +63 636 21 82
amsantos@adb.org

Mr. Kenji **Takamiya**
Economist
Manila, Philippines
🖷 Fax: +63 2 636 23 31
ktakamiya@adb.org

Mr. Wiliam **Willms**
Director
Manila, Philippines
🖷 Fax: +63 2 636 2347
wwillms@adb.org

Mr. Joseph **Zveglich**
Principal Strategy Policy Economist
Manila, Philippines
🖷 Fax: +63 636 2182
jezveglich@adb.org

Central American Bank for Economic Integration (CABEI)

Sr. Hernán **Alvarado**
Gerente Financiero
Tegucigalpa, Honduras
🖷 Fax: +504 240 21 44
halvarad@bcie.org

Commonwealth Secretariat

Mr. Matthew **Odedokun**
Deputy Director
Economic Affairs Division
London, United Kingdom
🖷 Fax: +44 20 7747 62 35
m.odedokun@commonwealth.int

Economic and Social Commission for Western Asia (ESCWA)

Ms. Souraya **Zein**
Research Assistant
Globalization and Regional Integration Division
Beyrouth, Lebanon
🖷 Fax: +961 1 981 510
zein@un.org

European Commission

Mr. Luis **Fau Sebastian**
Economist
Directorate General for Economic and Financial Affairs
Brussels, Belgium
🖷 Fax: +32 2 295 7699
luis.fau@ec.europa.eu

International Monetary Fund

Ms. Lucie **Laliberté**
Deputy Director
Statistics Department
Washington DC, USA
llaliberte@imf.org

Mr. Udaibir S. **Das**
Division Chief
Monetary and Capital Markets Department
Washington DC, USA
udas@imf.org

Islamic Development Bank (IsDB)

Mr. Emdadul **Bhuiya**
Finance Officer
Finance Department
Jeddah, Saudi Arabia
🖷 Fax: +966 2 636 4361
ebhuiya@isdb.org

Macroeconomic & Financial Management Institute of Eastern and Southern Africa (MEFMI)

Dr. Ellias E. **Ngalande**
Executive Director
Harare, Zimbabwe
🖷 Fax: +263 4 25 21 65
ellias.ngalande@mefmi.org

UNCTAD

Mr. Fred **Ruhakana**
Chief Technical Advisor
Dhaka, Bangladesh
🖷 +880 2 913 07 22
fruhakana@unctad.org

United Nations Institute for Training and Research (UNITAR)

Mr. Babar **Kamal**
Senior Programme Coordinator
Geneva, Switzerland
🖷 Fax: +41 22 917 80 47
babar.kamal@unitar.org

M. Andreas **Schmalz**
Associate Programme Officer
Geneva, Switzerland
🖷 Fax: +41 22 917 80 47
andreas.schmalz@unitar.org

West African Institute for Financial and Economic Management (WAIFEM)

Dr. Chris **Itsede**
Director General
Lagos, Nigeria
🖷 Fax: +234 1 589 05 42
citsede@waifem.org

World Bank

Mr. Tadashi **Endo**
Senior Financial Sector Specialist
Corporate Governance and Capital Markets Department
Washington DC, USA
🖷 Fax: +1 202 522 7105
tendo@worldbank.org

Mr. Tomas **Magnuson**
Lead Financial Officer
Washington DC, USA
🖷 Fax: +1 202 522 2102
tmagnuson@worldbank.org

Mr. Mark Roland **Thomas**
Lead Economist
Economic Policy and Debt Department
Washington DC, USA
🖷 Fax: +1 202 522 3740
mthomas1@worldbank.org

OTHER

Mlle. Karen **Bihr**
Epinal, France
renkabi@yahoo.fr

Sr. José **Flores**
Consultant
Tegucigalpa M.D.C., Honduras
🖷 Fax: +504 221 01 69
joseflores@hotmail.com

M. Christian **Schoenagel**
Consultant
Strasbourg, France
crisschoen@aol.com

M. Alessandro **Scipioni**
Consultant
Geneva, Switzerland
alessandroscipioni@yahoo.com

Mr. Vito **Tanzi**
Economist
Bethesda, USA
🖷 Fax: +1 301 229 4106
vitotanzi@msn.com

Mr. Mike **Williams**
Consultant on Government Debt and Cash Management
London, United Kingdom
🖷 Fax: +44 20 7771 07 82
mike.williams@mj-w.net

AFRODAD

Mr. Charles **Mutasa**
Executive Director
Harare, Zimbabwe
🖷 Fax: +263 4 74 78 78
charles@afrodad.co.zw

Aktion Finanzplatz Schweiz

Mr. Andre **Rothenbuehler**
Basel, Switzerland
🖷 Fax: +41 61 683 98 96
afp@aktionfinanzplatz.ch

Centre Europe-Tiers Monde (CETIM)

Mr. Melik **Őzden**
Responsable Programme DH
Geneva, Switzerland
🖷 Fax: +41 22 731 31 52
cetim@bluewin.ch

Cleary, Gottlieb, Steen & Hamilton

Mr. Lee C. **Buchheit**
Partner
New York, USA
🖶 Fax: +1 212 225 39 99

Crown Agents

Ms. Samantha **Attridge**
Deputy Director - Debt Management Services
Public Finance Management
Sutton, Surrey, United Kingdom
🖶 Fax: +44 20 8770 0194
samantha.attridge@crownagents.co.uk

Mr. Mac **Banda**
Systems Development Officer
Special Advisory Services
Sutton, Surrey, United Kingdom
🖶 Fax: +44 20 8648 8232
m.banda@crownagents.co.uk

Debt Advisory International, LLC

Mr. Daniel **Zavala**
Senior Vice President
Washington DC, USA
🖶 Fax: +1 202 463 72 85
dzavala@debtadvisory.com

Ecole Economie de Paris

M. Francois **Bourguigon**
Directeur
Paris, France
francois.bourguignon@parisschoolofeconomics.eu

Ecole Normale Supérieure

M. Daniel **Cohen**
Professor of Economic Science
Paris, France
daniel-cohen@ens.fr

EURODAD

Ms. Gail **Hurley**
Policy Officer
Brussels, Belgium
ghurley@eurodad.org

European Investment Bank (EIB/BEI)

M. Bernard **Ziller**
Senior Economic Advisor
Kirchberg, Luxemburg
🖶 Fax: +352 4379 7799
b.ziller@eib.org

Gesellschaft für Technische Zusammenarbeit t (GTZ)

Mr. Stefan **Jansen**
Project Manager
Eschborn, Germany
🖶 Fax: +49 6196 79 1115
stephan.jansen@gtz.de

Humboldt - University of Berlin

Mr. Christoph **Paulus**
Professor of Law
Berlin, Germany
🖶 Fax: +49 30 2093 3432
chrpaulus@t-online.de

Institute of Economic Research UNAM

Sr. Oscar **Ugarteche**
Investigador titular
Universidad Nacional Autónoma de México
México, D.F. Mexico
🖶 Fax: +52 55 56 23 00 92
ugarteche@iiec.unam.mx

INTOSAI Development Initiative

Mrs. Else Karin **Kristensen**
Deputy Director General
Oslo, Norway
🖶 Fax: +47 21 54 08 10
else-karin.kristensen@idi.no

Ms. Archana **Shirsat**
Programme and E-Learning Manager
Oslo, Norway
🖶 Fax: +47 21 54 08 50
archana.shirsat@idi.no

Jubilee USA

Mr. Neil **Watkins**
National Coordinator
Washington DC, USA
🖶 Fax: +1 202 546 4468
neil@jubileeusa.org

KFW Development Bank

Dr. Anne Juliane **Hünnemeyer**
Economist
Palmengartenstr. 5-9
Frankfurt, Germany
🖶 Fax: +49 69 7431 3363
anne.huennemeyer@kfw.de

Lazard Frères

M. Dominique **De Guerre**
Gérant
Paris, France
🖶 Fax: +33 1 44 13 08 18
dominique.de.guerre@lazard.fr

LogicaCMG

Mr. Lucien **Etzlinger**
Business Area Manager
Geneva, Switzerland
🖶 Fax: +41 79 460 03 50
lucien.etzlinger@logicacmg.com

Ms. Isabella **Ricaboni**
Consultant
Geneva, Switzerland
🖶 Fax: +41 79 328 41 83
isabella.ricaboni@logicacmg.com

Norwegian Church Aid

Mr. Josten Hole **Kobbeltvedt**
Advisor, Global Economy
Department for Development Policy
Oslo, Norway
🖶 Fax: +47 22 09 27 20
jhk@nca.no

Open University

Mr. Jospeh **Hanlon**
Senior Lecturer in Development Policy and Practise
London, United Kingdom
j.hanlon@open.ac.uk

Standard & Poors

Mr. David T. **Beers**
Managing Director
Sovereign & International Public Finance Ratings
London, United Kingdom
🖶 Fax: +44 20 7176 7101
david_beers@standardandpoors.com

University of Michigan Law School

Mr. Robert **Howse**
Professor of Law
USA

University of Salento

Ms. Maria Chiara **Malaguti**
Professor of international economic law
Salento, Italy
🖶 Fax: +39 06 679 00 05
malaguti@mazzonieassociati.it

University of Vienna

Mr. Kunibert **Raffer**
Associate Professor
Department of Economics
Vienna, Austria
🖶 Fax: +43 1 42 77 93 74
kunibert.raffer@univie.ac.at