SM/83/46
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

April 15, 1983

To: Members of the Executive Board

From: The Secretary

Subject: External Debt Servicing Problems - Background Information

The following corrections have been made in SM/83/46 (3/9/83):

Page 59, footnote 1, lines 1 and 2: for "Argentina, Brazil, and the Philippines submitted...all employed" read "Argentina and Brazil submitted... both employed"

Page 60, second full para., line 3: for "21 programs" read "22 programs"

line 7: for "20 programs" read "22 programs"

footnote 2, lines 1 and 2: for "Argentina, Brazil, and the Philippines already referred" read "Argentina and Brazil already referred"

Page 64, Table 4, column 2, penultimate line: for "3" read "4"

column 5: for "21" read "22"

last column: for "7" read "8"

Page 77, under Stand-By Arrangement, column 4, line 10: for "all maturities" read "1-10"

columns 1-5, last line:

for "			1 year	Quarterly"
read "Yugoslavia	Public	Debt outstanding	Over 1 year	Quarterly"

Page 86: Last four lines and footnote 1 added.

Corrected pages are attached.

Att: (5)

Other Distribution:
Department Heads

Special Characteristics of Certain External Borrowing Operations

In most cases, external borrowing operations have broadly similar features that allow their identification and classification for the purpose of formulating and monitoring performance criteria. However, past experience shows that there are certain kinds of external borrowing operations which can complicate the task of analyzing the debt position and designing borrowing ceilings. The purpose of this Annex is to review the following issues of this type: (i) loans with unconventional terms of borrowing; (ii) leasing operations; (iii) the treatment of debt in nonconvertible currencies; and (iv) loans involving set-aside arrangements.

1. Unconventional terms of borrowing

a. Unconventional interest rates or other costs

The present guideline relies on the maturity of loans as the principal means of classifying borrowing operations. In most cases, other characteristics of a loan will follow a typical pattern, depending mainly on the source of the loan (e.g., official, commercial, etc.). There are cases, however, where these other characteristics, such as interest rates, front-end fees, and servicing charges, which could have significant debt service implications, may differ widely between loans of similar maturities.

Attempts at incorporating the effect of these other characteristics by devising alternative forms of debt limitations have concluded that, while this is in principle possible, in most cases these alternative forms would pose operationally difficult problems. 1/ However, while limitations based on maturity do not deal with unconventional terms of borrowing, it should be noted that, since debt limitations do not necessarily imply absolute prohibitions, if thought appropriate, the size of the ceiling can always be adjusted in order to accommodate particular loans of this type.

b. Unconventional grace periods or repayment schedules

Limitations based on broad maturities are generally sufficient to achieve the external debt objectives of an adjustment program when they are applied to loans with conventional repayment terms, that is, loans with equal periodic repayment installments following the grace period (if any). However, problems may arise in the case of loans which are not characterized by equal repayment installments; such loans are principally of the following types:

1/ See "Alternative Forms of External Debt Limitation" (SM/75/167, 6/27/75) for three possible alternative approaches: limitations on annual debt service, on "discounted" debt service, and in respect of new borrowing according to "adjusted maturities."

Quantitative Limitations on External Debt in Upper Credit Tranche Conditionality Programs, 1979-1982 (concluded)

Country	Sector 1/	Form of Limitation	Maturity Limits (years)	Period Covered
1982				
Stand-by arrangements				
Hungary (a)	Public	Contracting/guaranteeing	1-12	Annual
(b)	Specified financial institutions	Debt outstanding	All maturities	Quarterly
Kenya	Public	Contracting/guaranteeing	1-12	Annual
Liberia	Public	Contracting/guaranteeing	1-12	Annual
Madagascar	Public	Contracting/guaranteeing	1-10/1-5	Annual
Malawi	Public	Contracting/guaranteeing	1-12/1-5	Annual
Mali	Public	Contracting/guaranteeing	1-12	Annual
Mauritius (a)	Public	Contracting/guaranteeing	1-10/1-5	Semiannual
(b)	Public	Gross disbursement	1-10	Semiannual
Morocco	Public	Contracting/guaranteeing	1-10/1-5	Annual
Panama	Public	Net borrowing	All maturities	Annual
Romania	Public	Debt outstanding	Under 1 year	Annual
Senegal	Public	Contracting/guaranteeing	1-12/1-5	Semiannual
Somalia	Public	Contracting/guaranteeing	1-12	Annual
Sudan	Public	Contracting/guaranteeing	1-10/1-5	Annual
Thailand	Public	Contracting/guaranteeing	1-12/1-5	Annual
Turkey	Public	Contracting/guaranteeing	0-10	Annual
Uganda	Public	Contracting/guaranteeing	1-12/1-5	Semiannual
Yugoslavia	Public	Debt outstanding	Over 1 year	Quarterly
Extended arrangements				
Dominican Republic 2/	Public	Net borrowing	0-1/0-3/0-10	Annual
Gabon	Public	Contracting/guaranteeing	1-10	Annual
India	Public	Contracting/guaranteeing	1-12/1-5	Annual
Ivory Coast	Public	Contracting/guaranteeing	1-12/1-5	Annual
Jamaica	Public	Net borrowing	1-12/1-5	Annual
Mexico	Public	Net borrowing	All maturities	Quarterly
Peru	Public	Contracting/guaranteeing	1-10/1-5	Quarterly

1/ In some instances, the wording of the ceiling was in terms of borrowing or guaranteeing by the government only. However, in practice, this wording generally implied coverage of the entire public sector, since borrowing by the latter normally requires government guarantees.
2/ Approved in January 1983.

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Corrected: 4/14/83

Table 4. Maturities Covered by Foreign Debt Limitations in Upper Credit Tranche Conditionality Programs, 1979-82

(Number of programs)

	1979	1980	1981	1982	1979-82 Total	1979-82 SBAs	1979-82 EFs
Total number of programs containing debt limitations as performance criteria	21	26	32	31	110	78	32
Number of programs with a single debt ceiling	7	13	12	15	47	37	10
Maturity:							
1-12 years	4	6	4	4	18	17	1
1-10 years	1	4	2	4	11	7	4
0-10 years	1	--	2	2	5	2	3
Under 1 year	--	--	1	1	2	2	--
Over 1 year	--	1	1	1	3	3	--
All maturities	1	2	2	3	8	6	2
Number of programs containing more than one debt ceiling	14	13	20	16	63	41	22
Maturities:							
1-15/1-5 years	6	--	1	--	7	6	1
1-12/1-5 years	2	8	14	8	32	18	14
1-10/1-5 years	2	4	5	6	17	12	5
Other	4	1	--	2	7	5	2
Memorandum item:							
Number of programs containing limit on debt of under one year maturity (either separately or within an overall maturity ceiling)	5	4	5	8	22	14	8
Of which:							
Program with separate ceiling on under one year maturity	(--)	(1)	(1)	(2)	(4)	(3)	(1)

Source: Staff papers dealing with requests by members for upper credit tranche stand-by arrangements and extended arrangements.

Table 3. Categories of Loans Excluded from Foreign Debt Limitations in Upper Credit Tranche Conditionality Programs, 1979-82 1/ (concluded)

Program Year		Excluded Loans
1982	Stand-by arrangements	
	Senegal	Loans to Air Afrique, ASECNA.
	Turkey	Loans to the Central Bank; loans under the OECD assistance program.
1982	Stand-by arrangements	
	Chile	Loans to the Central Bank, the Banco del Estado, SINA; private foreign debt guaranteed by CORFU.
	Costa Rica	Loans under the Mexican/Venezuelan oil facility.
	Haiti	Short-term suppliers' credits for strictly seasonal needs.
	Honduras	Use of the Mexican/Venezuelan oil facility; trade credits.
	Extended arrangements	
	Ivory Coast	Loans to Air Afrique, CIMAO, SM Bitumes, and the Conseil de l'Entente.
	Jamaica	Loans from foreign governments, their agencies, and multilateral lending institutions.
	Mexico	Borrowing by the Bank of Mexico.

Source: Staff papers relating to requests by members for stand-by or extended arrangements.

1/ Other than: concessional loans, purchases from the IMF, other reserve liabilities of the banking system (including, in some cases, arrears), and refinancing/restructuring loans.

in addition to the refinancing exclusion already referred to. In several instances, the exclusion related to loans which were reserve liabilities of the central bank and which were included under a separate program ceiling on the net foreign asset position of the central bank or the banking system. A listing of the remaining exclusions is given in Table 3. 1/

6. Maturity coverage

Less than one half of the programs (47 out of 110) reviewed contained one foreign borrowing ceiling; for over 60 per cent of this group, as provided for in the external debt guideline, the ceiling was set within the maturity ranges of 1-10 or 1-12 years (Table 4). For the 63 programs which included a subceiling, the most common range of maturities covered was 1-12/1-5 years (32 programs) followed by 1-10/1-5 years (17 programs).

Several programs did not specify any maturity range--these were generally those which employed a disbursement ceiling linked to the program's budgetary targets. A total of 22 programs included short-term debt with a maturity under one year: as in the case of ceilings on disbursed debt, the inclusion of short-term debt in borrowing ceilings became somewhat more common in the recent past, especially in 1982. 2/ Of the 22 programs, however, only four [Bolivia (1980), Dominican Republic (1982), Romania (1981), and Romania (1982)] provided for a separate ceiling on under-one-year debt. In the remaining programs in this category, short-term debt was subsumed within the overall maturity ceiling.

III. Utilization of External Debt Ceilings

In general, the actual amount of debt contracted (or disbursed) during the program period was significantly less than that provided for by the ceiling under the program (Table 5). Thus, during the period 1979-81, of 68 programs reviewed, 3/ the performance criteria relating to external borrowing were not observed in only seven programs.

1/ In a number of the cases listed in Table 3, the excluded loans were partly limited in an indirect sense, in that other program ceilings on net domestic assets or net credit to government were adjusted downwards if the actual size of the excluded loans exceeded some pre-specified amount.

2/ In addition, the 1983 programs for Argentina and Brazil already referred to provide for external borrowing limitations which include short-term debt.

3/ This review was based on data for about 90 per cent of programs approved during this period. Data were not available for the remaining programs, in most cases because the arrangement became inoperative.

or public sector; this approach was often adopted in programs for Latin American or Central American countries (e.g., Bolivia, Costa Rica, Honduras, and Mexico). There was also some tendency observed for the more frequent use of disbursement ceilings in 1981-82 compared to earlier periods. 1/

4. Time period covered by performance criteria

In about three quarters of the programs, the performance criterion consisted of one ceiling covering the entire annual period following the approval of the program (Table 2). However, some programs provided for separate quarterly ceilings, reflecting a desire to monitor external debt developments in a more continuous manner. On occasion, ceilings were formulated on a semiannual basis (either set in advance for six monthly periods ahead, or subject to review after six months), partly as a result of uncertainties which were present in some instances. Where semiannual or quarterly ceilings were employed, these were often set on the basis of disbursed debt and were designed to be consistent with the projected intrayear evolution of external sector or budgetary aggregates.

5. Loans excluded from ceilings

The guideline on the use of external debt limitations explicitly provided for the exclusion from the coverage of performance criteria loans defined as concessional. 2/ Apart from this exclusion, 3/ over half (55 per cent) of the programs reviewed contained other exclusions (Table 2).

The most common category of loans excluded consisted of refinancing loans which was the only additional exclusion present for about a quarter of the programs. The wording and substance of this exclusion varied considerably as between programs. In some instances, it referred to refinancing loans in the context of multilateral debt rescheduling exercises by the Paris Club and/or by commercial banks which were explicitly envisaged at the time the adjustment program was formulated. In other cases, however, the exclusion was stated in more general terms, without specifying the nature of the refinancing loans or the context in which they might be obtained.

About a quarter of the programs excluded from the coverage of the performance criteria other specific loan categories, many of which were

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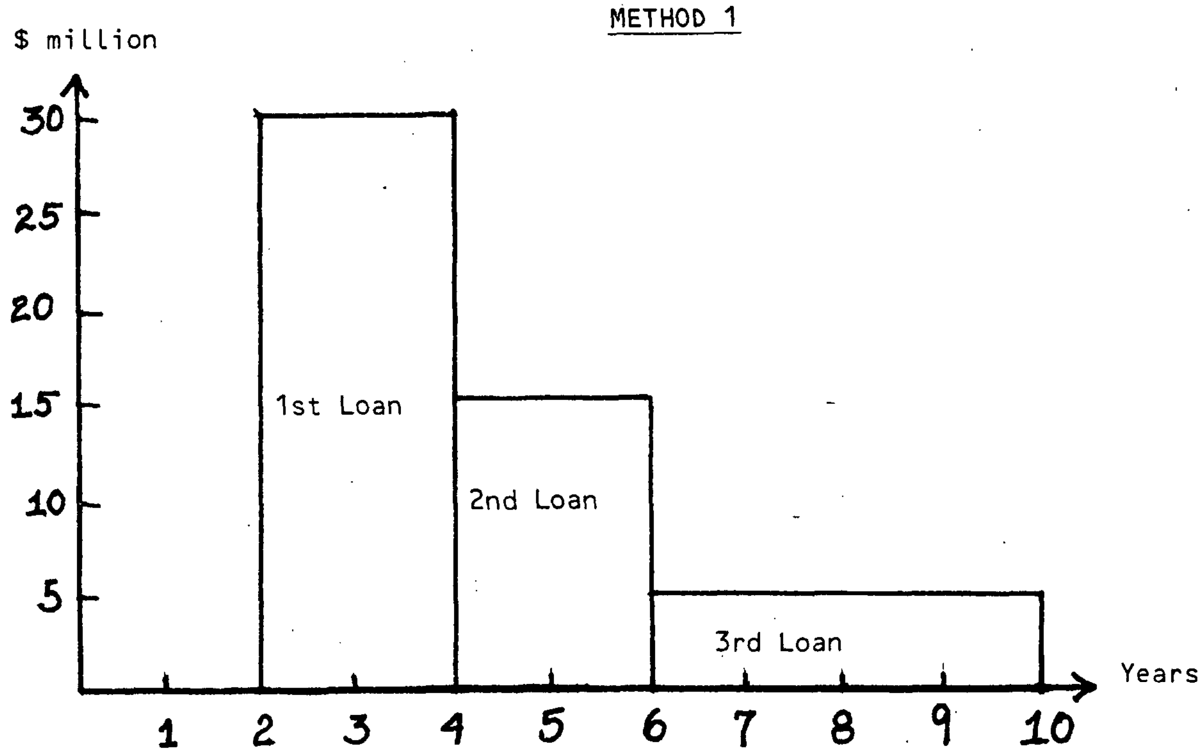
1/ It may be noted that the programs for Argentina and Brazil submitted to the Board in early 1983 both employed the disbursement approach.

2/ See Annex C for a discussion of the concessionality definition.

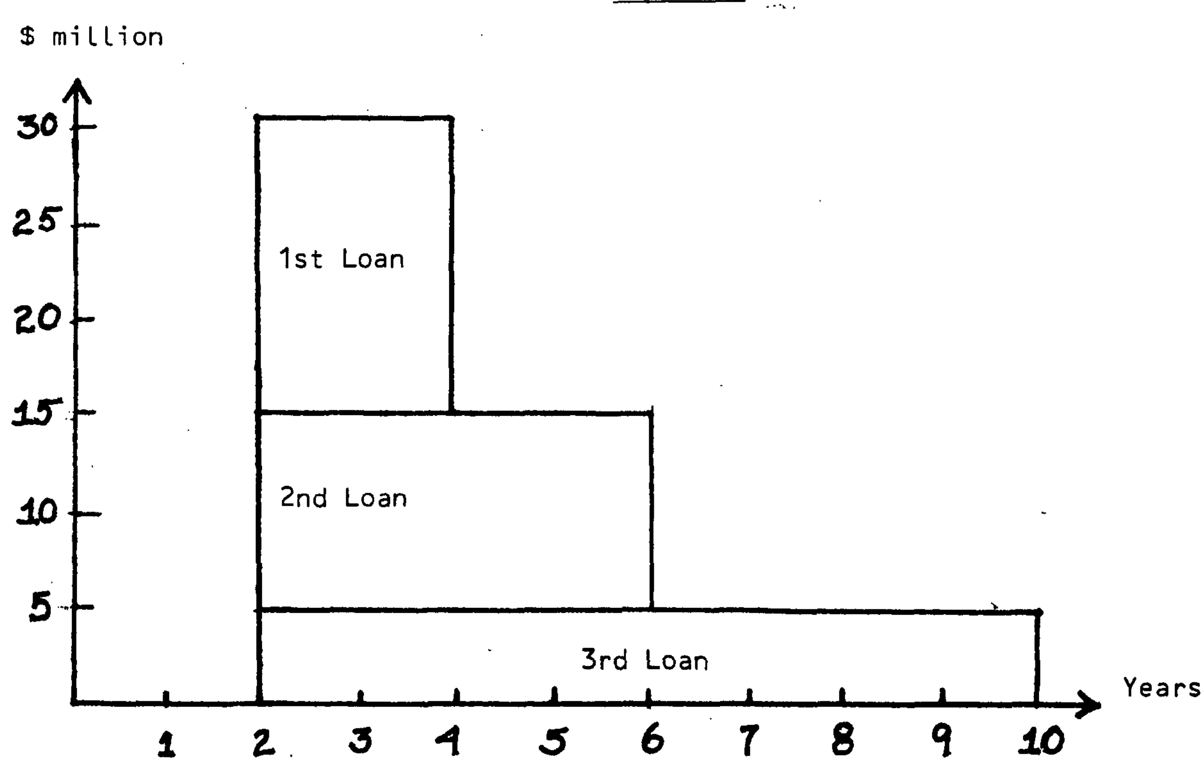
3/ In several instances, however, the wording of the performance criterion contained in arrangements did not refer explicitly to this exclusion.

Diagram 1. Alternative Methods of Segmenting "Front-ended" Loans

METHOD 1



METHOD 2



Concessionality in Foreign Loans

The longer the maturity and grace period and the lower the interest rate, the more concessional is a loan. One measure of the degree of concessionality of a loan is to express its value in comparison to a direct grant. This measure is referred to as the grant element of a loan. To compare a grant--which is unique over time--with a loan, which is distributed over several time periods, the present value of the loans--where the future flows are discounted by a rate reflecting society's time preference--must be considered. Hence, the grant element (GE) of a loan is the ratio to the principal of the loan of that principal less the discounted value of the stream of principal and interest payments due on the loan, i.e.:

$$GE = \frac{P - \sum_{t=1}^{m} (P_t + I_t)/(1 + d)^t}{P}$$

where P is the principal of the loan, P_t and I_t are the payments of principal and interest, respectively, in year t; m is the maturity of the loan and d is the rate of discount. Once account is taken of grace periods and the frequency of payments, this formula becomes:

$$GE = (1 - i/d) - \frac{(1 - i/d)}{d(m-g)(1+d)_g} \left[1 - \frac{1}{(1+d)^{m-g}}\right]$$

which applies to equal annual payments of principal, and where i is the interest rate of the loan and g its grace period.

It is evident from this formula that the choice of the discount rate will significantly affect the calculated value of the grant element. The higher the rate of discount used, the closer the grant element will be to 100 per cent; when the discount rate equals the interest rate of the loan, the grant element will be zero, and it will turn negative when the discount rate drops below the interest rate.

The proper rate of discount, which in theory should be some measure of society's time preference or the opportunity cost of capital, is difficult to ascertain. In order to determine the degree of concessionality of official development assistance (ODA), the DAC of the OECD has assumed a discount rate of 10 per cent throughout the past decade. For a loan to qualify as ODA under the rules of DAC, there must be a minimum grant element of at least 25 per cent at the assumed discount rate of 10 per cent. This rate is only a conventional benchmark and no special significance should therefore be attached to any absolute value of the the grant element; however, within certain limits, grant element computations remain a useful device to rank and compare different loans. 1/ The following table shows the maximum interest rate a loan can have for a given maturity and grace period, in order to meet DAC's criterion of concessionality.

1/ It is possible that the ranking of two loans is reversed when different discount rates are used, especially when interest rates and maturities differ considerably for the loans being compared. For typical loans and discount rates, reversals in ranking are unlikely to occur.