INTERNATIONAL NEGOTIATION AND DEVELOPMENT
Sourcebooks on Policy and Practice

International Borrowing

Negotiating and Structuring International Debt Transactions

SECOND EDITION

Daniel D. Bradlow, Editor

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Second Edition

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International Negotiation and Development
Sourcebooks on Policy and Practice
Don Wallace, Jr. and Willis W. Jourdin Jr., General Editors

ILI

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PREFACE

This volume is the first published in "International Negotiation and Development: Sourcebooks on Policy and Practice," a new series of reference works and documentary collections on important issues in international trade, finance, and economic development. The series is being published in conjunction with the Negotiation and Development Training Program of the International Law Institute.

The Institute was founded in 1955 at Georgetown University (as the Institute for International and Foreign Trade Law) to promote a better understanding of the legal problems of international trade. Today the Institute is devoted to training, research, and practical responses to problems in social and economic development and to complex international policy issues and negotiation problems involving governments and multinational corporations. In this endeavor it hosts conferences and colloquia, presents training seminars, conducts research, advises, and publishes. Regular seminars are given in foreign investment and financing, procurement and contracting, arbitration, intellectual property and transfer of technology (including telecommunications, informatics, biotechnology, and computer policy), trade, petroleum and mining, management, public enterprises, national budgeting, lawmaking and constitutional administration of justice. In 1983 the Institute became an independent non-profit entity but continues to work in cooperation with Georgetown University in many of its programs.

In the past decade, the Institute's Negotiation and Development Training Program has trained over 2,000 officials and professionals, in both the public and private sectors, from 115 countries. Participants in the ILI program are trained to manage their organizations effectively, to carry out policies and effect change, and to negotiate on an equal footing with foreign investors and financiers, multilateral organizations, contractors, experts, consultants, exporters, suppliers and licensors, taking into account the latest developments in law, finance, economics, technology and public administration.

The books in this series will incorporate materials used in the Institute's seminars. Each volume will include articles, case studies, and essential documents on the substance and practice of negotiation, policy execution, and management in its respective field. The strong emphasis in ILI seminars is on the practical application of theory and on how the real (as opposed to the ideal) world works. That same emphasis on practical success in the real world will be embodied in the sourcebooks in this series.

Don Wallace, Jr.
Director

Willis W. Jourdin Jr.
Deputy Director

International Law Institute
Washington, D.C.
August 1986

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Introduction

This book is a reference work and training manual for officials in developing countries who are responsible for their nation's international financial transactions. It should also prove useful to academics, students, and practitioners in international finance.

The book is meant to inform readers about the technical aspects of international finance, particularly the financing of specific projects. The complex issues of public policy raised by general-purpose financing are outside the scope of this book. Nevertheless, the relationship between macroeconomic issues and project financing is such that the book would not be complete without some discussion of the International Monetary Fund, structural adjustment loans, and debt management. However, the chapters on these topics are intended only to be introductory.

The material in this collection falls into three categories. First, there are articles that describe particular financing sources and techniques. Second, resource materials are included to direct readers to further information. Finally, there are sample documents. The articles will illuminate the advantages and disadvantages of each type of financing source and technique, and the reference materials and documents will help government officials to plan the most effective use of available financing.

In selecting material for the book, there has been no attempt to advocate a particular perspective on international borrowing in general or to promote any financing source or technique in particular. The intention has been to provide officials with the technical information necessary to make their own informed decisions on these issues and to help them make the most effective use of their country's development financing opportunities.

The book is organized to follow the steps that a government official would take when structuring a financing package for a development project. It begins with a discussion of external debt management, because the debt-management policies of a developing country determine the parameters within which an official must operate. The articles in section 1 address some of the important considerations in developing efficient debt-management programs and policies.

Section 2 describes sources of funds for developing countries. The seven chapters in section 2 contain a great deal of factual information about each source, and a number of reference materials are included. Chapters 2-5 discuss multilateral financial institutions, in particular the World Bank. Chapter 6, on national aid, describes the aid programs of the OECD countries, Comecon countries, developing countries, and non-OECD industrialized countries, as well as nongovernmental sources of aid. Chapter 7 explains the mechanics of export financing and compares the positive and negative contributions that export financing can make to economic development. The chapter includes a list of many official export financing agencies. Chapter 8, which discusses commercial sources of funds, contains articles describing international capital markets and the process of raising debt through syndicated loans and bonds. It also includes a discussion of the role of foreign investment in economic development.

The third section of the book is devoted to the financing techniques most often used by developing countries. Chapter 9 is a discussion of project planning and project financing, followed in chapter 10 by a description of the under-utilized technique of lease financing. Chapter 11, which is a discussion of letters of credit and other forms of documentary credits, is a counterpart to chapter 12, an overview of countertrade. The focus of all of the chapters in section 3 is on describing the mechanics, benefits, detriments, and utility of these financing techniques.

Once an official has chosen a financing source and technique, attention shifts to the negotiation and structuring of the transaction. Section 4 is concerned with negotiating and structuring a loan transaction. The section begins with a chapter on the financial issues in loan agreements. The articles in chapter 13 discuss such issues as credit analysis, interest rates, interest periods, grace periods, and repayments. A checklist of key financial issues is included to assist readers in preparing for a loan negotiation. Chapter 14 analyzes the legal considerations relevant to loan transactions. An annotated loan agreement enables the reader to understand the key clauses in such an agreement. Section 4 concludes with chapter 15, a review of some factors that developing countries should consider when negotiating a loan agreement.

Inevitably, the process of negotiating a loan presents unexpected twists and turns. Sections 5 and 6 are concerned with some of the problems that can arise and with the institutions involved in sovereign debt renegotiations. Chapter 16 examines the International Monetary Fund (IMF) and its role in international finance, explaining the structure and functions of the IMF and providing the reader with insight into the present controversies surrounding IMF policies. This chapter, however, is only an introduction to this complex subject.

Chapter 17 focuses on the sovereign debt renegotiations that have characterized the first half of the 1980s. Again, this section is intended only as an introduction to the subject, but it gives the reader a good overview of the technicalities of debt renegotiations. A discussion of the renegotiation of official and private debt is included as well as articles on the financial and legal issues raised in debt renegotiations.

The final chapter in the book proposes a possible solution to the debt situation in the developing world. It is included not because the editor endorses its proposals but to stimulate readers into further thought about the dimensions of the debt crisis.

The characteristics and conditions of international financial transactions are subject to sudden change. This book can only elucidate the general outlines of international finance, and the editors caution that the information on the specific features of each financing source or technique should be treated as merely illustrative and subject to change. Consequently, readers should be aware that material in this book may not apply exactly to their financing programs.

A book such as this is never the product of only one person's work. It was originally developed in conjunction with the International Law Institute's training programs, "Financing Sources and Techniques" and "International Loan Negotiation and Renegotiations." Many people should share the credit for creation of this book. I especially wish to thank the International Law Institute, its director, Prof. Don Wallace Jr., and its executive director, Frank Loftus, for providing me with the opportunity and the support for this project; Willis W. Jourdin Jr., deputy director at the Institute, who gave me valued guidance and encouragement in developing courses on international borrowing out of which this book developed; Veronica Johns, who provided valued research assistance; Peter Whitten, who oversaw editing and production; and Vernita Greenfield, without whose secretarial skills this book would not have been completed. Furthermore, I particularly with to thank David Suratgar for all the advice and assistance he has given me; and Paul Reichler and my colleagues at Reichler & Appelbaum for encouraging me to persevere with this book and for allowing me the time to complete a project that they perceived to be as important as I did.

Washington, D.C. — Daniel D. Bradlow
August 1986

Section I:
The Management of External Debt
Chapter 1: Debt Management

1A. Issues in External Debt Management

Nicholas Hope and Thomas Klein***

Since 1973, more than 30 developing countries have had to reschedule their debts, some of them two or three times. Although the amounts involved are not very substantial measured against the total outstanding debt, they have increased considerably: debt relief agreements covered an annual average of US$2 billion of debts between 1974 and 1981; but some $10 billion was renegotiated in 1982. By mid-1983, debt in excess of $35 billion was under negotiation,, including short-term credits that would normally be "rolled-over" for countries not in economic difficulty.

As the accompanying article on rescheduling explains, debt problems may arise from many reasons—for instance in recent years depressed export markets and high interest rates have been important factors. But poor debt management policies also had contributed to the debt difficulties of developing countries during the past decade. What pitfalls for debt management—as distinct from overall economic management—must be avoided, if developing countries are to reduce costly debt servicing problem in the future?

The problems of managing external debt in the postwar period became apparent during the late 1950s and early 1960s when first Turkey, then Argentina, Brazil, Chile, Ghana, and Indonesia encountered severe debt servicing difficulties. In each country, large shares of capital formation by the public sector were financed through suppliers' creditors of five to seven years maturity. While this investment, for the most part, had a positive effect on economic growth, it did not lead to an acceleration of exports, nor did the returns from the projects always conform to the timing of sevice payments. For these countries, debt service obligations rose rapidly; foreign exchange earnings did not. Adding to their problems was the lack of timely information on the external debt. Borrowing was monitored poorly, if at all; in some countries (Turkey in the late 1950s; Ghana and Indonesia in the 1960s) there was a virtual absence of statistics on debt and debt servicing obligations. The common characteristics of all these countries were: excessive foreign borrowing relative to profitability and to export earnings, inappropriate borrowing terms, and inadequate information about the volume and composition of external debt. All these difficulties could have been alleviated by more effective debt management.

Developing countries borrow to promote their growth—generally by augmenting the resources available for investment. At the same time, borrowing imposes constraints on their future policies. Specifically, projected export earnings, possibly augmented by further borrowings and other foreign finance, must be sufficient to accommodate the required debt service obligations; and projected government revenue must be enough to provide the local currency equivalent of the government's debt service obligations. The latter requirement will be met more easily when the projects financed are successful; but even where returns are more than adequate to cover costs, the government's ability to raise revenues may constrain severely its ability to manage debt.

To manage debt effectively, authorities must project accurately the time profile of their debt service obligations, and forecast export earnings, domestic revenues, and future access to various sources of finance. They must also monitor the potential for prepaying or refinancing their debt: (1) to take advantage of new borrowings on better terms; (2) to adapt loan maturities to the revenues generated by the projects financed, or (3) to cope with shortfalls in earnings from exports or unanticipated expenditures on imports.

A major problem for a government is to view foreign borrowing in the broader framework of its overall economic policy decisions. Where policies are chosen so that key economic variables especially interest and exchange rates convey true economic costs to decisionmakers and where governments underpin their public investment programs with effective resource budgeting and measures to raise domestic savings, debt problems will rarely arise. But, as the past few years have shown, countries can find that they have "overborrowed" in deteriorating economic circumstances, making them vulnerable to painful deflationary pressures and slow growth. Beyond good macroeconomic policy, however, the effective management of external debt comprises three specific interrelated processes: knowing the debt;

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deciding how much to borrow; and selecting the appropriate available financing.

KNOWING THE DEBT

Information on external debt and associated debt service payments is essential for the day-to-day management of foreign exchange transactions as well as for managing debt and planning foreign borrowing strategies. At the most detailed level, the information enables central authorities to ensure that individual creditors are paid promptly; at more aggregated levels, it is important for assessing current foreign exchange needs, and for projecting future debt service obligations and the consequences of further foreign borrowing.

In most countries, debt statistics are the responsibility of a debt recording agency affiliated with the ministry of finance or the central bank. The collection of these statistics has accounting, statistical, and analytical implications. Details of each loan contract and schedules of future service payments msut be recorded, figures on loan utilizations collected, and the payment of debt service obligations ordered promptly. The statistical and analytical aspect involves assembling summary figures on foreign borrowing, tabulating debt outstanding, and projecting debt service due. From these statistics, inputs are prepared for the government budget and for balance of payments projections. With the help of a macroeconomic model, the statistics department of a debt office can simulate the impact of alternative future borrowing patterns on the budget and on the balance of payments.

Developing countries typically encounter problems with the accounting of public sector debt. New loans are not always reported to the debt agency: in some countries, government agencies have considerable autonomy to borrow abroad, and this makes it difficult to have an overall picture of the country's external debt commitments. Another problem concerns loan disbursement. Autonomous public corporations are sometimes uncooperative in supplying figures on these to the central debt office responsible for monitoring debt transactions. Occasionally debt service payments are not made because of disorderly work procedures and ineffective management. Because of these administrative failures, a country that is able to service its debts may incur penalty charges and impair its creditworthiness. Even well-organized debt offices have experienced accounting difficulties when faced with a rapid growth in the volume of external debt transactions. In response to this, countries that have taken on large numbers of relatively small loans have benefited from computerizing their accounting operations.

The statistical and analytical function is an essential complement to the accounting exercise. A number of countries with well-developed accounting systems have been unable to generate useful statistics from the basic accounting records because their bookkeeping staff has not been complemented by economists or financial analysts. This work, too, has become more complex in recent years. Most financial credits from commercial banks now carry variable interest rates, so budget and balance of payments projections should allow for the effects of alternative interest charges. Similarly, the volatility of exchange rates necessitates several sets of projections to test the sensitivity of debt service payments. Even with a small volume of debt, this sensitivity assessment is difficult without the help of economic analysis and computer based models. In an increasing number of countries, the private sector borrows substantial sums abroad, in some countries, private borrowing comprises three quarters of the medium and long term debt. Debt offices are usually informed regarding private sector debt guaranteed by government, but data collection systems for private nonguaranteed debt are frequently inadequate.

A characteristic of recent debt problems is the important role of short-term debt; payments crises have erupted when countries failed in their attempts to refinance short maturities. Monitoring short-term debt is difficulty, however, and this is as true for the lender as for the borrower. Some short-term liabilities can be measured easily-for example, payments arrears on trade credits that arise when officials block transfers requiring approval under exchange controls. More difficult to monitor is the growth of new short-term financing arrangements, such as the Turkish convertible lira deposit system of the mid-1970s and lending to Mexico in 1981-82.

HOW MUCH TO BORROW

The amount of debt to contract is a basic policy decision, and the correct decision will depend on the skill and judgment of those responsible for making it. Formal models and related technical analyses cannot substitute for good policymaking, but they can aid it by providing information on the future implications of alternative borrowing strategies—especially their impact on a country's capacity to invest wisely in the light of its balance of payments prospects.

The amount that any country ought to borrow is governed by two factors: how much foreign capital the economy can absorb efficiently, and how much debt it can service without risking external payments problems. Each factor will depend on the effectiveness of overall economic management. But, considered narrowly, after the debt servicing capacity of the economy is projected, the volume of external borrowing will depend on the terms on which it is made available. The policy decision is complicated by different terms and currencies for borrowings and by uncertainty about the evolving debt servicing capacity of the economy (including the capacity to borrow further to service the debt). The interaction between debt servicing capacity, the type of finance available, and the borrowing decision increases in complexity as the number of loans increases. Computer-assisted models are important aids to the policy-maker in coping with this complexity.

Most governments, in assessing the feasibility of a borrowing strategy, pay particular attention to the risk of overtaxing their debt servicing capacity and causing balance of payments problems. But they also examine the costs, in terms of foregone growth of underborrowing. In foreign borrowing both over-optimism and excessive pessimism can be costly.

FINANCING TECHNIQUES

The best combination must be chosen from the available sources of external finance—whether loans, grants, or direct investment to suit the needs of individual projects and of the economy as a whole. The preceding discussion makes clear that a major concern in the selection is to avoid problems in making service payments on foreign capital. (These payments include profits and dividends remitted by direct investment enterprises, and obligations resulting from barter, prepayments for exports, or other similar arrangements.)

Authorities will have other objectives in choosing among sources of finance. For many, a major concern is to make the maximum use of—or obtain the most "leverage" from—those external capital flows that are scarce. Grants and foreign loans on concessional terms are clearly the cheapest form of financing, but these are generally inadequate to meet a country's needs. Maximum leverage can be obtained from them by combining them with other types of financing; for countries with limited ability for borrowing from financial markets, the leverage obtained from these funds can be very important.

Loans from international banks provide a flexible source of foreign exchange contrasting with much official capital and export related financng that is specific to particular projects or goods. Bank loans provide governments with the foreign exchange needed for participation in joint ventures, for the down payments on capital goods often required to secure preferential export credit finance, and for meeting unanticipated shortfalls of foreign exchange earnings, when the ability to "roll over" debts or meet debt service payments through new borrowing may be very important.

Commercial bank loans in recent years have carried high interest rates compared with official loans and guaranteed export credits, and many countries (such as China and Indonesia) have endeavored to minimize their use in project financing. Clearly, authorities should ensure that credits from the financial markets are part of a package that provides the best possible external financing mix for the economy as well as for an individual project. At the project level the best mix could mean one with: (1) the highest possible grant element; (2) the minimum amount of market finance; (3) the maximum amount of capital that can be rolled over easily; or (4) the minimum debt service due in the first five to ten years of the project.

As well as eveluating alternative financing packages for each major project, the authorities must ensure that the aggregate financing package meets national financial priorties. This involves an assessment of such aspects as the sources of finance the amounts of each type that could be borrowed and the prospects for future supply; the currency composition of foreign borrowing that would minimize exposure to exchange rate fluctuations; the exposure to interest rate fluctuations over the life of the loan; and the impact of new borrowing on the structure of debt service obligations and the overall future access to external finance. Analysis of this kind is not easy, but all developing countries must perform it effectively if they are to continue to benefit from foreign borrowing while avoiding balance of payments, problems.

A CONTINUING PRIORITY

Many countries are encountering the need to consolidate and restructure their external borrowing in an orderly fashion, and many more, less publicly, have experienced reduced growth as debt has become an increasing constraint on their development budgets. The resolution of these difficulties lies, to a large extent, in a restoration of economic health to the global economy, and a resumption of strong growth in international trade. But careful debt management—the most effective use of scarce borrowed resources—will remain an important function of national authorities.