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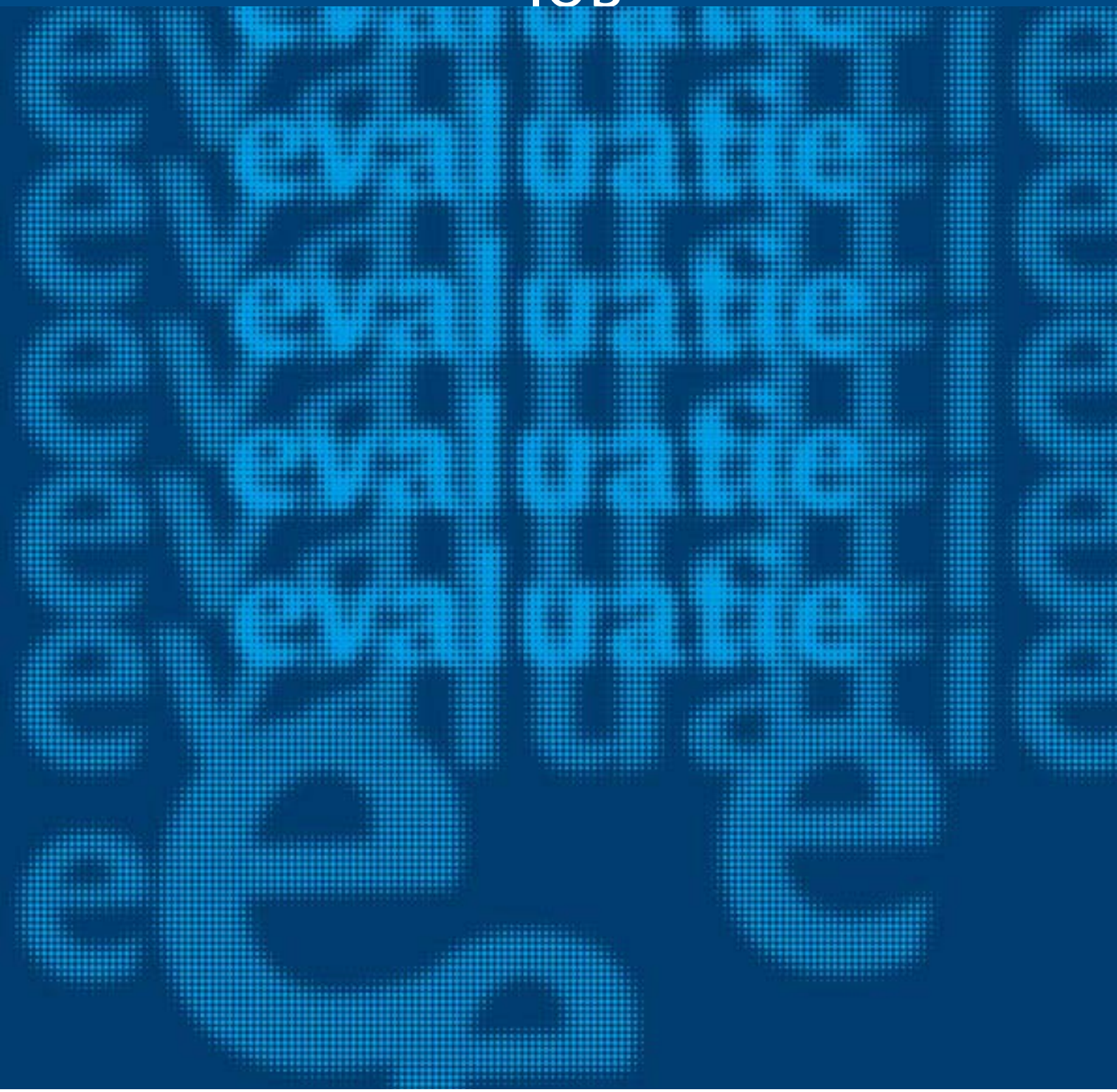

RESULTS OF INTERNATIONAL DEBT RELIEF IN PERU

Eisa Abdelgalil and Willem Cornelissen (SEOR B.V., Erasmus University Rotterdam)

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POLICY AND OPERATIONS EVALUATION DEPARTMENT

RESULTS OF INTERNATIONAL DEBT RELIEF IN PERU

CASE STUDY FOR THE IOB EVALUATION OF DUTCH DEBT RELIEF

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PREFACE

This report contains the findings of one of the eight country case studies that were undertaken in the context of an evaluation study of Dutch debt relief during the period 1990-1999, conducted by the Policy and Operations Evaluation Department (IOB) of the Netherlands' Ministry of Foreign Affairs. As the results of Dutch contributions to debt relief cannot be distinguished from the effects produced by contributions from other donors and creditors, the eight country studies analyse the results of the combined efforts of all actors.

The research was carried out – in close consultation with the chief consultant for the evaluation, Dr. A.G. Dijkstra – by W.J. Cornelissen and Dr. E. Abdelgalil of SEOR BV, a subsidiary company of Erasmus University, affiliated to the Faculty of Economics, who are responsible for the contents of this report. It is published in the series of IOB 'Working Documents', comprising consultant studies of interest to a wider public.

Rob D. van den Berg
Director, Policy and Operations Evaluation Department

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ABBREVIATIONS

BCRP	Central Reserve Bank of Peru (*Banco Central de Reserva del Perú)*
BEMO	*Beoordelingsmemorandum* (Appraisal Memorandum)
CAF	*Corporación Andina de Fomento* (Investment Corporation of the Andes Pact)
DAC	Development Assistance Committee (of the OECD)
DDSR	Debt and Debt-Service Reduction (operation)
DGIS	*Directoraat-Generaal Internationale Samenwerking* (Directorate General for International Co-operation)
EDT	External Debt Total
EFF	Extended Financing Facility
ESAF	Enhanced Structural Adjustment Facility
FDI	Foreign Direct Investment
FLAR	*Fondo Latino-Americano de Reserva* (Latin American Reserve Fund)
FLIRB	Front Loaded Interest Reduction Bond
GDP	Gross Domestic Product
GNP	Gross National Product
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IDB	Inter-American Development Bank
IFAD	International Fund for Agricultural Development
IFI	International Financial Institution
IMF	International Monetary Fund
I	Inti (national currency of Peru before 1991)
IOB	Policy and Operations Evaluation Department
JSA	Joint Staff Assessment
LDOD	Total Long-term Debt Outstanding and Disbursed, including IMF charges
MGS	Imports of Goods and Services
NCM	*Nederlandsche Crediet Verzekering Maatschappij* (Netherlands Credit Insurance Society)
NGO	Non-Governmental Organisation
NLG	Dutch guilder
NPV	Net Present Value
Ns	Nuevos Soles (national currency of Peru since 1991)
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
OPEC	Organisation of Oil Exporting Countries

PDI	Past Due Interest
PPG	Public and Publicly Guaranteed (debt)
SIMIC	Severely Indebted Middle-Income Country
RAP	Rights Accumulation Programme (IMF)
TDS	Total Debt Service on long-term debt
UNDP	United Nations Development Programme
UNICEF	United Nations Children's Fund
USD	United States dollar
USAID	United States Agency for International Development
WB	World Bank
XGS	Exports of Goods and Services

EXCHANGE RATES

Year	per United States Dollar	
	Nuevos Soles (PEN/USD)	Dutch Guilder (NLG/USD)
1989		2.1210
1990	202403.7 (intis)	1.8208
1991	0.770	1.8697
1992	1.246	1.7585
1993	1.988	1.8572
1994	2.195	1.8197
1995	2.253	1.6053
1996	2.453	1.6861
1997	2.664	1.9509
1998	2.930	1.9845
1999	3.383	2.0683
2000	3.484	2.3912

Sources: Banco Central de Reserva del Perú, ABN-AMRO.
For conversion in Euro (since 1999): 1 € = NLG 2.20371 (prior to 1999 fluctuating ECU rates).

SUMMARY AND CONCLUSIONS

This evaluation of debt relief to Peru, a Severely Indebted Middle-Income Country (SIMIC), covers the period 1990-1999, which happens to coincide with the rise and fall of the Fujimori regime. The desk study is based on secondary sources of information only.

The origin of the external debt

Peru's status of severe indebtedness is the result of external borrowing during one decade only and accumulation of arrears during another decade. Peru's external debt was modest until 1975. Prior to 1975, debt was mostly generated by private (and later nationalised) firms. Loans were mainly used for infrastructure works. Apart from IMF loans in support of the primary export growth strategy (pre-1968) and later in support of the import substitution model, there has never been any policy-based lending to Peru before 1990. Between 1975 and 1985 the external debt increased until Peru became blacklisted in the international financial world. In 1987, Peru stopped servicing its debt and arrears accumulated swiftly. The accumulation process of Peru's external debt is a direct consequence of its history of abrupt changes in economic policies.

Before 1990, rescheduling of debt by the Paris Club creditor countries was the only debt relief mechanism of importance. In addition, Peru intended to settle dubious debts to external suppliers (of nationalised enterprises).

In 1990, the Peruvian debt problem could be characterised as follows:

- A large debt overhang. Peru's total external debt reached nearly USD 22 billion, of which 34 per cent was owed to commercial banks and suppliers, 33 per cent to Paris Club creditors; 19 per cent to the International Financial Institutions (IFIs) and 10 per cent to other bilateral creditors. Over 98 per cent of the total external debt (EDT) was public and publicly guaranteed debt (PPG).
- A serious arrears problem, amounting to about USD 13.4 (62 per cent of total external debt) of which half (USD 6.3 billion) to commercial banks.
- The low confidence of creditors in Peru, reflected by the discount on commercial claims in the secondary market (94-95 per cent).

In 1990, Peru was in a state of bankruptcy, disintegration, civil war and anarchy. Capital flight was massive, as was the migration of the intellectual elite (target of the Shining Path movement). Coca leaf production had become the informal survival kit of the economy, surrounded by open corruption and violence. Political violence claimed 3,000 – 5,000 lives annually.

Peru’s relation with all external creditors was disrupted. Peru no longer had access to IMF support and was blacklisted by the international banks. The only –modest- access to external finance was through bilateral development loans and mixed credit systems.

When in 1990 the first Fujimori government was elected, this implied a drastic change in the economic policy, from the so-called heterodox policy to a neoliberal one.

Debt relief

During the decade three debt relief mechanisms have been of importance to Peru:

- the arrears clearance exercise in 1991 and 1992;
- the Paris Club exit agreement in 1996, and
- the Brady arrangement in 1996/97.

In 1990, apart from re-establishing peace in society, the first priority of government was to regain access to the international financial world, both to the International Financial Institutions (IFIs) and the commercial banks. To achieve that goal, an agreement with the International Monetary Fund (IMF) was the first step.

In order to come to such an agreement, Peru first had to eliminate first its accumulated arrears with the IFIs (IMF, World Bank and IDB). Since it lacked the resources to do so, Peru called for international support. A Support Group of bilateral donors (including the Netherlands) was established. The clearance exercise became a complicated political issue. Germany's participation in the Support Group was of critical importance, since it would contribute a large sum. However, a German condition for its contribution was that a Paris Club agreement had to be in place first. The elimination of multilateral arrears was a condition for the IMF to start a Rights Accumulation Programme (RAP). This RAP would trigger an Extended Financial Facility (EFF), which in turn was a condition for the World Bank to issue a Sectoral Adjustment Loan (SAL). For private creditors, access to their market depended on the normalisation of the relations with the IMF and World Bank. Peru used all its lobbying capacity and played hardball to reach a breakthrough. A restructuring of the arrears with the Paris Club creditors was agreed upon in 1991 and 1992. Within two years all other connected mechanisms became effective as well. By the end of 1992 Peru had eliminated all its multilateral arrears and most of its bilateral ones and was on-track with its current debt servicing to multilateral and bilateral creditors.

The normalisation of relations with the commercial creditors was a longer process. In the course of time the Peruvian economy started to recover. In consequence, the price of debt titles on the secondary market increased substantially. In 1996/97, the massive Brady arrangement made it possible to restructure and convert the debt to private creditors for some 98 per cent.

After the successful Brady arrangement, it became Peru’s policy to service all its debt and *not* seek any further reduction or restructuring of its debt. . Peru preferred to be recognised as an 'emerging market'. The government’s payment obligations were met with the proceeds of the privatisation process, new multilateral loans and with domestic borrowing.

Debt relief from the Netherlands
In 1990, Peru owed the Netherlands NLG 325 million. This sum comprised the controversial transaction of the vessel 'Admiraal de Ruyter' (converted into the 'Almirante Grau'), which led to the bankruptcy of the Amsterdamse Droogdok Maatschappij. Considering development loans only, the outstanding bilateral principal was NLG 33 million financed from the Dutch Ministry of Foreign Affairs’ own funds and NLG 185,180,000 borrowed by the Ministry on the capital market (on-lending). During the period 1985-90 arrears had accumulated to NLG 65.5 million. These were forgiven in two tranches: a first one of NLG 32.8 million in 1991 and a second one of NLG 32.7 in 1992.

The 1991 and 1992 current debt service obligations (amortisation and interest) were NLG 13.5 and 13.6 million respectively. These were forgiven as well.

The forgiveness of both arrears and current debt service implied that Peru was 'on-track' on its bilateral debt to the Netherlands by end 1992.

The Netherlands Government supported Peru in reducing its external debt with a variety of instruments. The Netherlands pledged NLG 92 million to the Support Group for the elimination of arrears to the multilateral creditors and there were also direct contributions

to the multilateral debt service. However, most support consisted of reduction of the bilateral development debt. It became routine to forgive the current debt service. In total the Netherlands contributed NLG 231,720,000 or USD 126,878,700 to relieving Peru's external debt.

Efficiency
The first step in Peru's return to the international financial community was the normalisation of the financial relations with multilateral financial institutions. Between 1991 and 1994, the multilateral financiers disbursed USD 2.4 billion, while repayments on principal and interest were USD 2.8 billion. So the debt situation was 'normalised' for a relatively low 'price'. New loans contracted were mainly for projects in transport, energy and social programmes. In general, there was no policy-based lending.

After the1996 Brady arrangement, it has been Peru's policy to service its debt and *not* seek restructuring or reduction of its debt.

Debt relief did not lead to a reduction in the debt service flow on public debt. On the contrary, this flow increased over time. Debt relief was mainly used to eliminate accumulated arrears. There was no direct flow effect of debt relief. It can be argued that there was an indirect flow effect, since new multilateral loans became available that –most likely- would not have been issued in the absence of debt relief.

The composition of the debt portfolio changed substantially and the total debt stock increased. The multilateral share in the total debt remained almost unaltered. The debt to private creditors was converted into tradable instruments, while the bilateral debt stock increased as a result of capitalisation of interest on rescheduled debts and the contracting of new bilateral loans. Apart from the Brady arrangement of 1996, there is no significant stock effect of the debt relief activities.

Effectiveness
Peru's total debt stock (LDOD) increased from USD 14 billion to USD 25 billion over the decade. The total debt forgiveness and reduction over the decade was approximately USD 2.5 billion, or 10 per cent of the total debt stock at the end of the decade. Most of the debt relief consisted of debt restructuring, that led to an increase in the debt stock as a result of the capitalisation of interest.

Although the total relief seems modest (Peru, a middle-income country, is only eligible for a limited number of relief instruments) the effects were significant. Over the period 1991-98, Peru was able to realise a high average growth rate (7.8 per cent), to limit inflation to a level of 5 per cent per year and to eliminate the budget deficit from 1997 onwards. An important result of the normalisation of international financial relations is the contracting of new multilateral debt.

Considering the classic sustainability indicators over the decade of the 1990s, these have either improved, or showed a more or less constant pattern. In the long run, however, Peru's debt is not considered sustainable, neither in terms of solvency nor in terms of liquidity. As in many countries, future sustainability depends on the growth pattern of the economy, as well as on the tax revenue system. Nevertheless, since 1996 Peru has been able to service all its external debt.

Since no direct flow effect can be attributed to debt relief, there is no evidence of effects of debt relief on public expenditure. However, there were indirect effects, since new multilateral loans became available as a result of debt relief.

The effects of debt relief on private investment in Peru were also indirect. When Peru's blacklisting was lifted, the psychological effect on investments was impressive. The creditworthiness rating improved substantially.

One of Peru's objectives had been the re-establishment of normal relations with the international financiers. Debt relief has been effective in that aspect, since by the end of the century, Peru had

- reached an exit agreement with the Paris Club bilateral creditors;
- regularised almost all bilateral debt to non Paris Club creditors;
- regained access to the IMF;
- contracted various new loans from the World Bank and the IDB;
- normalised relations with commercial creditors;
- restructured its portfolio of debt to private creditors and made those debts marketable instruments.

All social and poverty indicators improved over the decade. However, these improvements are at best an indirect effect of debt relief. Debt relief aimed at regaining access to new loans, which were partly used for social investment programmes. Some bilateral creditors applied debt swaps-for-poverty alleviation.

The Netherlands contributions were effective in the sense that all arrears on the bilateral debt to the Netherlands could be eliminated, and Peru could come 'on-track' in the Paris Club context. The Netherlands' contributions to the Support Group were equally effective: Peru regained access to the IFIs. The effectiveness of forgiveness in all subsequent years (1993 – 1999) is rather doubtful. Peru probably would not have paid its debt service until the 1996 Paris Club arrangement. After the 1996 agreement, the continuing Dutch debt service forgiveness becomes even surprising, since it became Peru's policy not to request for debt relief anymore (IMF, 2001:16).

Relevance

The impact of debt relief on economic growth cannot be determined directly. First, there was no direct flow effect and only a temporary stock effect of debt relief. The re-access conditionalities in 1991 and 1992 had more to do with compliance with debt service obligations than with economic policies. It can be concluded that there is no direct impact of debt relief on economic performance.

Although Peru achieved remarkable results in reducing extreme poverty, there is no causal relation between debt relief and poverty alleviation. However, it can be argued that there was an indirect impact. The 1991, 1992 debt relief triggered support first by the IMF and later other IFIs and Paris Club creditors. After 1996, the Brady arrangements even new commercial credits were contracted. As the stabilisation programme restructured the fundaments of the economy, structural adjustment changed the enabling environment. The private sector responded. Confidence in the economy was restored. So, debt relief has been instrumental in triggering economic growth.

The relevance of debt relief from the Netherlands

The Netherlands support to eliminate arrears in 1991 and 1992 has been relevant in enabling economic growth. Debt service forgiveness on bilateral loans, however, was hardly relevant to either economic growth or poverty reduction.

The Dutch Ministry of Foreign Affairs based its judgements and recommendations for debt relief on macroeconomic criteria only, even after 1998 when it was well-known that the Fujimori regime violated human rights and other principles of good governance.

1 DEBT PROBLEM ANALYSIS: NATURE, CAUSES AND CONSEQUENCES

1.1 Economic history and trends

Peru is considered a Severely Indebted Middle-Income Country (SIMIC). Its status of severe indebtedness is the result of external borrowing during one decade and the accumulation of arrears during another decade. Until 1975, Peru's external debt was modest as compared to neighbouring countries on the South American continent. Between 1975 and 1982, the external debt increased at such a pace that the international debt crisis of the early 1980s also affected Peru, although less than – for example – Argentina or Brasil. The accumulation process of Peru's external debt is a reflection of its history of abrupt changes in economic policies, where the tendency to adopt extreme approaches has become tradition (Dancourt, 1999:52).

The present evaluation of the debt relief to Peru covers the period 1990-1999. This period happens to coincide – more or less – with the rise and fall of the Fujimori regime. The start of that administration implied a drastic change in the economic policy, from the so-called heterodox policy to a neoliberal one.

The context of Peru's economic history is important for an understanding of its current external debt situation. Between the Second World War and 1990, Peru applied two entirely different economic models: the primary-export growth strategy and the import substitution strategy.

The primary export growth strategy

Starting with the Odría Government (1948-1956) and ending with the general Velasco Alvarado government (1968-1975), Peru applied a pure and almost extreme form of export growth strategy in combination with minimalist public sector involvement. Peru's orthodox export-led system allowed free entry of foreign capital and unrestricted repatriation of profits. Between 1950 and 1970 Peru experienced a period of rapid economic growth, interrupted only by some brief recessions in 1958 and 1968. GDP in the 1950s and 1960s increased at an average annual rate of 5-6 per cent, in later years slowing down to 2.5-3.0 per cent. Inflation was kept relatively low at 10 per cent annually (Dancourt, 1999:53). The expansion of the economy was based on a small number of private companies in the mining industry, agriculture and fisheries. The economic growth in the 1950s and 1960s enabled the development of a middle class in Peru.

This Peruvian system was an anachronism in the Southern Cone of Latin America, where the prevailing model in the sixties had shifted to import substitution and industrialisation, with protected domestic markets and relatively high rates of inflation.

The good economic performance up to the 1970s coincided with favourable external conditions: both the American and European economies were in expansion and their industries required primary commodities. Mineral prices – Peru's main export commodity – as well as prices for cocoa and coffee were high.

The Peruvian economic policy cannot be separated from the state model at the time. The state was oligarchic and the public sector functions were limited to a minimum and established for the benefit of the leading industries. 'Governments' were composed of a few politicians from the upper strata in society, with family ties in the export industry, the Catholic Church and the army. In practice, the public sector was so small that in a large part of the national territory it was absent (apart from the army). It lacked tax revenue collection capacity. This does not imply that these governments lacked policies. For example, the Odría government invested in mining and export agriculture, while executing an active private sector investment promotion programme. Successive governments made public investments for the benefit of the export industries, such as in irrigation works and road construction. For these investments in infrastructure works external loans were contracted, both from commercial banks and international financial institutions, such as the International Bank for Reconstruction and Development (IBRD) and the Inter-American Development Bank (IDB).

Peru's population doubled in three decades (1940-70), while the population of Lima quadrupled. Successive governments perceived the explosive increase in urban population as the prelude to social and political turmoil. These political views had a common thread: the perception that market mechanisms would be unable to ensure poverty reduction. Each government offered its own idiosyncratic solution to control latent social pressure. Vast experimentation in social engineering led to a steady increase in the scope of government intervention in the economy, drastic changes in the structure of property rights, a slowdown in economic growth and mounting terrorism (Webb, 1988).

The import substitution strategy

The downfall of the primary-export model came in spite of its good macroeconomic performance. During the first Belaúnde administration (1963-68) growing international political awareness, a characteristic of the sixties, led to increased political participation of middle class Peruvians. Although it had voting rights, in practice the majority of the rural population (the campesinos) was excluded from the political system, but their social and economic circumstances became a subject of national concern. The middle class started to question the structure of land ownership, the role of foreign capital and the poor quality of social services. While Belaúnde promoted some local industry for import substitution, the following military regime of General Velasco Alvarado, who took over government in 1968, was clearly influenced by the mood of the revolutionary year 1968.

Addressing society's call for change, he guided Peru to embark on an import substitution strategy. Peru did that in the most uncompromising version of the continent. Some of Velasco's policies (i.e. the Agrarian Reform) received international appreciation. This support strengthened his belief in radical economic measures, such as imposing a high degree of protection on the domestic market and the nationalisation of most foreign-owned interests, as well as a transfer of part of the assets of the oligarchy to the state. In less than two years time, the state built up control over 30 per cent of the GDP and became responsible for over three quarters of exports, half of imports, two-thirds of the bank credit and one-third of all employment (Dancourt, 1999:54). The strong protection of the manufacturing industry resulted initially in economic growth and expanding employment.

In 1979, complex multiple exchange rate mechanisms were introduced leading to a revival of local private industry. Between 1979 and 1982, there was even a kind of trade openness. But the second Belaúnde government (1980-85) faced a serious balance of payment crisis in combination with the international debt crisis. He put an end to the liberalisation of imports (Dancourt, 1999:54).

When the young and charismatic Alán García was elected president in 1985, he started to implement the economic programme that had been the subject of his electoral campaign. This so-called heterodox programme aimed at 'jump-starting' consumption (it assumed that the reaction would be investment in productive capacity) through large injections of public resources into the economy. Combating poverty by improvement of purchasing power and combating unemployment by job creation, in addition to investments in health and education would all lead to demand-induced growth. Price controls, along with broad-based subsidies and transfers were introduced with the explicit aim to protect the poor. Without a sufficiently developed tax revenue system, the necessary public resources for such an injection in the economy had to come from two sources only: bilateral grants and the reduction in foreign debt service payments to 10 per cent of the export earnings.

These policies fostered rapid economic growth in the short run, but the unsustainability became evident by mid 1987, when inflationary pressure and a widening budget deficit became insurmountable problems (Glewwe and Hall, 1992:11). Both public and private international creditors blacklisted Peru after president García announced his intention to restrict debt service to 10 per cent of export earnings. After a package of policy measures (‘el paquetazo') in 1988, social unrest caused the collapse of the economy. The government’s financial obligations could only be met by monetary expansion. Inflation soared to 1,720 per cent in 1988 and to almost 9,000 per cent at the moment of the change of government in July 1990.

Between 1987 and 1990 per capita production had declined by 25 per cent, the real minimum wage by 60 per cent, the poorest urban population had lost 62 per cent of their consumption level. While in 1985 about 15 per cent of the population of Lima was considered to survive below the poverty line, this had increased to over 50 per cent in 1990 (Glewwe and Hall, 1992:12). Under these circumstances, extreme political organisations, like Shining Path (Sendero Luminoso) and the Movimiento Revolucionario Tupac Amaru (MRTA) gained influence. Bomb attacks and political assassinations destabilised the state. The army lost control over large parts of the national territory.

1.2 The build-up of Peru’s external debt

Peru's Total Debt Stock (EDT) comprises both Long-term (LDOD) and short-term debt. Long-term debt consists of public and publicly guaranteed debt and private non-guaranteed debt. External debt is composed of multilateral, bilateral and debt to private creditors. This latter category is also known as public commercial debt. This report deals mainly with the Public and Publicly Guaranteed (PPG) debt.

The pattern of long and short-term debt shows some expansion of the short-term debt during the late 1970s. When the economy ran into problems by the end of the 1980s, the public sector had to make use of more expensive short-term, and mainly domestic, loans.

Bilateral debt originates from loans from governments and their agencies (including central banks), and direct loans from official export credit agencies. The bilateral debt may be contracted at concessional or commercial conditions. Peru serviced its bilateral debt on schedule up to 1983. After 1985 only 10 per cent of export earnings was used for debt servicing and it was government’s policy to give priority to the multilateral debt service. In 1987 all servicing to bilateral sources were put on hold, so arrears accumulated swiftly.

The *multilateral* debt consists of obligations to multilateral creditors. In the case of Peru these are mainly the International Bank for Reconstruction and Development (IBRD) and the Inter-American Development Bank (IDB). In some definitions, obligations to the IMF are considered part of the multilateral debt; others prefer to consider this a separate category. In any case, IMF financing is not considered as aid.

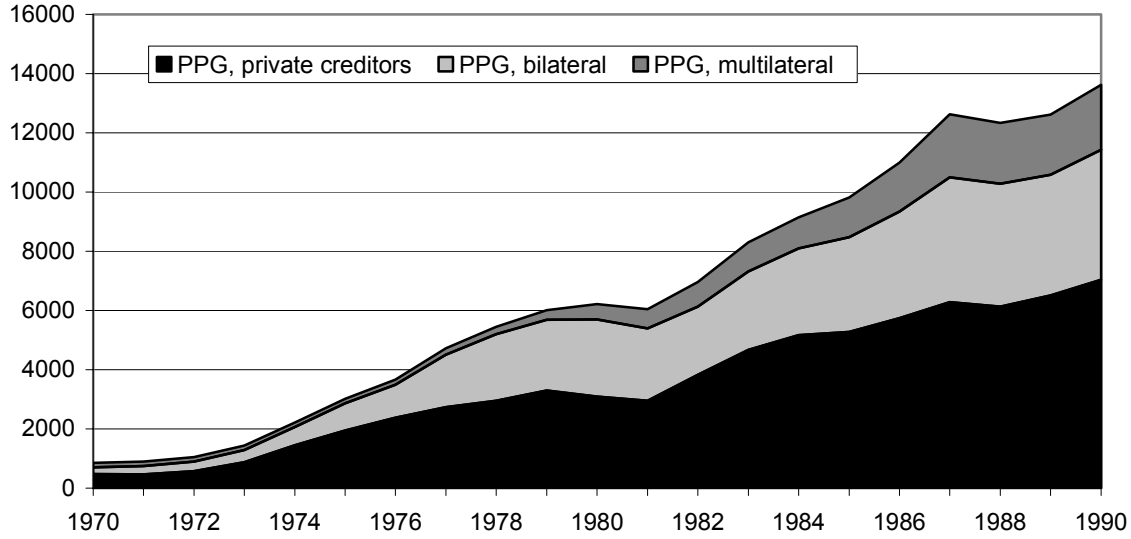
During the 1950s and 1960s investments were made in infrastructure works. The contracting of external loans for that purpose was on a project-by-project base. External loans were contracted mainly from private creditors. When Peru started to nationalise part of its industry, private banks became reluctant to issue new credits, and Peru became more careful as well, as interest rates increased. Since some of Velasco's policies were supported by the World Bank and bilateral donors, the IBRD and bilateral creditors quadrupled their credits over a five-year period. In later years, bilateral donors strengthened their development ties and provided both development assistance loans and mixed credit schemes.

When Peru announced that only 10 per cent of the export earnings would be used for debt service, it also indicated it would give priority to servicing the multilateral debt. In May 1987 Peru even suspended service of its multilateral debt. As a result the International Monetary Fund, the World Bank and the IDB suspended their disbursements on existing lending programmes. The number of 'active' Bank projects at the time was nineteen (19); by the end of the decade this had decreased to only five (5) (IBRD, 1991:4).

Private creditors consist mainly of commercial banks and sometimes, suppliers. In 1985, Peru became blacklisted. Peru first slowed down and subsequently discontinued (1987) servicing its debt to private creditors**.**

The composition of the debt stock over the period 1970-1989 is presented in the following figure.

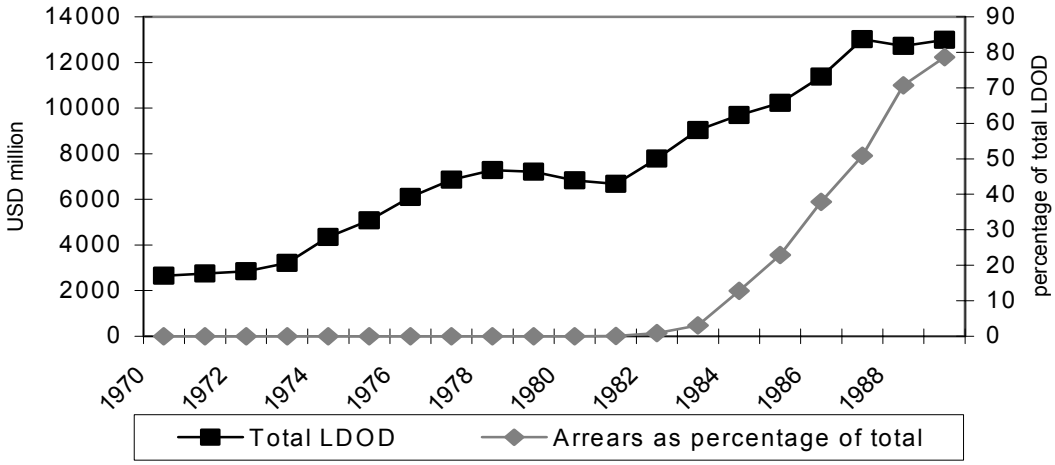
Figure 1–1 Composition of Public and Publicly Guaranteed Debt, 1970–1990 (USD million)



Source: Based on World Bank, 2001.

This figure shows a continuous increase in the debt stock. After 1983, this is attributable mainly to the accumulation of arrears.

Figure 1–2 Accumulation of arrears (USD million and per cent)



Source: Based on World Bank, 2001.

Table 1–1 indicates that no gradual trends can be identified in the internal composition of Peru's external debt. Apart from the general increase in indebtedness, the changes are attributable to specific periods in the economic policy, related to changes in access to the various financing sources.

The total public debt stock of USD 654 million in 1970 increased by 840 per cent during the decade 1970-1980 and doubled during the decade 1981-1990.

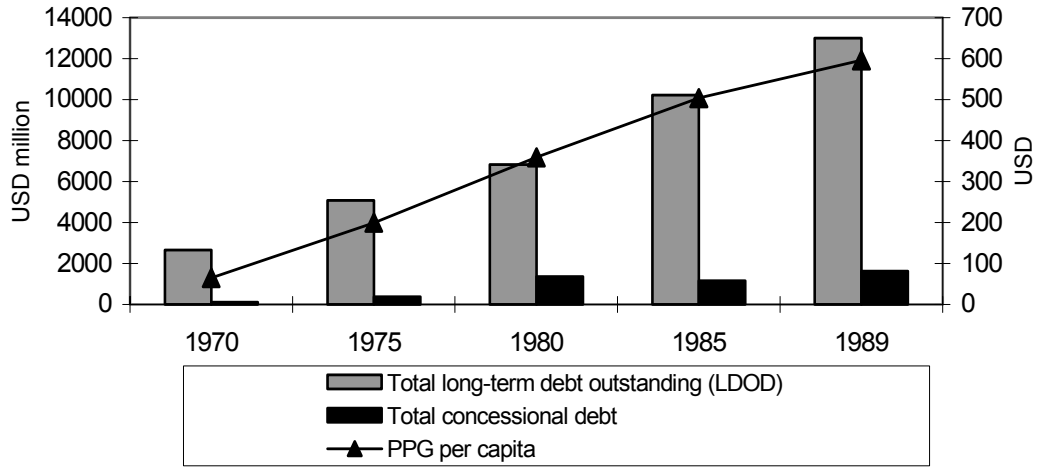
Table 1–1 Development of the public and publicly guaranteed debt 1970-1990, excluding arrears (USD million and per cent)

Year	commercial	Per cent	bilateral	Per cent	multilateral	per cent	bonds	Total
1970	147.6	22.5	336.7	51.5	148.3	22.7	21.7	654.3
1975	1,266.5	46.5	1,299.6	47.7	157.4	5.7	2.4	2,723.5
1980	1,694.1	27.5	3,927.1	63.6	549.3	8.9	2.1	6,172.6
1985	3,005.2	34.6	4,193.3	48.2	1,494.4	17.2	0.8	8,693.7
1990	3,158.8	27.3	6,039.8	52.1	2,383.6	20.6	0.8	11,583.0

Source: World Bank, 2001.

Even after 1987, when debt service to bilateral debt was put on hold, Peru was still able to contract new bilateral (concessional development aid) loans. The concessional part in Peru's medium and long-term debt was small. On a per capita base, the increase of the debt was almost linear during the 1970s and 1980s from USD 100 to USD 600 per capita, as shown in Figure 1–3:

Figure 1–3 Public and publicly guaranteed debt: total and per capita



Source: Based on World Bank, 2001.

1.3 Conditionality and characteristics of external debt

The conditions imposed on external loans prior to 1984 were exclusively of a technical and financial-administrative nature. Conditions focused on Peru's own contributions regarding financial inputs, while relatively strict reporting requirements were imposed. Since credits were provided for specific, well-defined projects, financial and economic feasibility (cost-benefit analysis) was a key criterion. Little or no attention was paid to the policy context, nor to the sustainability of the investments. Conditions had to be fulfilled at several stages of the financing process: conditions for contracting, conditions for effectiveness and conditions for disbursement.

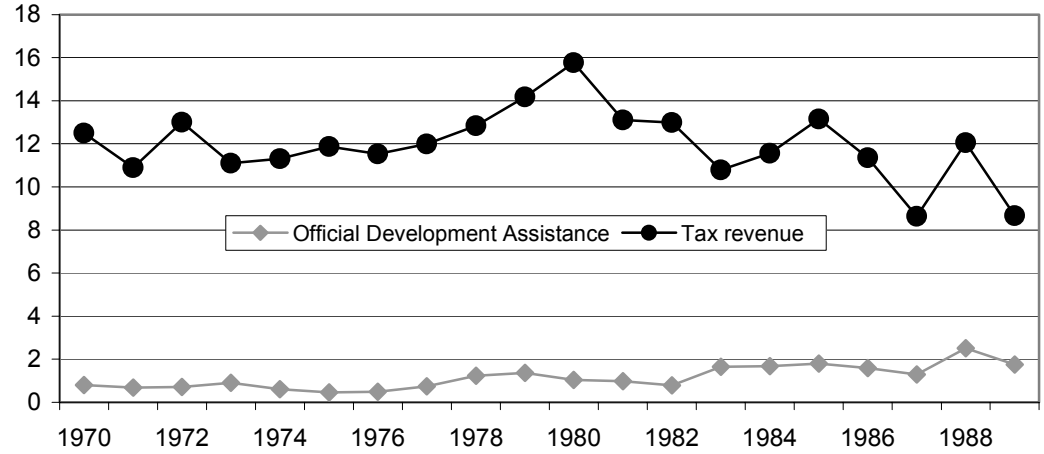
In addition, aid credits issued by bilateral and multilateral donors were conditioned only by project or programme progress criteria. Prior to 1990, Peru was not subject to 'policy-based lending', since there were no structural adjustment loans from the IMF, and only few sectoral adjustment loans from the World Bank.

1.4 Economic trends

The overall, economic trends described before can be illustrated with some indicators.

Official Development Assistance, although significant in itself, has been relatively small as compared to tax revenues. As can be observed from Figure 1–4 during the later years of the García regime, tax revenues deteriorated, while ODA became more important. Donors were concerned by the economic situation and started to finance development projects at the regional and local levels. Even when the García government embarked on impossible macroeconomic policies, bilateral donors pledged more development assistance, possibly motivated by the wish to compensate the population for the dramatic effects of these policies. The public budget depended more on external aid by the end of the 1980s than during the two decades before.

Figure 1–4 Tax revenue, and ODA as percentage of GDP



Source: Based on World Bank 2001.

At the start of the 1970s, foreign investments were negative as a result of the nationalisation process. Gradually new investments were made in industrial and service activities, mainly outside the traditional mining and agricultural activities. During the decades 1970-1990, foreign direct investments represented at most 3.5 per cent of GDP.

GDP growth fluctuated over the years, but came close to zero by the end of the 1980s.

At a first glance, there is no order in the pattern of imports and exports. However, imports increased in the years following growth in exports. Exports came under pressure from 1983 onwards. Imports had started to decline in the early 1980s, because the foreign exchange situation urged the government to impose import restrictions. When the second government Belaunde lifted these restrictions, imports increased again. In the second half of the 1980s, the effects of García's policy became visible: the large injections of public resources in the economy are reflected in increased imports**.**

Figure 1–5 Annual growth GDP, imports and exports, 1970-1989 (per cent).

Source: Based on World Bank, 2001.

1.5 Public external debt and debt sustainability

Before the 1970s, the share of private debt in the total external debt was about twice that of the public debt. Mining firms contracted most external debt. The turn around came in 1968, when the public sector started to nationalise enterprises, invested more in infrastructure and social services. By 1980, almost all major enterprises had been nationalised. Part of their debts had been taken over by the Treasury. In 1983, 1984 Peru slowed down its debt service and arrears accumulated. In 1985 it became policy to further restrict debt service, so arrears accumulated further. In 1987 all debt servicing was suspended.

Prior to 1985, Peru did have a system for domestic borrowing, but of minor significance only. Since access to external creditors was almost completely cut off (with exception of some bilateral development loans), Peru developed its domestic financial market.

The policy changes are clearly reflected in the debt sustainability indicators. As a reference, the debt service paid as a percentage of exports of goods and services (TDS/XGS) was well above the threshold level of sustainability in 1980 (20-25 per cent), and the suspension of debt servicing is shown in the 1989 data (World Bank, 1991). Although Figure 1–5 might suggest an improvement in debt sustainability, this was, obviously, not the case.

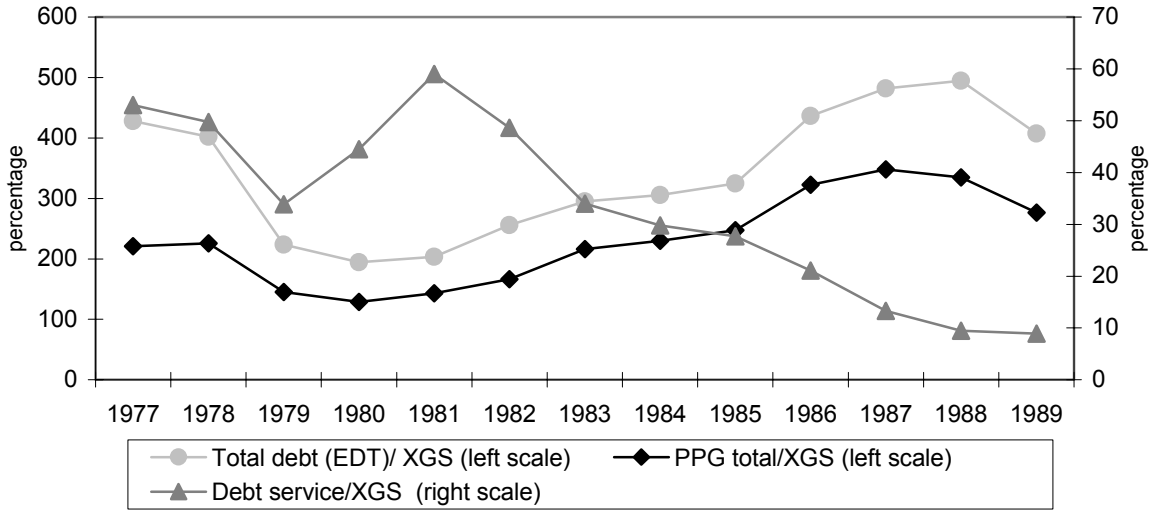
Table 1–2 Selected debt sustainability indicators 1977-1989 (per cent of XGS or GNP)

	1977	1980	1985	1989
Total debt service paid/ exports of goods and services (TDS/XGS)	53.0	34.0	27.7	8.9
Public and publicly guaranteed debt service/ exports of goods and services (PPG TDS/XGS)	30.1	31.1	18.0	5.9
Total Debt stock/ Gross National Product (EDT/GNP)	70.8	47.6	73.1	105.1
Total debt service/ Gross National Product (TDS/GNP)	8.8	10.9	6.2	3.3
Public and Publicly guaranteed debt service / Gross National Product (PPG TDS/GNP)	5.0	2.6	4.0	1.5
Interest/ Gross National Product (INT/GNP)	3.1	4.4	3.0	1.3

Source: Based on World Bank 2001.

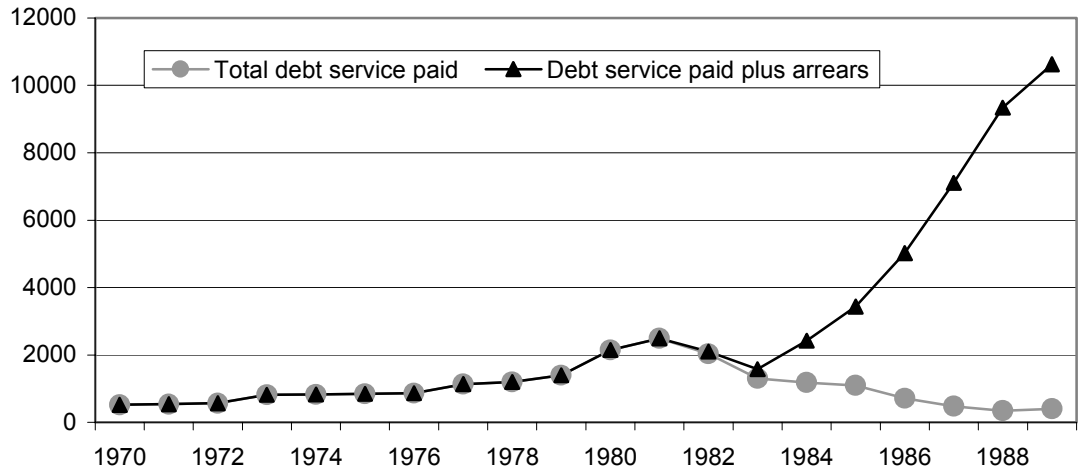
The debt service due over the period up to 1990 is not precisely known, but the sum of the debt service paid and the arrears has been taken as a proxy. Prior to 1979, Peru was a reliable payer of its obligations, although it lacked a central debt register. The state enterprises were not always fully aware of what they owed to creditors (mainly suppliers). When debt service paid peaked at USD 2,200 million per year (1980), the Treasury was confronted with the limits of its payment capacity. Servicing discipline slowed down and arrears accumulated. Debt service payments were deliberately delayed or postponed in order to limit them to a level of approximately USD 2 billion per year. After the 1985 decision to restrict servicing of external debt further, the arrears accumulated rapidly.

Figure 1–6 Debt and debt service-to export ratios



Source: Based on World Bank, 2001.

Figure 1–7 Debt service paid and arrears (USD million)



Source: Based on World Bank, 2001.

1.6 Net transfers on debt and aid flows

New investment may lead to economic growth. To that end it is essential to have a positive net financial flow. This positive flow can be achieved by either:

- export earnings exceeding expenditures for imports (positive balance of trade);
- foreign private investment;
- other transfers of capital from abroad (i.e. remittances);
- international (official) grants or loans.

In Peru, the trade balance showed swings between positive and negative, while private sector foreign investments were minor during the 1970s and 1980s, due to the nationalisation process. When international transfers became impossible and the banking system became nationalised in 1987, foreign investment came to a standstill.

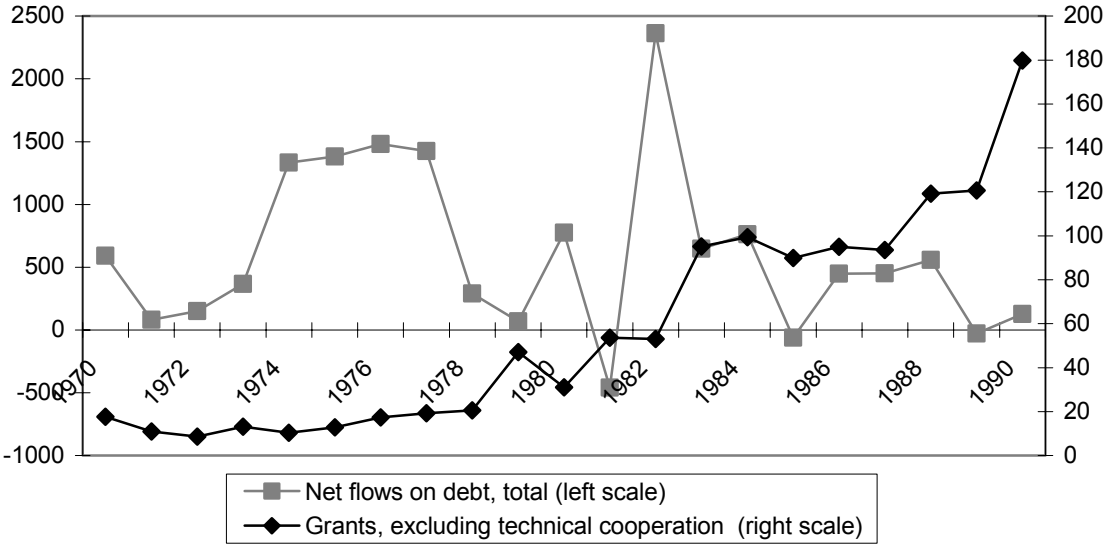
The net flow on debt and grants shows the importance of development grants at that time (Figure 1–7)

1.7 Debt relief before 1990

General Velasco Alvarado's (1968) ideas fitted well in the international political atmosphere at the time. Velasco requested a meeting with the Paris Club creditor countries with the aim to obtain some temporary liquidity 'room to manoeuvre' on the national budget for the implementation of his land reform plans. Both in 1968 (USD 120 million) and in 1969 (USD 100 million) the Paris Club authorised rescheduling. The interests became capitalised to the principal.

The Paris Club received Peru for the third time in 1978 and agreed on a rescheduling of USD 211 million, once more with capitalisation of the interest over the period of postponement of servicing.

Figure 1–8 Net flows on debt and grants (USD million)



Source: World Bank, 2001.

Prior to 1990, the rescheduling of debt by the Paris Club creditor countries was the only debt relief mechanism of importance for Peru. In addition, successive governments intended to settle dubious debts with external providers. Various of these debts originated in unpaid invoices by nationalised (para-)statal enterprises.

Peru's policy on debt management

During the nationalisation process, Peru had learned how to deal with debt to private creditors, since in most cases the nationalisation implied the incorporation of the enterprises' debt. The nationalisation process implied a substantial increase in the public debt to private creditors. Until the end of the 1970s, Peru was able to service all its obligations to these private creditors. Even when the interest rates started to increase at the end of the 1970s, the Belaunde 2 government intended to 'muddle through' in the hope of keeping access to the private creditors. The radical change came when Alan García required liquidity for the implementation of his heterodox reform programme. In 1987 debt servicing was put on hold, a policy lifted in July 1990, when Fujimori took over Government.

Official debt to private creditors.
In 1968, long before the international debt crisis, Peru renegotiated part of its debt to private creditors. The reason was that this debt had its origin in all kinds of uncontrolled and sometimes unrecorded deliveries to the former private companies. At the same time, the nationalisation process had scared the commercial banks and they wondered whether they would ever be able to recover their loans. They preferred negotiations to write-offs.

A decade later, a market had developed for 'secondhand' debt titles, that were traded at a discount. This discount was an indicator of the banks' confidence in the options of ever recovering the credits, as well as of the confidence in the country's economic performance. If this confidence was low, the discount was high. The following table presents some discount rates, comparing 1987 with 1991:

Table 1–3 Prices of debt titles of selected countries on the secondhand market (per cent of face value)

Country	1987	1991
Peru	6.00	11.00
Bolivia	11.00	16.00
Argentina	13.00	33.00
Nicaragua	1.00	--
Mexico	36.00	58.00

Source: IMF, 1992.

For Peru the discount amounted to 94 per cent in 1987, one of the highest at the time. This high discount was directly attributable to Peru's decision to restrict debt servicing, since in 1984 the discount rate was 'only' 46 per cent.

Paris Club creditors
The land reform of 1968 required large amounts of public resources. Since the compensation to landlords required a cash layout for only a short period in time, liquidity was required. The government approached the Paris Club creditor countries with the request to reschedule the debt portfolio to such an extent that liquidity would become available during a two-year period, by postponing debt service obligations. This was agreed upon in the first meeting of the Paris Club on Peru, which took place on 27 September 1968, when USD 120 million were restructured on so-called classic terms.

But Land Reform could not be implemented that quickly. The ownership of land could not always be determined also due an absence of a land registry. Once more Peru requested the Paris Club creditors to reschedule the payments due over 1969. This was agreed upon during the second meeting of the Paris Club (November 20, 1969), when US$ 100 million was rescheduled under classic terms.

Since there was some sympathy to Valasco's policy of Land Reform, the flow of bilateral credits quadrupled during the first five years of the 1970s. Bilateral donors strengthened development ties with Peru and provided new financial resources (aid loans, mixed credit schemes). Due to short grace periods (2-5 years) of some mixed credit schemes, the bilateral debt service obligations suffered from 'humps' in time. During the third meeting (called *Paris Club I*) on 3 November 1978, the Government of Peru requested to

smoothen out these humps over a longer period. USD 211 million was restructured accordingly.

With interest rates increased, debt service became a serious burden to the public budget. Contrary to other Latin American countries, like Bolivia, Peru never declared itself unable to service its debt. It did request support from the Paris Club creditor countries to extend grace and repayment periods. During *Paris Club II* (26 July 1983) USD 590 million was treated under the classic terms, while one year later, *Paris Club III* (5 June 1984) treated USD 640 million on the same conditions. The Netherlands participated in the Paris Club I, II and III (www.clubdeparis.org)

The1985 policy measures isolated Peru from the international financiers; the country was no longer eligible for assistance by the Paris Club.

The Netherlands contributions before 1990

The Dutch development loans to Peru have a long history. Approximately NLG 33 million was funded from the budget for development assistance, while some NLG 218 million was 'on lending' by the Netherlands of capital borrowed on the capital market. The objective of these loans varied from support to the fisheries sector (including the delivery of fishing boats) to support to the electricity company ENTEL. The majority of the loans were contracted between 1973 and 1979.

In 1990, Peru owed the Netherlands some NLG 325 million in aid loans and publicly guaranteed export credits, of which NLG 92 million pre-cutoff date (1 January 1983) aid loans (Ministry of Foreign Affairs files, 1996). The large official debt comprised the controversial transaction of the navy vessel 'Admiraal de Ruyter', converted into the 'Almirante Grau' by the Amsterdamse Droogdok Maatschappij (ADM). Although the Dutch Government 'sold' the Admiraal de Ruyter for a symbolic amount and supported the conversion and rehabilitation of the vessel (in an effort to guarantee employment in the Dutch shipyard industry) the vessel had sailed for Peru after payment for the ship, but not for the repairs. This contributed to the bankruptcy of the ADM. It is unclear how the Almirante Grau affair has been dealt with in terms of bilateral obligations, since two years later (1992), the files of the Ministry of Foreign Affairs refer only to NLG 159 million in aid loans and some NLG 25 million in export credits.

Restructuring of debt service obligations took place within the framework of the Paris Club meetings I, II and III.

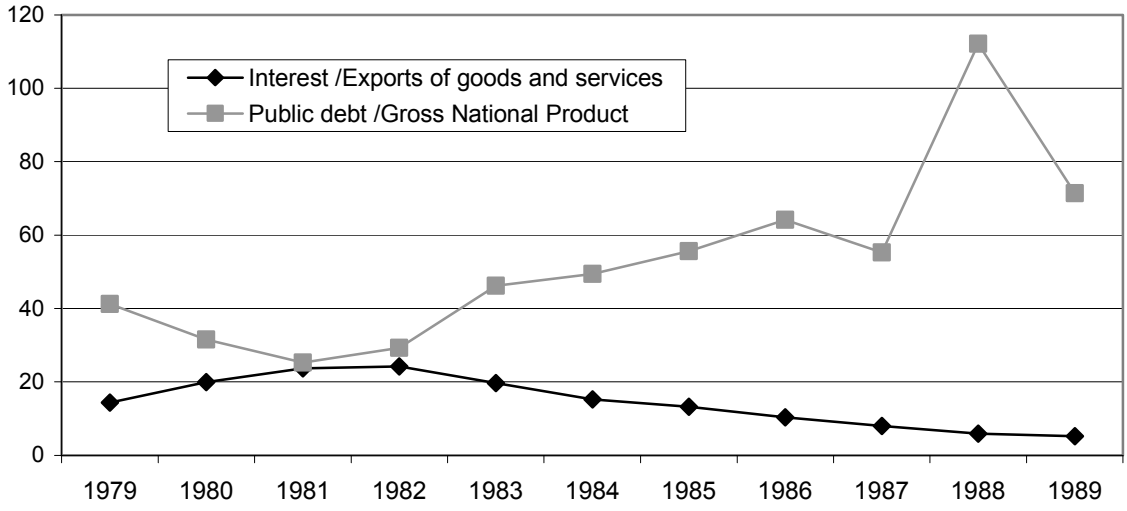
1.8 The nature of the debt problem in 1990

Debt has both liquidity and solvency aspects. A liquidity problem can be said to exist if there are large arrears and if the interest payment/exports ratio is at such a level that debt servicing cannot be sustained without affecting other payment obligations. Economic growth, increasing exports or increasing tax revenues may produce the means to service debt. Solvency problems occur when a country, even if it presents a reasonable economic growth, still does not have a sustainable debt profile. If there are liquidity, solvency or sustainability problems, it can be expected that debt relief, in principle, would be relevant and would contribute to solving the debt problem.

At the start of the debt crisis in 1982, the problem was internationally considered to be one of *liquidity* and not of *solvency.* In consequence, solutions looked for were capitalisation of interest, restructuring over time (Paris Club), and issuing of additional loans. But since the growth of the economies remained low, there was increasing awareness of the structural inability to meet debt service requirements.

At the start of the 1990s, the Peruvian debt problem was characterised by a large debt overhang and the accumulation of arrears. Peru's total external debt was USD 20 billion. Including arrears, over 98 per cent of the total external debt (EDT) was public or publicly guaranteed debt. Of this PPG debt over 50 per cent was owed to commercial banks and suppliers, 22 per cent to Paris Club creditors; and 16 per cent to the IFIs and 10 per cent to other bilateral creditors.

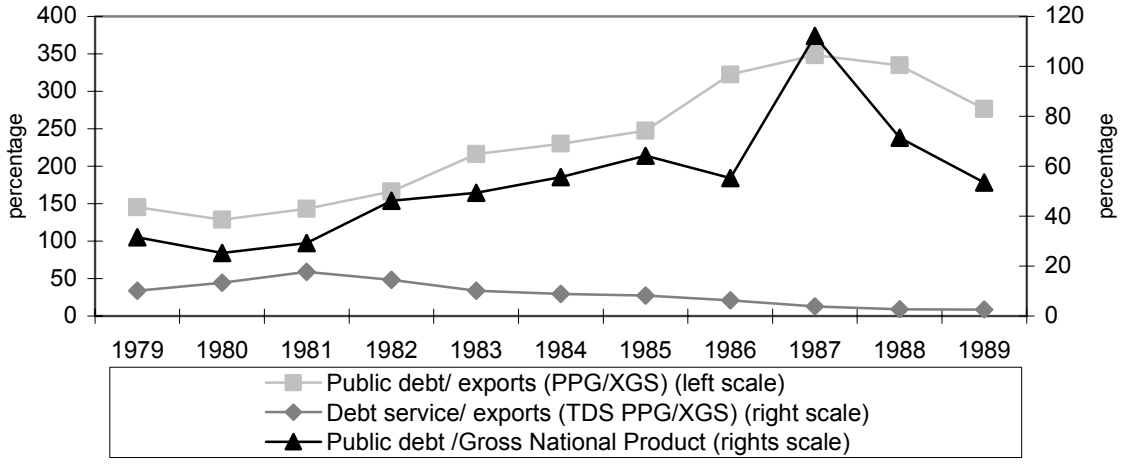
Figure 1–9 Liquidity indicators 1979-1989 (per cent)



Source: Based on World Bank, 2001.

After 1985, Peru reached a ratio of interest payments to exports earnings that was below the 15 per cent sustainability threshold. The reason is that the interest payments declined due to the fact that Peru deliberately restricted its debt service to a maximum of 10 per cent of the export earnings. In consequence, the total public debt increased due to accumulation of arrears. The arrears included USD 6.3 billion to commercial banks and suppliers; USD 4.8 billion to Paris Club members (including about USD 1.1 billion on post-cutoff obligations).

Figure 1–10 Solvency indictors 1979-1989 (per cent)



Source: Based on World Bank, 2001.

The arrears on the various categories of debt are shown in Table 1–4:

Table 1–4 External debt outstanding (USD million)

	1970	1980	1985	1990	Arrears (in % of debt due in 1990)
Total debt stocks (EDT)	3,211.3	9,385.8	12,884.0	20,063.9	62.1
Debt outstanding (LDOD)	2,655.4	6,827.9	10,223.0	13,959.3	65.9
Short-term debt outstanding	546.0	2,084.0	1,959.1	5,349.9	4.3
PPG, total	856.0	6,217.9	9,816.0	13,629.3	67.2
Multilateral as percentage of PPG	17.3	8.3	13.6	16.1	54.3
Bilateral as percentage of PPG	26.3	42.0	32.5	32.2	54.6
Private creditors as percentage of PPG	56.4	49.8	53.8	51.7	91.4

Source: Based on World Bank, 2001 and IBRD, 1991 attachment 1.

Since it was Peru's policy to give priority to service the multilateral debt (1984-1987), the arrears to private creditors accumulated more rapidly than the arrears to the multilateral creditors. Nevertheless, over half of the debt service due to the multilaterals in 1990 consisted of payment of arrears.

'When the Fujimori government took over, Peru was in a state of bankruptcy, disintegration, civil war and anarchy. Capital flight was massive, as was the migration of the intellectual elite (a target of the Shining Path movement) to the United States and Canada. Coca leaf production had become the informal survival kit of the economy, surrounded by open corruption and violence. Political violence claimed 3,000 – 5,000 lives a year.

The relation with all external creditors was disrupted. Peru had no access to IMF support, while on none of all World Bank and IDB loans disbursements had been made since 1985. The international banks had blacklisted Peru. The only – modest – means of external finance were the development assistance loans (and grants) and mixed credit schemes.

1.9 Trends in poverty and social indicators

Between 1975 and 1990, income per capita decreased with an average of 2.2 per cent per year, affecting more the population in the highlands (Sierra) and tropical lowlands (Selva) than that of the Coastal zone. In 1990, about 54 per cent of the population could be considered as poor (their consumption was below the income necessary to purchase a consumer basket defined as the poverty line) and 24 per cent of the people were extremely poor (without enough money to buy even basic food requirements) (World Bank, 1995:4).

Enrolment rates in Peru have been traditionally high. With over 90 per cent these are well above the Latin American average. Even in 1990, the enrolment rate was still 98 per cent. However, in areas hit by the political violence enrolment had crumbled to less than 50 per cent. The educational efficiency can be considered low. Only 43 per cent of the children in Sierra and Selva finished primary school in 1990, compared to 70 per cent in the Coast and Lima Metropolitan Area (World Bank, 1995:7). In 1990, about 93 per cent of all students lacked textbooks, with the majority of teaching personnel not being qualified.

In 1990, the life expectancy in Peru was some 10 per cent lower than the Latin American average, while infant and child mortality were twice as high. Acute malnutrition ('wasting') and chronic malnutrition ('stunting') hardly improved during the period 1970-90. While in Lima stunting affected 13.5 per cent of the children under five, this figure was 53.7 per cent in the southern Sierra. The average caloric intake fell dramatically between 1985 and 1991 (World Bank, 1995:9).

Table 1–5 Selected social indicators 1970-1990

	1970	1975	1980	1985	1986	1987	1988	1989	Average L.A. 1990
Poverty									
GNP per capita (USD)	1,090			950				920	3,320
national headcount index								54.0	
urban headcount index								50.3	
rural headcount index								68.0	
Health									
Population growth (annual %)	2.8	2.7	2.6	2.2	2.1	2.1	2.0	1.9	1.7
Birth rate, crude (per 1,000 people)	41.7	39	35.5	31.8		30.6			
Births attended by health staff (% of total)				44	49	78			
Contraceptive prevalence (% of women ages 15-49)					46				
Life expectancy at birth, female (years)	55.6	59.2	62.5	65.6		65.8			72
Life expectancy at birth, male (years)	52.4	55.5	58.4	61.1		62.1			66
Malnutrition prevalence, height for age (% of children under 5)		39.7		37.8				37.5	
Malnutrition prevalence, weight for age (% of children under 5)		16.1		13.4				16.1	10
Mortality rate, infant (per 1,000 live births)	108	96	81	72		68		55	37
Mortality rate, under-5 (per 1,000 live births)	178		126						47
Access to safe water (percentage)	47.0			53.0				60.0	80.0
Education									
Primary education, pupils (% female)	45.9		47.9	48.1					
School enrolment, primary (% net)	77.7		86.3	95.9			92.3		92
School enrolment, primary, female (% net)	74		89.1						94
School enrolment, secondary (% net)	26.8		45.7	49			49.6		
School enrolment, secondary, female (% net)	23.6		42.8						
Illiteracy rate, adult female (% of females ages 15 and above)	39.6	34.3	29.2	24.7	23.8	23	22.3	21.5	17.2
Illiteracy rate, adult male (% of males ages 15 and above)	17.3	14.3	11.7	9.7	9.3	8.9	8.6	8.3	
Illiteracy rate, adult total (% of people ages 15 and above)	28.4	24.3	20.5	17.2	16.6	16	15.5	14.9	15.5

Source: Based on WDI, 2001 and Ministry of Economy and Finance.

In 1990, only 9 per cent of the Peruvian economically active population could be considered as formally and fully employed, while 74 per cent was 'underemployed' (in practice self-employed).

Peru's position on the country list of the Human Development Indicators had dropped over the 1980-1990 period. In 1990, Peru occupied the 95th position on a list of 174 countries.

2 INPUTS: AMOUNTS AND MODALITIES OF DEBT REFLIEF (1990-1999)

2.1 A new president, the Support Group

An independent candidate of Japanese descent, Alberto Fujimori, won the 1990 presidential elections. The political movement Cambio 90 was his main support in Parliament, but it lacked a majority. The first Cabinet was composed of high level technocrats, amongst them economist Hernando de Soto and financial expert Carlos Boloña.

On August 8, 1990, ten days after his presidential inauguration, Fujimori adopted a package of bold measures (the so-called "Fujishock") to reduce the role of the State, to liberalise markets, to balance the budget and to improve commercial ties with the rest of the world. After five years of default on its external debt service, the Government made a determined effort to reintegrate Peru into the international financial community. These measures had three short-term objectives (IBRD, 1991:2):

(a) To stop hyperinflation. Stabilisation measures: price stabilisation through control on public spending, termination of monetary financing of the budget deficits, increase of gasoline prices (32-fold!), and elimination of price subsidies. Tax on wealth.
(b) To initiate structural reform. Removal of virtually all price controls, introduction of an unified exchange rate, the elimination of quantitative restrictions on imports, simplification of the import tariff system. The 1987 Law of Nationalisation of Banking was repealed.
(c) To alleviate the fiscal burden of the inherited crisis on wage earners and the poorer classes. Government provided an one-time bonus equal to a month salary to absorb the shock; it introduced an emergency social programme for food aid and medicine supply; and curtailed social programmes to the barest minimum.

The new government considered reintegration of Peru into the international financing community of primordial importance to the recovery of the Peruvian economy. As a first step, in October 1990, Peru resumed current debt service payments to the World Bank and the IMF and one month later to the IDB. Payments to commercial banks were not resumed. At that time the arrears accounted for almost two-thirds of the external debt (IBRD 1991:1,2). It was evident that the large protracted arrears to the IFIs would be an impediment to obtain new loans by the multilateral financiers.

According to IMF estimates (IMF, 1991), Peru's external financing requirements for the period 1991-1992 would total USD 18.4 billion. Rescheduling of debt service to official bilateral and private creditors could cover about USD 14.4 billion, while the Latin American Reserve Fund (FLAR)[1] was willing to contribute some USD 400 million. In the case the IFIs could account for arrears clearance strategies, then the remaining financing requirements were estimated at USD 1.3 billion (USD 500 million in 1991 and USD 800 million in 1992).

With Peru as a first case, in 1990 the IMF established the guidelines for a 'Rights Accumulation Programme' (RAP) under which a member in arrears to the IMF could earn rights towards a quick disbursement that would become available once arrears are cleared and upon approval of a successor IMF arrangement (in the case of Peru an

[1] The FLAR was created in 1978 by the Central Banks of Bolivia, Colombia, Costa Rica, Ecuador, Peru and Venezuela with a starting capital of USD 240 million. In 2000, the eighth round of pledges increased the capital to USD 2 billion. Bolivia and Ecuador are considered less developed countries and contribute less. The aim of FLAR is to provide credits to Central Banks in financial emergency situations.

Extended Financing Facility – EFF). Peru would be eligible for a two-years RAP valued at SDR 625 million provided the USD 1.3 billion could be cleared.

The arrears clearance would made Peru eligible for the RAP and the RAP would enable Peru to access an EFF agreement for USD 1.4 billion (later signed in December 1992). Once the EFF had been signed the World Bank would follow with a Sectoral Adjustment Facility (also December 1992) for USD 900 million. These arrangements were considered a prerequisite for any agreement with the commercial bank creditors.

The IMF suggested establishing an International Support Group to assist Peru in clearing its arrears. This Support Group would pledge resources to be deposited in a special account with the IMF. In April 1991, the United States and Japan co-chaired this Support Group and the first formal meeting was held in early June 1991. The USA indicated a contribution of USD 406 million, Japan USD 350 million, the Netherlands USD 20 million (NLG 40 million), France USD 15 million, Italy USD 15 million, Sweden USD 5 million, Belgium USD 3 million, Switzerland USD 10 million and Spain USD 55 million. Germany expressed interest, but did not make a pledge. The total amount pledged was insufficient to start up the RAP.

Simultaneously, and comparable to the IMF guidelines for the RAP, the World Bank elaborated its "Guiding principles for Countries with Protracted Arrears" (IBRD, April 1991). These guidelines comprised the following:

- the country must agree to and implement a structural adjustment programme with the Bank;
- the country must undertake a stabilisation programme, endorsed and monitored by the IMF or supported by its RAP;
- there must be an agreed financing plan for the country which provides for the full clearance of arrears to the Bank as well as for the normalisation of relations with other IFIs (where there are also arrears to them), and
- the country must continue to service Bank debt falling due during the pre-clearance 'performance period'.

In order to put pressure on the Support Group, the Government of Peru made one of its notorious radical moves: in June 1991 it stopped payments to the three IFIs, depositing the debt service obligations in a special account at the Peruvian Central Bank. The subsequent (second) meeting of the Support Group turned into a battlefield (Ministry of Foreign Affairs files, June 1991). The World Bank vice-president accused Peru of making unacceptable moves. The Peruvian Minister of Finance criticised the conditions of the World Bank's 'principles for countries with protracted arrears'. He argued that Peru – on its own initiative – had taken draconian stabilisation measures, endorsed ex-post by the IMF. In consequence, any additional measure imposed by the World Bank would be superfluous. After the meeting, Peru deployed its ultimate artillery: the (Peruvian) Secretary General of the United Nations. Javier Pérez de Cuéllar sent letters to all potential donors involved asking for support to Peru's position (Ministry of Foreign Affairs files). As a result of that effort, Germany indicated to make DEM 235 million available under the condition of a successful agreement with the Paris Club creditors. The World Bank softened its conditions.

In sum: a successful Paris Club agreement was pre-condition for Germany's participation in the Support Group. The Support Group's contributions to eliminate arrears (in part within the framework of the Paris Club arrangements) were condition to start a RAP agreement with the IMF. The RAP would trigger the EFF. A two–year EFF agreement was required for the World Bank to issue a Sectoral Adjustment Loan. Having re-established

the ties with the IFIs was a prerequisite for becoming eligible for debt negotiations with the private creditors under the terms of the Brady Initiative.

2.2 Bilateral debt

Reaching an agreement with the Paris Club creditors became of utmost importance for the re-integration of Peru into the international financial community.

The participants to the *Paris Club IV* (17th September 1991) were aware of this transcendental importance. The treatment given to Peru was far from the 'normal' terms and conditions.

The cutoff date for Peru was 1 January 1983. Usually any agreement with the Paris Club countries relate to the credits issued prior to that date only, while the servicing on post-cutoff date debt is supposed to be done according to the contractual obligations. Paris Club IV decided that all obligations in terms of interest and principal amortisation up to 31 December 1992, plus all arrears up to September 1991 could be included. So post-cutoff debt was included as well. Service obligations would be rescheduled and become payable during the period 2000-2007: a maximum of 15 years referral period for the commercial part and a maximum 20 year deferral period for the development assistance loans, counted from the original date of expected servicing. In total USD 4,661 million were treated under the so-called Houston terms (see Annex A). Debt swaps were encouraged up to 10 per cent of non-ODA and on all ODA loans on a voluntary base.

Regarding the post-cutoff debt, the payment of arrears was postponed for two years (payable starting July 1993 during a period of 6 years). In order to guarantee these payments Peru was obliged to deposit every month SDR 15 million in an account in the name of the Paris Club.

Since it was the Paris Club IV's intention to assist Peru in getting access to multilateral support as soon as possible, some of the arrangements were rather ad-hoc. In 1993 (4 May), the Paris Club considered once more Peru's debt situation. (*Paris Club V).* The Houston terms were applied again and the options to conduct debt swaps were extended. In total USD 1,884 million were treated at the time. By the end of 1993, Peru had managed to get rid of all arrears to Paris Club creditors (Banco Central de Reserva del Peru, 1996), while during the period 1993-1995 Peru yearly paid USD 350 million in debt service to Paris Club creditors.

Although Peru had lobbied intensively to get a debt reduction treatment by the Paris Club, the intention of the *Paris Club VI* creditor countries (July 20, 1996) was to come to an exit agreement, based on restructuring of debt only and NOT on reduction of debt[2]. The meeting took place immediately after Peru agreed with the IMF on a follow-up programme to the EFF (1 July, 1996). This Paris Club meeting was dominated by the preparations for a Brady arrangement with the commercial creditors. The IMF insisted on a flexible arrangement in order to free sufficient resources for Peru to enable it to finance its part of the Brady deal. Once more, the Paris Club countries entered into unusual constructs, resulting in a menu of options. Although formally an exit agreement, the door to future arrangements was deliberately left open. The Netherlands' delegation stressed the point that Peru was expected to face a 'hump' in its servicing obligations (as a result of the Paris Club arrangement 1991) between 2000 and 2005 (NCM files). The total amount treated was USD 6,723 million, including all maturities falling due between April 1996 and

[2] Peru did not qualify for debt reduction, because it is not an IDA-only country. However, the Peruvian Minister of Finance visited all Paris Club member countries stressing the point that other middle-income countries, like Poland and Egypt, had benefited from a stock-of-debt reduction.

December 1998. The Houston terms were applied, but options were left open to enter into debt swaps and voluntary additional arrangements on the concessional bilateral loans.

In sum, with the Paris Club creditor countries no debt reduction arrangements were agreed upon, only debt restructuring. However, the option to enter into specific arrangements regarding the concessional debt, including stock reduction or total forgiveness, was left open to each creditor.

Non Paris Club creditors
Peru had bilateral debt to a number of Latin American countries amounting USD 450 million and debt to Eastern European countries (USD 140 million). When Peru resumed servicing its debt, the Latin American debt was included, but payment to Eastern European countries was postponed. It was only in 1996 that Peru settled its debt to the Russian Federation, while in 1997 arrangements were made with other non-Paris Club bilateral creditors.

2.3 Official debt to private creditors

Apart from minor exceptions, no payments to commercial banks had been made since 1984. By the end of 1993, the stock of debt owed to these banks reached USD 7.1 billion, of which 85 per cent was medium and long term and 15 per cent short term (Republic of Peru, 1994:16). It was estimated that past due interest on the medium and long-term commercial bank debt reached USD 2.9 billion, or 44 per cent of this debt. Unless GDP would grow over 7 per cent a year, the debt-GDP ratio would continue to rise due to accumulation of arrears on commercial debt alone.

Between 1991 and 1995, the privatisation process required a continuous process of conversions, and changes in the official debt to private creditors. In some cases, the sales comprised the debt to commercial banks and suppliers, in others the debt remained with the Peruvian state. Prior to the Brady arrangement, the Government had privatised 33 state-owned enterprises (World Bank press release May 1994). In the meantime, the privatisation process itself and the strengthening of the economy implied an increased confidence by the banks, evidenced by the fact that the discount of debt papers on the secondary market had dropped substantially, from 94 per cent in 1989 to 53 per cent in 1993, which made debt buyback mechanisms more expensive (Republic of Peru, 1994:16).

In October 1995, Peru reached an agreement with the Advisory Committee of private creditors on the main terms of a debt and debt-service reduction operation (DDSR) by means of an arrangement on Brady terms (see Box 2–1) covering USD 7.9 billion of commercial debt, including USD 3.7 billion of past due interest (PDI). Creditors had been given the option of either selling their claims to the government through a debt buyback scheme or exchanging eligible principals for discount bonds, par bonds or front-loaded interest reduction bonds (FLIRB). The agreement called on Peru to make an immediate down payment of USD 225 million on PDI, while making all interest payments due during the entire period of implementing the arrangement (USD 22 million) (IMF 1997:9). For its implementation an initial financing (up front) of approximately USD 1.3 billion was required, of which Peru could fund USD 550, while the remainder had to be assumed by IMF, World Bank and the IDB.

Late December 1996, creditors accounting for 99 per cent of claims had expressed their commitment to participate in the Brady operation. Creditors with claims equivalent to 30 per cent of eligible principal opted for the buyback, 43 per cent for FLIRB and 22 per cent for the discount bonds, 5 per cent for the par bond (see box 2–1).

Box 2–1 Type of bonds in the Brady deal

- *Par and discount bonds have a 30-year maturity with a fully collaterised (zero-coupon US Treasury obligation) bullet repayment. The below-market interest rate on the par bonds rises progressively from 3 per cent initially to 5 per cent by the twenty-sixth year. The discount bonds were issued at a face value equal to 55 per cent of principal exchanged and carried a 0.8 per cent spread over the six-month US dollar LIBOR.*
- *The FLIRB had a 20 year graduated repayment period beginning on the eighth anniversary. They carried a below-market interest rate through year ten and a market related rate (six-month US dollar LIBOR plus a margin of 0.8 per cent a year) thereafter Interest payments on the FLIRB are guaranteed by a six-month rolling guarantee for the first ten years.*
- *The stock of past due interest (PDI) was exchanged for graduated repayment bonds with a 20-year maturity and a 5-year grace period. Interest is below market interest rate for the first ten years and will be equivalent to the six-months US dollar LIBOR plus a margin of 0.8 per cent thereafter. These bonds do not bear guarantees*.

Source: IMF, 1997.

The buyback required USD 940 million; the purchase of guarantees USD 180 million and the down payment on PDI USD 225 million. Peru indicated the use USD 545 of its own resources (about 41 per cent of total costs), while IMF, World Bank and IDB would each contribute with USD 233 million. The remainder (about USD 100 million) had to come from bilateral donors. The July 1996 arrangement with the Paris Club creditors was meant to produce results in such a way that it would 'free' this USD 100 million at short notice, enabling Peru to cover the financing gap (IMF 1997:10). Still, a special loan from the World Bank was required (USD 183 million). Finally, the following arrangement was achieved:

It took the Peruvian Central Bank over two years to identify most (98 per cent) of the private creditors. Many of those got a free ride during the Brady arrangement. Suppliers might have written off or simply forgotten about claims already a long time ago.

It took the Peruvian Central Bank over two years to identify most (98 per cent) of the private creditors. Many of those got a free ride during the Brady arrangement. Suppliers might have written off or simply forgotten about claims already a long time ago.

Table 2–1 The Brady operation (USD million)

1	Total Eligible debt	7,925
1.1	Eligible principal	4,183
	Buyback	1,265
	Exchanged for new par bonds	191
	Exchanged for new discount bonds	948
	Discount (debt reduction)	427
	Face value of new discount bonds	521
	Exchanged for FLIRBs	1,779
1.2	Eligible interest arrears	3,742
	Eliminated through buyback	1,207
	Eliminated through cash down payments	225
	Exchanged for PDI bonds	2,310
2	Total cost of DDSR operation	1,345
	Cash payment of interest arrears	225
	Collateral	181
	Par bonds	38
	Discount bonds	114
	FLIRBs	29
	Buyback	939
3	Financing of SSDR operation	1,345
	Official Support	800
	IMF (incl. set-asides under stand-by and augmentation)	465
	Inter-American Development Bank	233
	World Bank (incl. set-aside under SAL II)	283
	World Bank DDSR loan	183
	Bilateral financing (Paris Club)	100
	Peruvian resources	545

Source: based on IMF 1997: Appendix V.

2.4 Multilateral debt

Up to 1990, the World Bank had disbursed 65 loans to Peru for a total amount of USD 2,201 million (IMF,1997:33). Peru's arrears to the World Bank totalled USD 924 million, including late payment charges. The IDB had 116 loans fully disbursed at the start of the decade for a total amount of USD 2,183 million (IMF,1997:35)

In October 1990, the World Bank sent an introductory mission to Peru in order to re-establish relations with Peru in formal terms. Payment of current debt service due was resumed that same month, while debt service payment on IDB debts was resumed in November 1990.

With the assistance of the Support Group, Peru achieved the clearance of all arrears to the multilateral financiers between 1991 and 1993. Although additional lending was made available and a restructuring programme was worked out to deal with the arrears between 1991 and 1993, no real multilateral debt relief mechanism was applied.

In the course of time, in particular in 1992, as well as prior to the start of the Brady deal in 1996, some bilateral donors –amongst them the Netherlands- assumed the payment of

multilateral debt service on behalf of Peru. In December 1992, the Netherlands Government made NLG 18.5 million available to the World Bank in order to assist the Government of Peru in meeting its principal and interest payments to the IBRD.

In general, it can be stated that the multilateral debt relief was almost absent, since Peru is a middle income country and not eligible for multilateral debt relief. Bilateral donors contributed in paying arrears and assumed debt service obligations on multilateral debt on behalf of Peru.

2.5 Motives for debt relief 1990-1999

Regarding the motives for international support to reduce the debt burden on Peru's public budget, these can be distinguished at two moments in time.

Firstly, in 1991-92, support was entirely focused on stabilisation of the economy and the re-integration of Peru into the international financial world. All arguments were of a macroeconomic character. The anti-inflation policy predominated.

Secondly, in 1996/97 also macroeconomic considerations were mentioned, but much more attention was paid to issues like poverty alleviation, as well as to the elimination of coca and cocaine production (compliance with the United States' certification system).

Table 2–2 presents some of the motives and conditionalities for debt relief assistance in the 1990-1992 period and in the Brady Deal.

In 1996, the Peruvian authorities proposed to create a counterpart fund for poverty alleviation and environmental protection to be fed with resources emerging from debt swaps by the Paris Club Creditors. The example used was that of the Peruvian-Swiss counterpart fund. The Peruvian proposal comprised two types of debt conversions:

- debt-for-development swaps;
- debt-equity swaps.

Peru argued for stock of debt reduction through debt-for-development swaps (Republic of Peru, 1996): The resources freed could then be used for the financing of three sets of activities

- the implementation of the poverty reduction programme (mainly FONCODES and justice projects);
- environmental programmes, and
- drugs control (amongst others through ‘alternative development’ projects).

Paris Club members Germany, Canada, Finland and Switzerland converted up to USD 300 million of their claims into contributions for the counterpart funds for poverty reduction and the environment. The USA swapped USD 180 million for drugs control programmes. The Netherlands and the United Kingdom decided to forgive the debt service without requiring any swap.

Table 2–2 Motives and conditionality in main debt relief agreements

Area	Policy/target	Re-entrance IFIs 1990-92	Brady arrangement
Macro-economic	Stock of international reserves	yes	yes
	Government deficit (% GDP)	yes	no (no deficit)
	Government expenditure (% GDP)	yes	yes
Economic reforms	Tax reform	yes	No (implemented)
	Public sector reform	yes	no
	Composition of public expenditure	no	yes
	Privatisation	yes	no (implemented)
	Liberalisation of goods markets	yes	no (implemented)
	Liberalisation of foreign trade	yes	no (implemented)
	Liberalisation of labour market	yes	no (implemented)
	Financial liberalisation	yes	no (implemented)
	Other sector reform	no	yes (social)
Political reforms	Elections	yes (Congress '92)	yes
	Multiparty system	no	no
	Human rights observance	no	yes
	Independent judiciary	no	yes (fragile)
	Free press	no	no
Governance	Transparency of budgeting	no	No
	Transparency of budget execution	no	yes
	Accountability	no	no
	Anti-corruption measures	no	no
	Establishment of and respect for audit office	no	no
	Decentralisation	no	yes (incipient)
	Participation	no	no
	Control on coca production	no	yes (certification)
Poverty reduction	Social expenditure	yes (reduce!)	yes (increase)
	Social sector reform	yes	yes
	Quality of social service delivery	no	yes

2.6 Netherlands contributions to debt relief

In the period 1990-1992, all Dutch contributions should be considered as elements contributing to the donor-supported effort by Peru to regain access to the international financial world. The Dutch contributions consisted of:

- direct payments to the Support Group, aimed at reducing arrears on multilateral debt ;
- contributions in the context of the Paris Club;
- in addition to Paris Club agreements, relief on bilateral debt to the Netherlands.

Direct contributions to the Support Group were made in 1991 and 1992. The total Dutch pledge to the Support Group was relatively high (in 2 years time NLG 40 million). Various groups in the Dutch society expressed criticism, because Peru had never paid for the costs of the rehabilitation of the navy vessel Almirante Grau[3].

[3] The total costs to the State of the Netherlands as a result of this affair had accumulated to some NLG 520 million (Ministry of Foreign Affairs files, April 1992 and NRC 15 July 1991).

In the context of the Paris Club, the agreement was to restructure debt and – on a voluntary base **–** to forgive arrears as much as possible, in order to enable Peru to get 'on-track' in 1992. At the start of the decade outstanding bilateral principals on aid debts amounted to NLG 33 million. The arrears over the period 1985-90 had accumulated to NLG 65.5 million. These arrears debt service, were forgiven in two tranches, the first of NLG 32.8 million in 1991 and the second of NLG 32.7 in 1992.

In addition to the forgiveness on arrears, the Netherlands forgave the 1991 and 1992 debt service obligations (amortisation and interest) to the amounts of NLG 13.2 and 11.6 million respectively. The combination of forgiveness of arrears and of current debt service implied that Peru became 'on-track' by end 1992. The remaining principal in 1992 was 159 million (excluding the Almirante Grau affair).

Over the decade, the Netherlands supported the Government of Peru in reducing its external debt in a variety of forms. There were contributions to pay the multilateral debt service, but most support was provided to the reduction of the bilateral aid debts. The Netherlands did not contribute to the Brady deal, apart from its participation in the USD 100 million contributions through the Paris Club agreement (see Table 2**–**1). The contributions are summarised in Table 2**–**3.

All contributions for debt relief were financed from the aid budget of the Dutch Ministry of Foreign Affairs, either the macroeconomic support programme or the Andes programme. All contributions were paid from category 1-d (macroeconomic support) with exception of two cases: NLG 14.6 million of the Dutch contribution to the 1991 Support Group and the reduction of the bilateral debt in 1996 (NLG 5.8 million) were paid from the Andes budget (total NLG 20.4 million).

In the Paris Club 1996 agreement, countries like Germany and Switzerland opted for a debt-swap for the social fund FONCODES. The Netherlands and the United Kingdom decided to forgive the debt outright, but assumed that the resources freed to the public budget of Peru would be used for the same purpose.

The files of the Ministry of Foreign Affairs show a growing concern for the net ODA flow. From 1996 onwards, the concern for the ODA flow was aggravated by the fact that the Netherlands had started an exit programme for its bilateral development co-operation programme with Peru and in 1998 Peru was eliminated from the list of structural bilateral aid relations. It was the minister's explicit wish to maintain a positive resource flow to Peru, but the instruments for doing so were few only.

From1994 onwards, the files of the Ministry of Foreign Affairs show increasing criticism of the forgiveness of debt service, mainly because the economy of Peru performed extremely well and Peru was considered able to service its debt.

In 1998, the Ministry of Foreign Affairs approved a multilateral debt relief transaction after the Consultative Group meeting, where the United States had pushed its 'War on Drugs'. While donors paid for multilateral debt service, the equivalent in US dollars had to be deposited in a special account for the exclusive use for drugs control and the so-called 'alternative development' programmes[4].

[4] The Dutch participation in this transaction is surprising, since:
-.The Ministry of Foreign Affairs has questioned the logic of countervalue funds several times and used to consider it 'double tying'. During the Consultative Group meeting for Peru in 1993 and 1995, the Netherlands' delegation argued against the use of countervalue funds (Ministry of Foreign Affairs files).

Table 2–3 Netherlands contributions to debt relief for Peru, 1990-1999

Year	Name of activity	type of debt	NLG	USD
1991	Forgiveness debt service b)	bilateral (aid loan)	13,200,000	7,059,956
1991	Contribution Support Group IMF/WB	multilateral (IBRD)	21,500,000	11,499,171
1991	Forgiveness 50 % on arrears debt service until 1990	bilateral (aid loan)	32,800,000	17,542,921
1992	Forgiveness arrears debt service until 1990	bilateral (aid loan)	32,700,000	18,595,394
1992	Forgiveness debt service	bilateral (aid loan)	11,663,000	6,632,357
1992	Contribution Support Group IMF/WB	multilateral (IBRD)	18,500,000	10,520,330
1993	Forgiveness debt service 1993	bilateral (aid loan)	13,310,000	7,166,703
1993	Forgiveness principals to SIMICs	bilateral (aid loan)	3,652,196	1,966,506
1994	Forgiveness debt service 1994	bilateral (aid loan)	12,490,725	6,864,315
1995	Forgiveness debt service 1995	bilateral (aid loan)	12,089,000	7,530,680
1996	Forgiveness debt service 1996	bilateral (aid loan)	11,842,430	7,023,563
1996	Reduction bilateral debt (Paris Club)	bilateral (aid loan)	5,839,173	3,463,123
1997	Reduction NIO – portfolio debt service	bilateral (aid loan)	11,021,419	5,549,402
1998	Reduction NIO – portfolio debt service bilateral 1998	bilateral (aid loan)	10,658,543	5,370,896
1998	Multilateral debt relief IBRD 1998	multilateral	10,000,000	5,039,053
1999	Reduction NIO – portfolio debt service bilateral 1999	bilateral (aid loan)	10,453,470	5,054,105
	Total		231,720,000	126,878,700

Source: Files Netherlands Ministry of Foreign Affairs.

Prior to 1996, the files of the Ministry of Foreign Affairs are relatively sketchy as far as the objectives and motives of the Dutch contributions to debt relief are concerned. Later, the contributions are accompanied by a more elaborated economic report, usually based on the most recent IMF Article IV Consultation. The Dutch motives and objectives for debt relief can be summarised as follows:

Bilateral debt

- improvement of the macroeconomic situation;
- improvement of the cash flow as a result of reduction of debt service;
- support to the stabilisation and reform programmes;
- support to the re-establishment of relations with the IFIs.

Poverty alleviation is mentioned in 1996 for the first time.

In 1999, the official bilateral debt of Peru to the Netherlands had been reduced to NLG 91.7 million. In these years the concern for the direction of the resource flow gained

- In its bilateral aid co-operation, the Netherlands never supported the so-called 'alternative development' activities as promoted by i.e. the United Nations Drugs Control Programme and the United States USAID.
-.Peru had indicated that the Drugs Control programme had come under the supervision of the national intelligence service and was to be implemented by the national anti-drugs division (Verslag van de Bijeenkomst van de Consultatieve Groep Peru 1998:3). At that time Amnesty International and other sources had reported serious violations of human rights by this anti-drugs division.

importance. In order to maintain a net ODA flow to Peru, the Ministry considered forgiveness of debt service part of the exit strategy for Peru.

It is remarkable that the Netherlands continued with current debt service forgiveness even after the Peruvian Government had declared itself able to service its debt (1997) and that it would not request relief anymore.

Multilateral debt
In general, the Dutch policy[5] on multilateral debt relief implies that its support should contribute to balance the debt service of a country with its capacity to pay. Multilateral debt relief may contribute to sustainable solutions. The first multilateral debt relief programme to Peru was launched because the country had hardly serviced it external debt for almost a decade. And there was a liquidity problem in resuming servicing, since the arrears had to be cleared first.
The Netherlands applied two main arguments for their support:

- the improvement of the macroeconomic situation and support to the stabilisation policy;
- the seriousness of the debt service situation.

In later years (after 1996) continuity in support is used as an argument and in 1998 the support to the War on Drugs.

On 5 April 1992, president Fujimori executed the so-called "auto golpe", a coup d'état in which he reduced the powers of both Parliament and the judicial system and attributed almost unlimited powers to the president. Bilateral donors considered free November elections for the National Congress a test case. The United States, president of the Support Group was of the opinion that financial support had to be postponed until democratic elections were held. The Netherlands adhered to that view. The second phase of support to debt service to IBRD (NLG 18.5 million) was postponed. After the elections, the Netherlands Embassy considered the Dutch contribution as 'a premium on the democratic elections' for the National Congress.

2.7 New loans and grants

During the period 1990-1999 the new loans were mainly contracted from the International Financial Institutions.

Table 2–4 New WB and IDB loans 1990-1999 (USD million)

Year of contracting	World Bank	IDB
1991		4.7
1992		21.1
1993	290.8	196.7
1994	284	484.5
1995	446.4	138.9
1996	90	752.8
1997	286	209.8
1998	38	558.8
1999	?	218.9

Source: IMF, 1997 and 2001.

[5] The Netherlands' policy on multilateral debt relief has been elaborated in the Report on Debt Strategy by the Ministers for Finance and Development Co-operation, presented to Parliament. 1992-1993, 22800V, nr.54 and in the Note on Multilateral Debt, August 1995.

Over the period 1993-1994 various new loans were issued, mainly for the privatisation process, the Social Investment Fund FONCODES, Basic Health and Nutrition, the Lima Water Rehabilitation Project and Primary Education for a total of USD 1,740 million. The IDB issued new loans for a total value of USD 760 million during the period 1990-1997. The new loans had the following characteristics:

Table 2–5 Features of official loans and grants 1990-1999

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Disbursements on loans*	169	837	385	1,452	605	684	441	1,765	780	1,229
Interest (per cent)	7.1	5.6	7.2	6.5	6.9	6.2	4.6	5.8	6.9	3.8
Maturity (years)	9.1	24.7	20.1	21.3	18.5	17.4	22.9	20.2	20.4	17.5
Grace period (years)	2.4	7.6	5.6	5.2	4.5	4.6	6.5	5.5	4.5	4.9
Grant element (per cent)	14	33.7	17.8	22.2	18.8	23.3	39.1	28.5	19	38.2
Grants	179.8	251.2	237.8	235.7	225.8	271.3	237.8	224.4	238.7	148.9

* = total disbursements, excluding food imports and defence.
Source: BCRP, MEF-DGCP and World Bank, 2001.

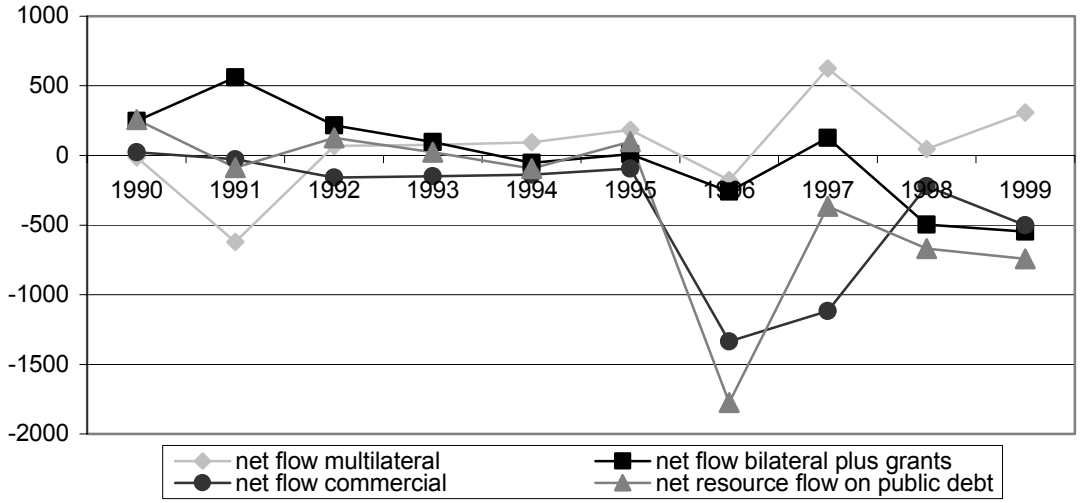
It should be observed that most of the new loans were project- or sector-oriented and, apart from the IMF assistance, they cannot be considered as policy-based lending. The following table shows the resource flow, comparing the debt service with the new disbursements.

Table 2–6 Resource flows on public debt by type of creditor (USD million)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Service public debt (total)	178	854	731	1,695	930	893	2,385	2,050	1,547	1,937
Disbursements on public loans (total)	337.7	289.4	533.6	631.3	1515.5	612.9	724.9	377.8	1517.5	639.1
Service on multilateral debt	51	660	404	1,236	406	446	446	501	513	580
Disbursements on multilateral loans	38.1	39.6	473.3	1312.2	499.5	630.7	268.9	1125.8	559.9	886.7
Service on bilateral debt	81	103	165	311	387	352	604	432	814	875
Disbursements on bilateral loans	148.7	411.2	143.6	171.5	109.3	89.1	105.3	334.1	78.8	178.1
Service private creditors debt	46	91	162	149	137	95	1,336	1,116	220	502
Disbursements commercial loans	68.9	64	3.2	0	0	0	0	0	0	1.4

Source: World Bank, 2001.

Figure 2–1 Net resource flow on public debt (USD million)



Source: Tables 2–5 and 26

The graph indicates that over the first half of the decade the bilateral and multilateral resource flows were positive and 'pulled' the overall resource flow to a positive level. By the end of the decade, debt service on bilateral loans started to exceed disbursements, while grants remained at a constant level or were reduced. This resulted in a negative resource flow during the second half of the decade.

2.8 Additionality of debt relief

Additionality can be considered from the perspective of the recipient country and from the perspective of the donor. Here, we restrict ourselves to the perspective of the recipient country.

Additionality is the amount of financial support a country receives that it would not have received otherwise. For example, it refers to the amount of debt relief on top of the 'regular' flows of development assistance.

By the start of the 1990s, development assistance to Peru had become rather erratic, with several donors questioning whether it made sense or not to continue implementing projects in Peru, under conditions of political violence and the chaotic macroeconomic situation. As a support to Fujimori's policies, bilateral donors resumed or increased their development assistance in 1990 and 1991 (see Figure 2–1).

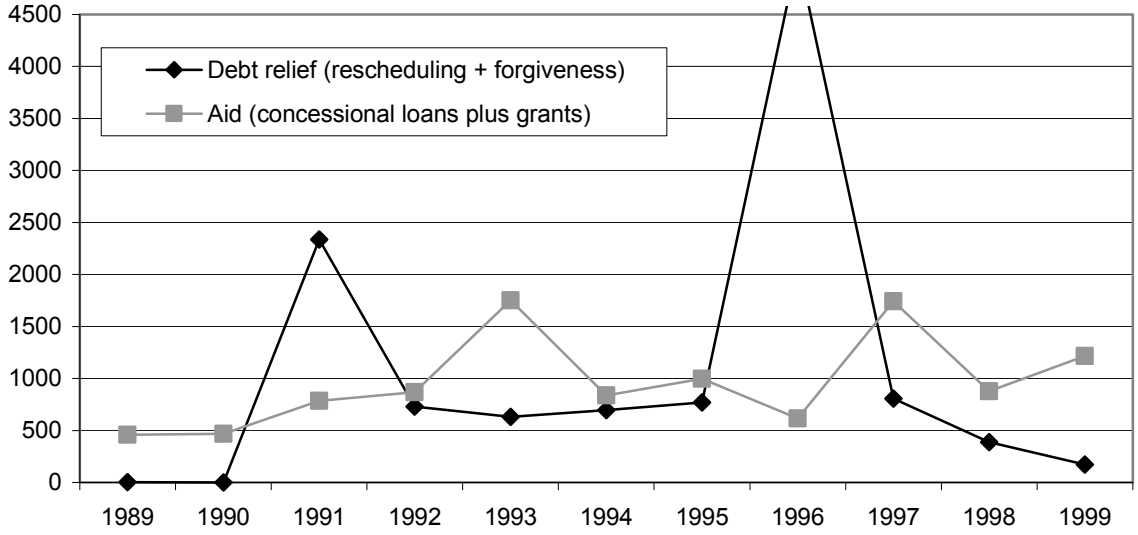
The 1991/92 contributions by the bilateral donors to the Support Group for almost USD 1.3 billion can be considered as additional. Possibly a small proportion of that amount would have been made available in the form of programme aid otherwise, but few donors would have made contributions of a similar magnitude. The case of Japan is illustrative. Its large contribution of almost USD 380 million to the Support Group was exceptional and can only be understood as emotional support to president Fujimori. Although the contributions by the Support Group are not precisely traceable in the GDF tables, some indication of the 'jump' in the relief curve is shown in Figure 2–1.

Most arrangements in the Paris Club (in particular 1991 and 1996) comprised restructuring of service obligations (and some swaps) but no stock-of-debt relief. Individual countries, like the Netherlands and the United Kingdom, have forgiven debt

service obligations on concessional loans. These may be considered as additional to the volume of grants they used to make available to Peru.

Comparing debt relief to total aid, there has been no substitution of aid by debt relief. Debt relief can be considered additional.

Figure 2–2 Indication of additionality: debt relief and total aid (USD million)



Source: Based on World Bank, 2001.

2.9 Extent to which debt relief implied bailing out

With respect to bailing out effects, the bilateral debt restructuring in the Paris Club, the arrears elimination in 1991/1992 and the Brady exercise in 1996/97 have been subjects of analysis.

Bilateral debt (Paris Club)

Since Peru is a middle-income county, it was eligible for restructuring, as well as for debt swaps, but not for debt reduction. For the bilateral debt swaps (mostly for nature, but also for social investments and drugs control programmes) a higher price was paid than justified by the market value. The difference between the market value and the price paid can be considered as a bailout. In a number of cases 67 per cent of face value was used as the indicative amount (Swiss counterpart fund), while the market value at the time was 40-53 per cent.

The Latin American creditor countries were bailed out by the agreements of the Paris Club members. The situation of some other Latin American countries, at the same time debtor countries to the Paris Club, were taken into consideration in the Peru arrangements and Peru resumed payments to these creditors (Bolivia, Argentina; see section 2.2)

In the Brady deal, the bilateral donors contributed to a bailout of private creditors, although the contribution of USD 100 million was only a minor part of the total financing of the Brady arrangement.

Multilateral debt

Although in 1990, multilateral debt service was 21.8 per cent of export earnings (the highest after Uganda and Nicaragua) it is remarkable that the multilateral financial institutions showed little creativity in assisting Peru in solving its arrears problem. The position was simple: Peru had to settle its arrears first, and if it did not have the resources for that, it had better look for donor assistance. Even when Peru had taken drastic macroeconomic measures, the World Bank on at least two occasions raised the threshold by insisting on additional conditions. Politically, the elimination of arrears in 1991 and 1992 was the most important debt arrangement to Peru. Although IMF and World Bank did contribute by restructuring loans and by issuing new ones, bilateral donors paid for USD 1.3 billion. Most of those bilateral donors were members the Paris Club. So these countries have forgiven not only the arrears on bilateral debt, on top of that they paid for the elimination of the arrears to the multilateral creditors. In this case, the bilateral donors bailed out the multilateral financiers.

Calomiris (1998) argued that the IMF and the World Bank always counted on being compensated by the (US) taxpayer's money, and that this contributed to a practice of making large loans at low interest rates to risky economies. By doing so, these institutions contributed to the general moral hazard of 'easy lending and borrowing'. In the tailwind of IMF arrangements all kind of bilateral and commercial credits become accessible to a country and indebtedness increases. At first, the local taxpayer is paying the price for that. Since tax systems are far from perfect, the middle class is the only 'taxable' group, which finally bails out other classes in society. Although multilateral lending has never represented a high share in the Peruvian debt profile, it did provide the legitimacy for several operations with commercial banks in the 1970s and 1980s. And, directly or indirectly, the Peruvian middle class did pay the price.

Debt to private creditors

The bilateral support to assist Peru in eliminating its large arrears – and through that **–** to regain access to multilateral financing had an impact on the price of debt papers on the secondhand market. The discount decreased substantially.

The Brady deal was the effort to take out approximately USD 7,925 million of commercial debt by buybacks, swaps and conversions into bonds. For the financing of that operation there was support from official creditors up to USD 800 million, of which USD 100 bilateral financing.

The Brady arrangement started rather late. The opportunity of a commercial bank to recuperate its 'dubious debt' is reflected in the discount at the face value of debt titles. For Peru, the discount had been approximately 94 per cent in 1990, but the re-integration of Peru into the international financial community, as well as its explosive economic growth had contributed to increased confidence of the banks. At the second hand market debt papers were traded at 47 per cent discount in 1996.

In the Brady arrangement for the buybacks an incentive of approximately 2.0 per cent was paid. This was relatively high; as compared to similar deals elsewhere. The 53 per cent over the face value was paid for at 55 per cent (IMF, 1997).

In the Brady deal the premium paid to private banks was at least USD 25.5 million (2 per cent over USD 1,275 in direct buybacks). But the real bailout might have been a different one. Calomiris (1998) argued that private banks had benefited from the recovery of the Peruvian economy. During the period of economic chaos of the late 1980s, private banks had written off bad debts and registered this loss in their balance sheets. So for several years, less profit tax had been paid in the country of registration. When the economy

recovered, the value of the written off debt papers started to increase again. On top of that, because Peru wanted to reorganise its commercial debt portfolio, the banks received USD 225 in debt service arrears, which they would never have received otherwise.

Since the bilateral creditors (the Support Group) contributed to the decrease in discount of private debt papers (apart from the late moment of the Brady deal), their contributions bailed out the private creditors. Similarly, the large influx of external resources from official creditors during the first half of the decade, enabled Peru to comply with its obligations to private creditors. The official creditors bailed out the private creditors.

Bail-in

During the preparation of the Brady arrangement and in the context of rapid economic growth during the mid 1990s, the issue of private sector involvement in crisis resolution (PSI) was raised (Republic of Peru, 1995). This issue became a hot debate in Peru, also because some international companies planned to make huge investments (Shell's Camisea gas exploration) and required public sector participation for doing so (i.e. infrastructure development). In the local press this was dubbed 'bail in', but the term was considered a bit too coercive. For that reason the IMF preferred 'burden sharing' and later 'private sector involvement in crisis resolution' (PSI). Although various efforts were made to get the private sector actively on board in the financing of the Brady arrangements, the government did not succeed in doing so (IMF, 1997).

2.10 Assessment

Peru came out of a deep recession caused by an economic policy that turned out not to be realistic. The situation was aggravated by terrorism. Peru designed its own macroeconomic stabilisation programme, which was endorsed and supported by the IMF. The re-integration of the country into the IMF and World Bank circles was of fundamental importance in regaining access to other financial means.

The various forms and modalities of debt relief described in the previous sections are shown in summary Table 2**–**7. It should be observed, however, that the large contributions by the Support Group are not reflected in the statistics on debt relief. Since donors assumed servicing obligations to the multilateral creditors, a proxy of these contributions is the ‘total debt service paid’, which increased by almost USD 700 million between 1990 and 1991.

Comparing debt relief to total aid, it can be concluded that there has been no substitution of aid by debt relief and that debt relief can be considered additional.

The bilateral donors bailed out the multilateral and private creditors. The Paris Club members bailed out some Latin American bilateral creditors.

Table 2–7 Debt relief by type, 1990-1999 (USD million)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Debt service long term debt	296.8	257.3	949.2	803.4	1758.4	993.2	1,004.0	2,534.7	2,390.2	1,857.9	2,386.8
Interest rescheduled	2.7	0	1,518.9	489.6	400.6	419	515.6	2,813.0	476.6	243.0	0
Principal rescheduled	1.0	0	813.8	191.1	230.0	277.2	254.5	73.7	328.9	29.7	0
Total rescheduled	3.7	0	2,332.7	680.7	630.6	696.2	770.1	2,886.7	805.5	272.7	0
Forgiveness											
Total long term debt outstanding	12,999	13,959	15,660	15,807	16,948	18,853	20,215	21,702	22,482	23,872	25,193
Principal forgiven	0	0	-2.1	-47.8	0	0	0	-32.2	-2.6	-116.1	-174
Interest forgiven	0	0	1	23.9	0	0	0	758.1	0.7	1	1.3
Debt stock reduction	0	0	0	0	0	0	0	-2,149.6	0	0	0
Buyback	0	0	0	0	0	0	0	943.5	0	0	0
Forgiveness (% of LDOD)	0	0	0	0.3	0	0	0	5.7	0	0.5	0.7

Note: Debt forgiveness defined as ‘debt forgiveness or reduction minus debt buyback’.
Source: Based on World Bank, 2001.

During the first half of the 1990s both the bilateral and multilateral resource flows were positive, during the second half only the multilateral flow. During the first half of the decade the bilateral flow raised the overall resource flow to a positive level. By the end of the decade, the debt service on bilateral loans started to exceed disbursements, while grants remained at a constant level or declined. This resulted in a negative resource flow during the second half of the decade.

3 OUTPUTS OF DEBT RELIEF: EFFICIENCY ANALYSIS

3.1 Introduction

This chapter presents an assessment of the efficiency by looking at three (immediate) outputs and two intermediate outputs. The immediate outputs are:

- the extent to which debt relief efforts led to freeing of resources for the debtor government (section 3.2);
- the extent to which they led to a reduction in the debt stock (section 3.3);
- the extent to which the debtor government complied with the conditions attached to debt relief (section 3.4).

In addition, and if debt relief has led to the availability of more resources in the public budget, its consequences are examined on the government accounts (section 3.5) and balance of payments (section 3.6).

The intended output of debt relief is to either reduce debt service obligations or stocks in such a way that the 'freed' liquidity can be used for alternative purposes. Debt service relief (being either rescheduling or forgiveness of principal or interest) contributes to liquidity in the public budget for a specific period (debt relief refers only to publicly guaranteed debt). In general, debt stock reductions have a longer-lasting effect on debt service obligations.

The main question is whether debt would have been serviced in the absence of debt relief anyhow. If so, then resources have become available for other purposes. If not, then debt relief is a way to provide resources for debt service obligations. The assessment whether Peru would have serviced its debt or not, is risky. Huge arrears had accumulated. In 1991, many uncertainties existed about what should or should not be considered as service due (IMF, 1991). The first aim of the Fujimori government was to regain access to new loans and to become creditworthy to foreign investors.

The debt service due has been assessed based on the Global Development Finance tables 2001. Debt service due has been computed by adding to the debt service paid (TDS) the total amount of debt rescheduled; the debt service forgiven and the arrears on the debt service.

Table 3–1 presents the characteristics of the debt service over the decade. In this table the 1991 and 1992 contributions of donors to eliminate the arrears on the multilateral debts are ‘hidden’ in the USD 4 billion arrears reduction in 1991 and another USD 1.5 billion in 1992.

Table: 3–1 Debt service due and paid (USD million)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Debt outstanding (LDOD), total long-term	13,959	15,660	15,807	16,948	18,853	20,215	21,702	22,482	23,872	25,193
Interest arrears on LDOD	3,732	2,431	1,793	4,089	4,449	4,605	220	177	180	167
Principal arrears on LDOD	8,344	5,640	4,739	4,087	4,147	4,165	862	735	741	724
Total arrears on LDOD	12,077	8,072	6,532	8,177	8,597	8,771	1,082	913	921	891
Interest forgiven	-	1	23	-	-	-	758	0	1	1
Principal forgiven	-	2	47	-	-	-	32	26	116	174
debt service forgiveness	-	3	71	-	-	-	790	26	117	175
Debt stock reduction	-	-	-	-	-	-	2,149	-	-	-
Debt buy back							943.5			
Total debt forgiveness	-	3	71	-	-	-	1,206	26	117	175
Debt stock rescheduled	-	-	-	-	-	-	2,488	-	4,414	5
Interest rescheduled (capitalised)	-	1,518	489	400	419	515	2,813	476	243	-
Principal rescheduled	-	813	191	230	277	254	73	328	29	-
debt service rescheduled	-	2,332	680	630	696	770	2,886	805	272	-
total debt rescheduled	-	2,332	680	630	696	770	5,375	805	4,687	5
Debt service (LTDS), total long-term (	257	949	803	1,758	993	1,004	2,534	2,390	1,857	2,386
debt service due	12,335	11,357	8,088	10,566	10,286	10,545	7,294	4,135	3,169	3,453
Debt service due – debt service paid	12,077	10,407	7,284	8,808	9,293	9,541	4,759	1,745	1,311	1,067

Source: Based on World Bank, 2001.

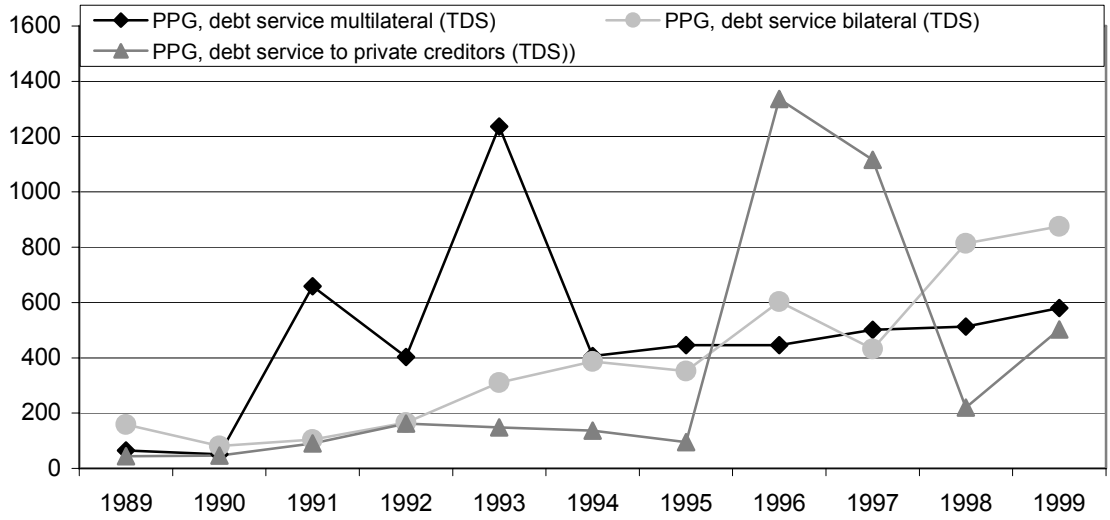
3.2 Debt relief and availability of resources for the public budget

During the decade, the debt service on the three categories of public and publicly guaranteed debt depended on the relief activities. Between 1991-1993 preference was given to payment of the debt service to the multilateral creditors, while in 1996 the effect of the Brady deal is tangible (servicing, -in this case mainly elimination of arrears- to private creditors), together with the Paris Club meeting in the same year (Figure 3–1).

With the change of government in 1990, payment of current debt service to the multilateral creditors was resumed. Peru had paid multilateral debt service up to 1987, although in decreasing amounts. Payments to bilateral creditors and commercial banks had been put on hold since 1987 (although this is not accurately reflected in the GDF figures). The elimination of arrears on multilateral debt paved the way for new support by the IMF. Once on-track with the multilateral creditors, servicing the debt required an effort of approximately USD 400-500 million a year.

Payment of arrears on multilateral debt was different from the elimination of bilateral arrears. One may assume that Peru would have used all means in order to regain access to IMF and World Bank and that it would have cleared its debt to these institutions. Here the USD 1.3 billion support during 1991 and 1992 can be considered as 'freeing resources', since Peru would have paid them anyhow, although possibly not in the same years.

Figure 3–1 Debt service by creditor category on PPG debt, 1990-1999 (USD million)



Source: Based on World Bank, 2001.

The elimination of arrears on bilateral debt was a condition of the Paris Club creditors as well, but here the efficiency might have been less. Since part of the bilateral loans found their origin in development programmes, Peru might have guessed that these debts would have been forgiven anyhow. Illustrative is the development loans by the Netherlands. The Guarantee Article in the Netherlands development budget already covered the debt service past due. So 'forgiveness' of these arrears by the Dutch government had a symbolic function only. The forgiveness of the arrears on concessional bilateral loans was of little significance to the Peruvian government: most likely it was what Peru guessed that would happen sooner or later. It is not very likely that Peru would have paid the arrears on the aid loans.

Peru could not count on similar forgiveness of the publicly guaranteed export transactions. Since the Paris Club restructured the current and past due service obligations, the debt service paid hardly increased, until the later part of the decade. A further increase is to be expected, since most bilateral debt service restructured in 1996 becomes payable between 2000 and 2007. As shown in Figure 3–2, during the later part of the decade the bilateral aid loans to Peru diminished, while the debt service increased substantially.

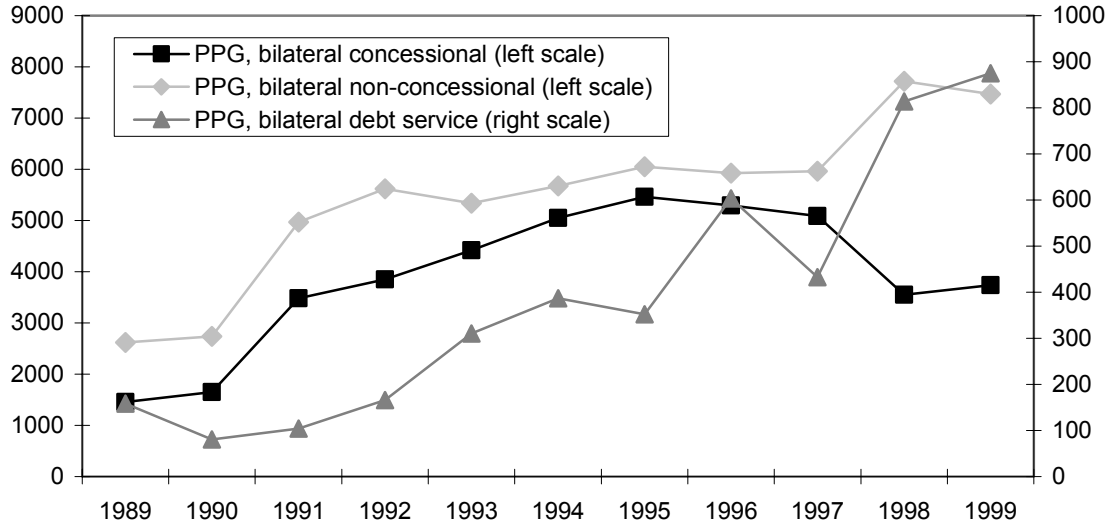
Since Peru is a middle-income country, a number of new bilateral loans were not, or only in part concessional, for example new loans by the German KfW for the social investment fund FONCODES.

The Brady deal was meant to enable Peru to regain access to commercial creditors. The effect of the Brady arrangement is mainly on stocks, but in order to comply with the conditions for the arrangement, a temporary effort in paying arrears to private creditors was required, as shown in Figure 3–1 (1996). The increase in payments to private creditors after 1998 is largely explained by the issuance of short term papers.

In practice, debt service over the various debt categories was highly interrelated, as explained in the previous chapter. Without the German contribution to the Support Group, the RAP/EFF arrangement with the IMF might have required more time. Without the IMF arrangement, the World Bank would not have issued new loans and the private banks

would not have dealt with Peru at all. But thanks to the new arrangement with the IMF and the stabilisation measures taken by the Peruvian government, the economy embarked upon an unprecedented growth path, which impressed the financial world. Worthless debt paper became in demand on the secondary market and the discount rate dropped rapidly. Private Banks dealing in those papers may have got much more than they ever had expected to receive during the 1980s.

Figure 3–2 Concessional and commercial bilateral loans (USD million)



Source: Based on World Bank, 2001.

The extent to which resources were freed for the government as a result of debt relief is assessed on the basis of Table 3–2. However, the total liquidity 'freed' has been different, since:

- donors (incl. the Netherlands) assumed payment of multilateral debt service on behalf of Peru several times;
- donors expanded their technical co-operation programmes;
- new concessional loans were issued.

On the other hand, it is justified to assume that a substantial part of the debt service rescheduled by the Paris creditors (mainly the aid loans) would not have been (entirely) repaid.

The total annual amount of programme aid is not known. In Peru, programme aid has been mainly in the form of commodity aid (amongst them PL480 and EU assistance). The level of grants to Peru is largely determined by USAID, which ties a substantial part to the drugs eradication programme. Budget support is not a regular aid form to Peru. Grants are mostly in the form of project aid. In 1997, 28 per cent of all grants were recorded as programme aid. Note that there is a certain element of double counting, since part of the debt relief mechanisms forms part of the 'grants' as well. In Table 3–3 it has been assumed that annually 28 per cent of the grants has been programme aid (based on grant data by the World Bank, 2001).

Debt relief effects are shown by the availability of external resources to the public sector in the years 1991/1992 (the support to eliminate the accumulated arrears) and in 1996 (the Brady arrangement).

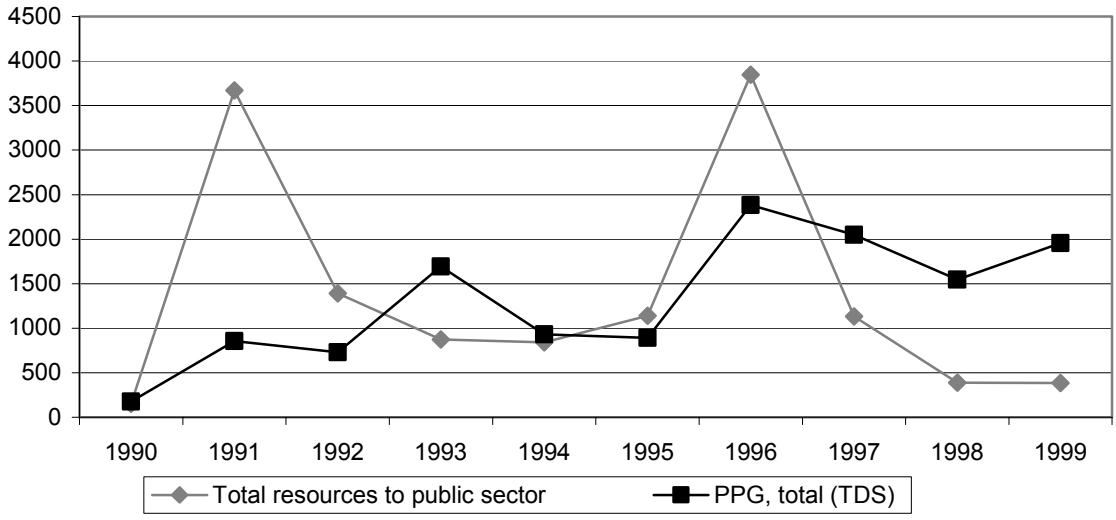
Table 3–2 External resources to the public sector (USD million)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Support Group		879	421							
Debt relief*	-	2,335	752	630	696	770	3,676	832	389	175
Grants (excl.TA)	179.8	251.2	237.8	235.7	225.8	271.3	237.8	224.4	238.7	148.9
Programme aid (proxy)	50.3	70.3	66.6	66.0	63.2	75.9	66.6	62.8	66.8	41.7
Disbursements on concessional loans	102.2	384.7	149.0	172.0	83.6	295.0	102.2	216.9	76.5	168.1
Total resources to public sector	152.5	3,669	1,389	875	842	1,141	3,845	1,131	388	385

*Including flow rescheduling and flow forgiveness.
Source: Based on World Bank, 2001 and IBRD, 1991.

Over time, the total debt service of public and publicly guaranteed debt did not decline.

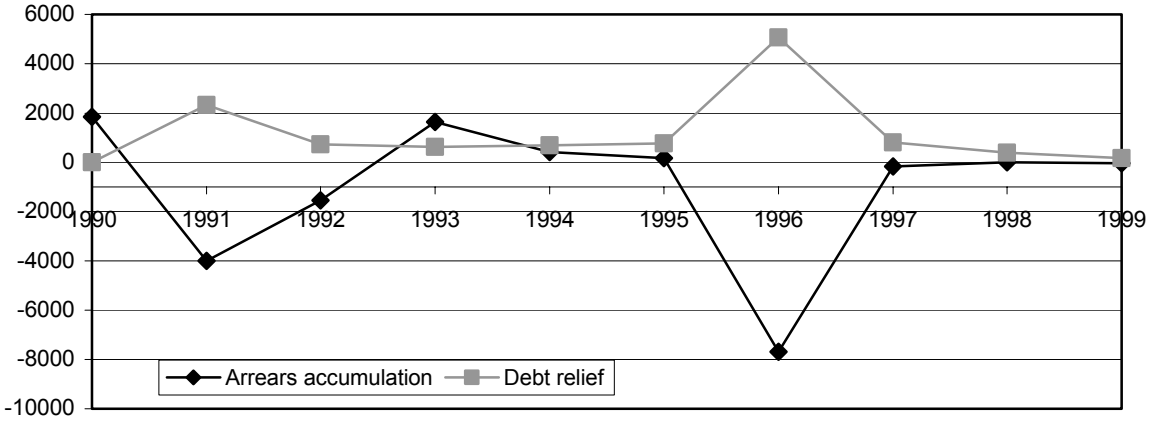
Figure 3–3 Effect of debt relief on resources freed for the public sector and total debt service on PPG debt (USD million)



Source: Table 3.3 and based on World Bank, 2001.

Comparing the debt relief (forgiveness and reduction) with the arrears accumulation shows a rather clear ‘mirror’ effect, as is evident in the next figure:

Figure 3–4 Debt relief and arrears accumulation (USD million)



Source: Based on World Bank, 2001.

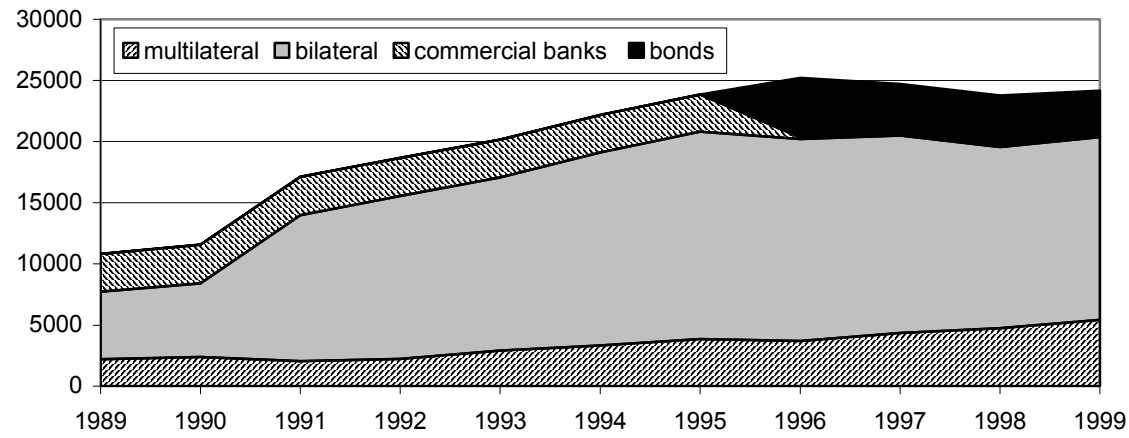
It can be assumed that without debt relief arrears would have accumulated further. The conclusion is that no noticeable flow effect from debt relief took place. So, no significant amount of resources was 'freed' from debt service obligations to be used for alternative purposes in the public budget. However, the clearance of arrears triggered the issuance of new multilateral loans. These loans can be considered as an indirect flow effect and did make additional resources available.

3.3 Effect of debt relief on the reduction of the debt stock

The internal composition of the PPG debt changed over the decade. The share of multilateral debt increased modestly as a result of new World Bank and IDB loans for a variety of activities. The 1996/97 Brady arrangement converted the public debt to private creditors into –mainly- bonds, as can be appreciated from Figure 3–5.

Debt relief aims at public and publicly guaranteed debt only, it leaves the private sector external debt unaltered. However, the Brady arrangement had an effect on the private sector. By converting public debt into tradable instruments via the issuance of bonds, the private sector became involved. Part of the capital required to purchase bonds was obtained from private sector credits.

Figure 3–5 Composition of PPG debt, 1990-1999 (USD million)



Source: Based on World Bank, 2001.

Debt rescheduling, forgiveness and conversions contributed to noticeable changes in indebtedness. Over the decade, the total debt stock increased substantially, mainly as a result of the increase in the bilateral debt. Apart from the capitalisation of interest under the Paris Club rescheduling arrangements, new loans were contracted from e.g. Japan, the United States and the German KfW.

Although the data presented in Table 3–4 are derived form the Central Reserve Bank of Peru, and are not comparable to the GDF data of the World Bank, they illustrate the dynamics of the changes in the external indebtedness. As can be observed, Total disbursement over the decade balances total amortisation. At the same time, the net increase in debt stock was larger than the new disbursement minus amortisation. This is probably the result of the rescheduling of non-concessional debt.

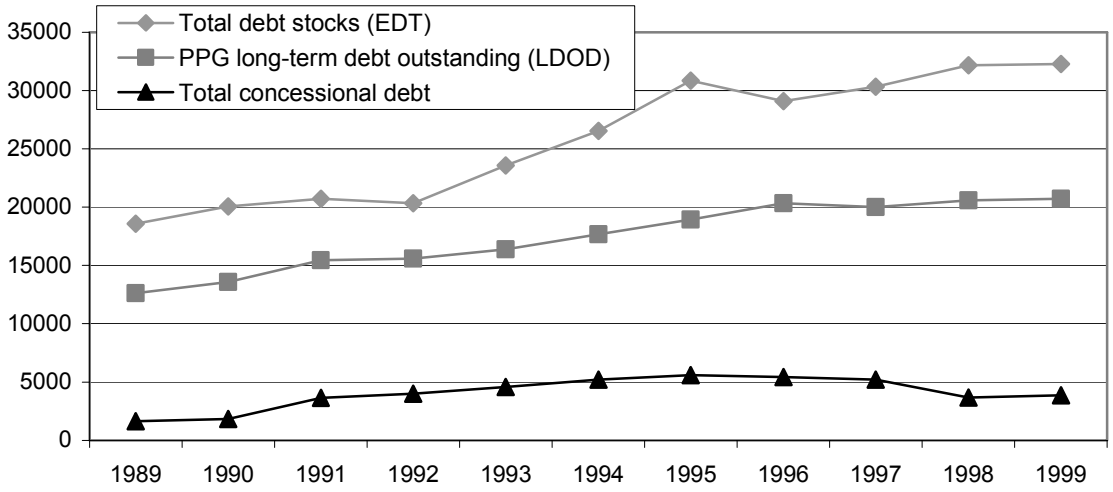
Table 3–3 Changes in Public and Publicly Guaranteed External Debt

	Disburse-ments	Amorti-sation[1]	Refinancing disbursements	Other Capital[2]	Net external Indebtedness	Other Amendments[3]	Change in Indebtedness
	I	II	III	IV	V=I-II+III+IV	VI	VII=V+VI
1991	909	1 035	5 529[4]	-4 208[4]	1 195	911	2 106
1992	396	777	691	712	1 022	- 549	473
1993	1 454	957	1 313	- 735	1 075	- 418	657
1994	625	962	705	725	1 093	717	1 810
1995	718	859	676	746	1 281	391	1 672
1996	464	878	586	343	515	- 971	- 456
1997	1 774	837	5 304[5]	-6 139	102	-6 511	-6 409
1998	790	859	217	- 18	130	645	775
1999	1 237	971	0	- 27	239	- 301	- 62

1/ Includes forgiveness on current principal and interest obligations.
2/ Net flow on debt service arrears. Includes forgiveness on arrears.
3/ Includes debt reduction as a result of the difference between effective and nominal value, as well as result of exchange rate variation.
4/ Includes the restructuring and arrears arrangements with Club de Paris creditors.
5/ Includes Brady bond emission for a nominal value of USD 4 873 millions..
Source: Based on BCRP statistics (www.bcrp.gob.pe).

Since Peru is a middle-income country, the level of concessional loans is relatively low. Nor was it eligible for the various stock-of-debt reduction instruments by the Paris Club creditors or combined instruments like the Heavily Indebted Poor Countries (HIPC) Initiative. The stock-of-debt reduction was mainly the result of individual arrangements with bilateral donors concerning their aid loans and the US initiative for the War on Drugs (1998). Some new concessional loans could be contracted from bilateral creditors. Approximately 15 per cent of the debt portfolio can be considered as concessional. The concessional share in the total PPG debt has decreased after 1996 (Paris Club exit agreement).

Figure 3–6 Total debt stocks, total long-term debt and total concessional debt (USD million)



Source: Based on World Bank, 2001.

The total stock effect of debt relief has been expressed by the debt forgiveness as a percentage of the PPG debt stock. As can be observed from table 3.5, the stock effect is only significant for the year 1996.

Table 3–4 Stock effect on PPG debt (in USD million)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Total
Debt outstanding total long-term(t-1)	12,575	13,583	15,432	15,573	16,379	17,675	18,921	20,324	20,007	19,183	
Debt forgiveness	0	-2.1	-47.8	0	0	0	-2181.7	-2.6	-116.1	-174	-2524.3
Forgiveness (%)	0.00	-0.02	-0.31	0.00	0.00	0.00	-11.53	-0.01	-0.58	-0.91	
Total forgiveness (% of 1999 stock)											13.16

Source: Based on World Bank, 2001. Own calculations.
Debt forgiveness is defined as debt forgiveness or reduction - debt buyback.

3.4 Compliance with debt relief conditionality

The third immediate output of debt relief is the compliance with conditions for debt relief.

Peru's strategy for its external debt reduction was simple: the single most important objective was to regain access to IMF support and monitoring. Access to the IMF would imply new relations with Paris Club creditors and renewed confidence from the commercial banks. The first arrears elimination exercise was entirely placed in the context of the stabilisation measures. Although the IMF mentioned its concern for the social effects of the harsh 1991 measures and stressed the importance of social safety net facilities (IMF, 1991) this was more an observation than a policy condition. Inflation control, reduction of the public sector deficit, trade and financial liberalisation, and privatisation were the main issues. Peru complied swiftly, because these policies formed the core of the liberal course pursued by Government itself.

From 1993 onwards, the IMF and the World Bank stressed the importance of social sector policies. The title of the Peruvian presentation to the Consultative Group meeting in 1995 is possibly a good summary of the priority sequence of its overall policy "Stabilisation, Economic Reform and Social Programmes in Peru".

The Social Programmes were threefold: a large social investment fund (FONCODES), a system of pension funds and a housing fund (FONAVI). The FONCODES (initially pushed by the World Bank as a copy of the Bolivian social investment fund) soon became a political vehicle of president Fujimori[6]. The Netherlands supported FONCODES through parallel financing of the activities in the Cusco and Cajamarca regions (PREDES). Under pressure of the presidential election of 1995, the budget restrictions were lifted.

The adherence to IMF conditions was no effort at all: they fitted well in Government's own strategies. Entirely different was the compliance with conditions imposed upon by other external financiers, such as the reluctance to accept additional conditions from the World Bank in 1991 and the United States focus on the War on Drugs in 1998. To the latter, the government paid lip service only. Late 2000 it became evident that high government officials, including the head of the secret service and the General in charge of the Anti Drug Department were directly involved in the coca - cocaine industry and trafficking.

3.5 The effect of debt relief on the government accounts

The debt relief mechanisms discussed here, refer to the public and publicly guaranteed debt only. So the intermediate effect of debt relief could be traceable in the public budget if and when a flow effect can be identified. As indicated in 3.3, no direct flow effect could be found, although indirectly new loans became available as a result of debt relief.
The following information on the government accounts should be considered as building blocks for the next chapters, not as a cause-effect relation attributable to debt relief.

For a number of years (1994-1996) Peru did not have a fiscal deficit as a result of the revenues obtained from the privatisation process. The fiscal surplus was not influenced by reduced debt service, since the debt serviced increased.
In the public budget, a number of substantial changes took place over the decade:

- the privatisation process implied that less capital and recurrent expenditures were required for the public and parastatal enterprises. More resources became available for investment in the social sectors and transport;
- as a result of the decentralisation policy part of the national budget (both capital and recurrent) devolved to the regional level;
- an increasing part of the public capital investment in the social sectors was channelled through FONCODES. The responsibility did no longer rest with the line ministries, but with the Ministry of the Presidency (IMF, 1997:14).

Table 3–6 presents the functional classification of the public budget expressed as percentage of GDP and is compared to the debt service on public debt.

[6] President Fujimori had promised to open one new school a day and he did so for several months under full media coverage.

Table 3–5 Functional classification Central Government Expenditure (per cent of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total	12.8	11.2	14.2	14.0	15.8	16.8	15.9	18.8	17.3	19
Planning and Administration								5.6	4	4.7
Pensions and social assistance								3.6	3.5	4.1
Education	2.1	2.8	2.4	2.8	3.5	2.8	2.6	2.7	2.7	3
Defence and Nation Security								2.9	2.9	2.8
Health and Water	1.1		0.8			0.9	0.9	1.4	1.5	1.5
Transportation								1.1	0.9	1
Agriculture								0.6	0.7	0.7
Industry Commerce and services								0.1	0.1	0.1
Others								0.9	1	1.1
Total social expenditure	3.2	4.5	4.2	4.5	5	5.8	5.9	6.9	6.5	7
Debt service on PPG	0.67	3.59	2.03	4.86	2.07	1.66	4.27	3.47	2.71	3.75

Sources: Republic of Peru, 1995; Ministry of Economy and Finance 1997, IMF 1991, 1997. World Bank, 2001.

3.6 The effect of debt relief on the Balance of Payments

A second intermediate flow effect of debt relief can be expected on the Balance of Payments, mainly on the level of imports. Once more, in the absence of this flow effect, it is unlikely that debt relief would have contributed to an increase in imports.

Imports did increase during the decade, while the internal composition of imports showed a sharper increase in the imports of intermediate and capital goods than for consumer goods.

The sharp increase in capital good imports during the years 1994 – 1997 was in part attributable to the privatisation of public enterprises, which was accompanied by new investments and technological modernisation. Foreign Direct Investments in those years was high.

Table 3–6 Composition of imports (USD million)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Consumer goods	338	754	903	934	1,365	1,783	1,847	1,909	1,883	1,438
Raw materials and intermediate goods	1,333	1,514	1,780	1,858	2,302	3,236	3,236	3,436	3,386	3,015
Capital goods	885	934	1,062	1,142	1,698	2,392	2,416	2,816	2,602	2,139
Other goods	364	391	254	186	230	341	385	389	349	135

Source: Banco Central de Reserva del Peru (data base www.bcrp.gob.pe).

The balance of payments shows the debt relief and Brady Plan (separately) in Table 3–8.

Table 3–7 Balance of Payments (USD million)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
I. Current Account	**-1418**	**-1501**	**-2087**	**-2289**	**-2550**	**-4115**	**-3429**	**-3059**	**-3634**	**-1817**
I.1 Trade balance	399	-189	-341	-607	-997	-2165	-1988	-1721	-2466	-616
Exports	3321	3406	3661	3516	4598	5589	5898	6832	5757	6113
Imports	-2922	-3595	-4002	-4123	-5596	-7754	-7886	-8553	-8222	-6729
I.2 Services	-365	-413	-575	-575	-502	-763	-685	-767	-593	-600
Exports	799	826	836	837	1064	1131	1414	1538	1748	1522
Imports	-1164	-1238	-1411	-1412	-1565	-1894	-2099	-2305	-2341	-2122
I.3 Investment income	-1733	-1367	-1632	-1615	-1799	-1999	-1639	-1472	-1488	-1545
Private sector	-35	-51	-226	-239	-352	-597	-743	-971	-1039	-974
Public sector	-1698	-1216	-1406	-1376	-1447	-1402	-896	-502	-449	-571
I.4 Current transfers	281	467	460	508	748	812	883	901	912	944
II Financial Account	**-713**	**-56**	**857**	**1830**	**3874**	**3044**	**3488**	**5705**	**1718**	**760**
II.1 Private sector	47	139	234	1220	3806	2565	4096	2463	1959	2041
II.2 Public sector	-1067	-129	-411	473	-369	-158	-434	601	-57	393
II.3 short-term capital	308	-66	1034	137	437	637	-174	2641	-185	-1674
III Exceptional financing	**2491**	**1390**	**1490**	**629**	**1611**	**1504**	**922**	**-829**	**365**	**18**
III.1 Brady Plan	0	0	0	0	0	0	0	4873	0	0
III.2 refinancing	25	5529	691	1313	705	676	586	431	217	0
III.3 Debt relief	0	12	53	7	138	20	60	6	157	32
III.4 net change in arrears	2466	-4151	746	-691	768	808	276	-6139	-9	-14
IV BCRP Net International Reserves Flow*	**-176**	**-788**	**-716**	**-657**	**-2978**	**-929**	-1932	-1733	1006	775
IV.1 Change in Central Bank reserves	-174	-773	-697	-741	-2976	-923	-1899	-1629	986	780
IV.2 Valuation changes and monetisation of gold	2	15	19	-84	2	6	33	104	-20	5
V Net errors and omissions	**-184**	**955**	**457**	**487**	**43**	**496**	952	-83	546	264
Note:										
Privatisation	0	0	6	168	2241	547	1688	145	60	219
Direct investment without privatisation	41	-7	144	519	867	1501	1554	1552	1820	1750

* = increase with a negative sign.
Source: BCRP. MEF.

3.7 Assessment of efficiency

The inputs (chapter 2) resulted in the following outputs: the accumulated arrears were cleared and debt service obligations were restructured. This was achieved in record time. In 1992 Peru was on-track with the multilateral financiers and most of the Paris Club creditor countries. Commercial banks followed in 1996/97.

The first step in Peru's return to the international financial community was the normalisation of the financial relations with multilateral financial organisations, paying the arrears with the IDB in 1991 and with the IMF and World Bank in 1992/93. These organisations, together with multilateral creditors like the Andean Development Fund, the International Fund for Agricultural Development and others have fully re-established financial support to the Peruvian government. Between 1991 and 1994, the multilateral organisations – excluding loans from the IMF to the Central Reserve Bank – disbursed

USD 2.4 billion, while the repayments of principal and interest were USD 2.8 billion. So the debt situation could be normalised for a relatively low 'price'. The new loans contracted were for projects in transportation, energy and social programmes (FONCODES) (Republic of Peru, 1995a: 7).

The Brady arrangement came late, possibly too late. Peru had to pay more for the buyback and conversions than it would have paid some years before. In addition, a number of debts that – most likely – would never have been paid by Peru were converted into tradable bonds.

The internal composition of the debt portfolio changed substantially, while the total debt stock increased. The multilateral share in the total debt remained almost unaltered. The debt to private creditors was converted into tradable instruments, while the bilateral debt stock increased as a result of capitalisation of interest on rescheduled debts and the contracting of new bilateral loans. Apart from the Brady arrangement of 1996, there has been no significant stock effect of the debt relief activities.

In the effort to clear arrears on multilateral debt one would have expected a more creative role of the IFIs for two reasons. Firstly, because they had initially endorsed García's heterodox economic policy, so they could be held co-responsible. Secondly, normalisation of the situation with the IFIs was a precondition for all kind of other financial agreements.

Without debt relief, it is unlikely that Peru would have paid all its debt service in the early 1990s (Memo DMP/MZ 216-92), although that is hard to assess, considering the shift in political regime in 1990. The new Peruvian policy was to regain access to the Bretton Woods institutes. Possibly, in the absence of debt relief, Peru would have tried to pay the multilateral creditors anyhow, but it is unlikely that the same effort would have been made to service debt to bilateral and private creditors. It is even more unlikely that Peru would have serviced the bilateral aid loans. In 1990, donors had already started to forgive the debt service on these loans, so Peru –probably- just counted on that.

Debt relief did not lead to a reduction in the debt service flow. On the contrary, this flow increased over time. Debt relief was mainly used to eliminate accumulated arrears. In consequence, there was no flow effect of debt relief. Since 1996, it has been Peru's policy to service its debt and *not* to seek a restructuring or reduction of its debt.

4 OUTCOMES OF DEBT RELIEF: EFFECTIVENESS

The effectiveness of debt relief is examined by comparing the outputs with the outcomes. In principle, this involves the examination of three issues: debt sustainability, and the flow and stock effects of debt relief.

4.1 Flow effect

As indicated in Chapter 3, in Peru there was no direct flow effect of debt relief, while the stock effect was mainly restricted to the year 1996. However, there have been indirect flow effects, mainly in the form of new multilateral loans. In the absence of debt relief, mainly by the bilateral donors, it would have been highly unlikely that new multilateral credits (mainly World Bank and IDB) would have been issued with the arrears still in place. This does not comprise the new IMF assistance, since that is not considered as aid, nor is it concessional.
This indirect flow effect does not hold for bilateral donors. Bilateral aid (that even did not come to a complete standstill during the crisis situation of the late 1980s) would have been made available anyhow.

4.2 Debt sustainability indicators

Peru's objective was to regain access to new, fresh capital, to reduce the annual debt service. The aim was to boost the economy and in particular the export base. By doing so, the carrying capacity for the external debt would improve.

The usual debt sustainability indicators express the total debt stock (EDT) as a percentage of the export earnings on goods and services. Since debt relief deals exclusively with the public debt, the PPG long-term debt has been taken as the indicator. The main sustainability indicators that use exports as denominator are reflected in Figure 4–1, and the main indicators that use GNP as denominator in Figure 4–2.

Table 4–1 Data for debt sustainability indicators (USD million)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Total debt stocks (EDT)	20,063	20,716	20,337	23,573	26,527	30,851	29,085	30,325	32,175	32,283
Debt outstanding (LDOD), long-term	13,959	15,660	15,807	16,948	18,853	20,215	21,702	22,482	23,872	25,193
PPG long-term debt outstanding (LDOD)	13,567	15,442	15,579	16,384	17,680	18,927	20,324	20,007	20,582	20,709
Debt service (LTDS), total long-term	257	949	803	1,758	993	1,004	2,534	2,390	1,857	2,386
Debt service PPG, total (TDS)	178	854	732	1,695	930	892	2,385	2,049	1,547	1,957
Gross national product (GNP)	25,509	22,256	34,921	33,555	43,290	51,823	54,318	57,782	55,517	50,388
Exports of goods and services (XGS)	4,402	4,606	4,939	4,854	6,476	7,903	8,523	9,732	8,927	9,004

Source: World Bank, 2001.

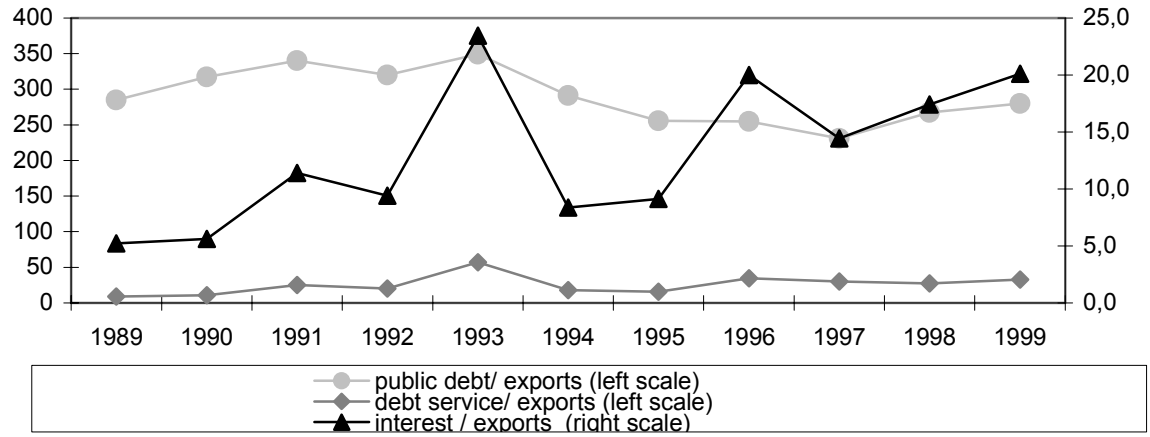
Table 4–2 Debt sustainability indicators (per cent)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
EDT / XGS	407	456	446	411	486	409	390	341	311	360	358
LDOD / XGS	284.8	317.1	340.0	320.1	349.2	291.1	255.8	254.6	231.0	267.4	279.8
LDOD / GNP	73.6	54.7	70.4	45.3	50.5	43.6	39.0	40.0	38.9	43.0	50.0
TDS / XGS	8.9	10.8	25.0	20.3	56.8	17.6	15.7	34.4	29.8	27.5	32.7
INT / XGS	5.2	5.6	11.4	9.4	23.4	8.4	9.1	20.0	14.4	17.4	20.1
INT / GNP	1.4	1.0	2.4	1.3	3.4	1.3	1.4	3.1	2.4	2.8	3.6
RES / MGS (months)	3.6	3.8	5.8	5.7	6.4	9.6	8.5	10.8	10.4	9.2	9.5
Short-term / LDOD	26.0	26.7	21.0	19.2	24.4	25.4	31.4	22.2	22.5	23.0	19.7
Concessional / LDOD	12.6	13.1	23.3	25.3	27.0	27.6	27.7	25.0	23.2	15.3	15.4
Multilateral / LDOD	15.6	15.8	12.0	13.2	16.2	16.9	18.4	16.4	18.9	19.5	21.1

Source: Based on World Bank, 2001.

Note that the debt service and interest over export indicators are high in 1996. This is the result of the additional payments made in the context of the Brady arrangement.

Figure 4–1 Export-based debt sustainability indicators (per cent)



Source: Based on data World Bank, 2001.

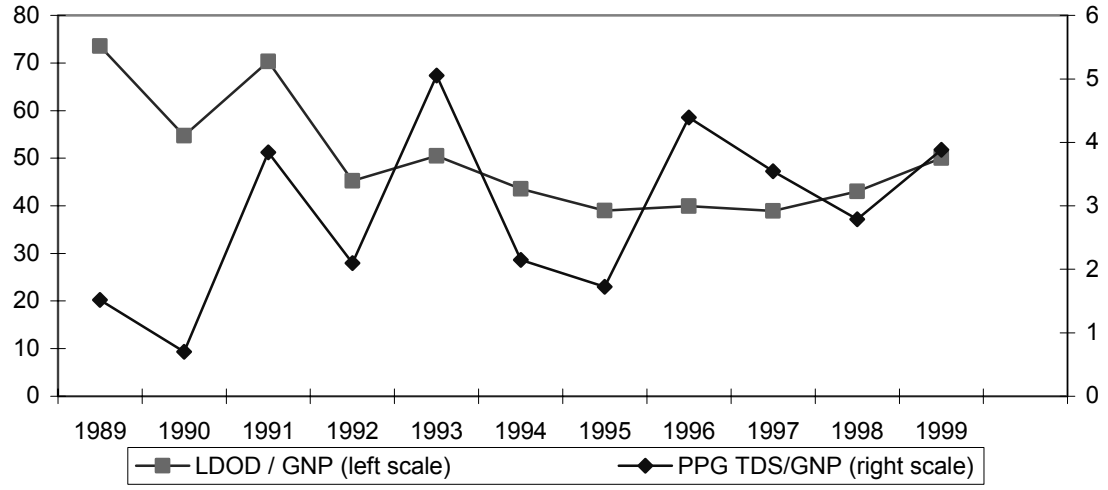
The total debt (EDT) has become slightly more sustainable over the decade: from approximately 400 per cent over exports to 350 per cent over exports, while the LDOD of the public and publicly guaranteed debt over exports showed some fluctuation. The debt stock as percentage of the export earnings seems to be well above the sustainability threshold of 150 per cent.

It is important to observe that the value of exports doubled. Nevertheless, the total debt service as percentage of export increased substantially, which in the first place indicates that Peru resumed servicing its debts, but also that the total debt stock increased. The concessional part of it increased over the years, but by the end of the decade it was decreasing.

A clear result of the normalisation of international financial relations is the increase of the multilateral debt in the total debt portfolio up to 1997. Taking the international yardstick

that a debt service/ export ratio of 20 per cent would be sustainable, Peru's debt service would clearly be considered unsustainable, since it ranges around the 30 per cent. Of particular concern is the interest component within the debt service. Interest alone requires approximately 20 per cent of export earnings.
The share of the interest in the debt service is explained by the short-term debt. Although the short debt as a percentage of total debt has not increased (see Table 4–2), the average interest rate did. The previously existing debt to private creditors was converted into short-term bonds with usually higher interest rates or interest rates to follow the market rates (Brady arrangement) (IMF, 2001).

Figure 4–2 GNP-based debt sustainability indicators (per cent)



Source: Based on World Bank, 2001.

As shown in Figure 4–2 the long-term debt as percentage of GNP has improved over time, but increases again by the end of the decade, as a result of the change in the denominator (Table 4–1). The debt service on public and publicly guaranteed debt shows a certain trend to increase over time, from approximately 2 to 4 per cent of GNP.

Although the indicators presented above do not show a clear sustainability, Peru did service its debt.

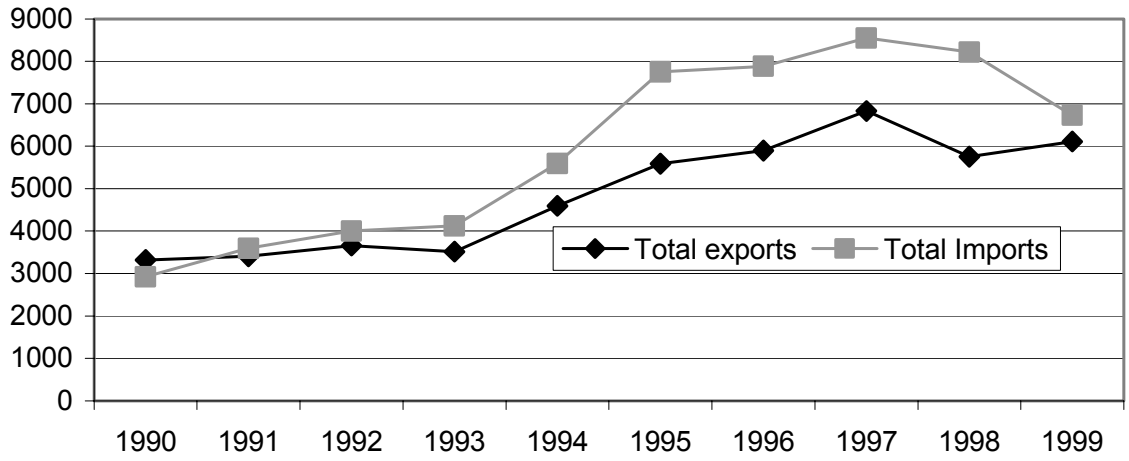
The *long-term sustainability* can be examined by comparing the average interest rate on new loans with the growth rates of exports and tax revenues. In the long run, debt service is considered sustainable if:

$D/X = a/ (g_E – i)$

where:
D = debt stock
X = Exports
a = trade gap (M-X)/X
g_E = growth rate of exports and
i = the average interest rate on debt.

Exports and imports showed a comparable pattern over the decade, as indicated in Figure 4–3:

Figure 4–3 Imports and Exports, 1990-1999 (USD million)



Source: Banco Central de Reserva del Peru (data base www.bcrp.gob.pe).

Comparing the growth rate of exports to the average interest rate of the debt stock shows that the average growth rate of exports is higher. However, the average growth rate on exports is determined by the high three years averages during the middle of the 1990s. On the basis of a comparison of the last two years, the growth rates of exports can be considered insufficient.

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	average
g_E	6.9	8.0	2.7	3.0	11.7	16.9	20.6	14.5	4.1	1.8	9.1
I	6.7	5.6	7.2	6.5	6.9	6.2	4.6	5.8	6.9	3.8	6.02

Note: 3-years average.

Based on that indication, Peru can be considered as balancing on the edge of sustainability.

The trade gap 'a' widened quickly in the years of economic expansion and – due to deliberate demand restricting policies – narrowed in the years afterwards. The trade gap was neither closed by aid flows, nor by debt relief. In practice, the current account deficit, caused by the trade deficit, was bridged by other capital inflows, mainly foreign direct investment.

If the growth rate of exports is lower than the interest rate, the debt/ export ratio is sustainable only if there is a surplus. This is not the case (M-[X+A]>0). So, based on the trade gap analysis, one may conclude that the debt is not sustainable in the long run.

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
X	4,437	4,643	4,945	4,854	6,476	7,903	8,523	9,732	8.927	9,004
M	6,014	6,426	7,249	7,360	9,306	12,233	12,238	13,053	12,831	11,057
a	0.355	0.384	0.465	0.516	0.437	0.547	0.435	0.341	0.437	0.228
AID	180	251	238	236	226	271	238	224	239	149
M-(X+A)	1,203	1,170	1,897	2,099	2,494	3,965	3,387	2,928	3,403	1,601
a_{adj}	0.315	-0.33	0.418	0.467	0.402	0.513	0.408	0.318	0.411	0.212

Note: M and X data from World Bank, 2001. Grants and DR: chapter 3.
Note: Aid data are from World Bank, and do not reflect the contributions of the Support Group.

Similarly, the debt/GNP ratio is sustainable in the long run if

$D/Y = (v-s)/(g_y-i)$

Y = GNP
v = the investment ratio I/Y
s= the savings ratio S/Y
g_y = growth rate of Y

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Average
D/Y	0.631	0.759	0.499	0.7025	0.6128	0.595	0.5355	0.5248	0.5795	0.6407	
Y	31822	27299	40795	33556	43290	51823	54319	57782	55518	50389	
g y	0.117	0.354	0.184	0.018	0.166	0.083	0.174	0.101	0.023	-0.025	0.120
i	0.067	0.056	0.072	0.065	0.069	0.062	0.046	0.058	0.069	0.038	0.060
I	4333	4116	6245	6727	9991	13438	13041	14525	13811	11407	
S	4841	3579	5181	5381	8473	10387	10277	11913	10760	10217	
V	0.136	0.151	0.153	0.200	0.231	0.259	0.240	0.251	0.249	0.226	
s	0.152	0.131	0.127	0.160	0.196	0.200	0.189	0.206	0.194	0.203	
v-s	-0.016	0.020	0.026	0.040	0.035	0.059	0.051	0.045	0.055	0.024	
Aid	180	251	238	236	226	271	238	224	239	149	
Aid/ Y	0.006	0.009	0.006	0.007	0.005	0.005	0.004	0.004	0.004	0.003	
g-i	0.050	0.298	0.112	-0.047	0.097	0.021	0.128	0.043	-0.046	-0.063	
(v-s)/g-i)	-0.319	0.066	0.233	-0.853	0.3615	2.803	0.3975	1.051	-1.195	-0.375	

Note: three years average in i and gy calculation.

As can be observed, the growth rate of the GNP (g_y) over the decade has been higher than the interest rate. From that perspective the debt can be considered sustainable.

The public sector is responsible for servicing the public debt. To the public sector, sustainability is directly related to taxes. In tax revenue collection, impressive progress has been made during the decade, but economic adverse circumstances during the last years of the decade have affected revenue collection. To the public sector, debt is sustainable if:

$PPGD/T = \{(G-T)/T\}/ (r_t - i)$

where

PPGD = public and publicly guaranteed debt (including IMF)
G = government expenditure

T = Tax income
r_t = growth rate of taxes

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	average
PPG Total	13,629	15,442	15,580	16,385	17,681	18,927	20,324	20,007	20,582	20,709	
T	2860	3536.3	4259	4083.5	6074.09	7292	7614.4	8193.3	7929.3	6433.2	
D/T	4.765	4.366	3.658	4.012	2.910	2.596	2.669	2.441	2.595	3.219	
G	4715	4936.3	6171	5751	7908.18	9707	9606.8	9821.5	9826.9	9226.8	
Rt	-0.081	0.068	0.222	0.126	0.198	0.196	0.231	0.105	0.028	-0.055	0.104
Er	0.200	0.800	1.200	2.000	2.200	2.300	2.500	2.700	2.900	3.400	
G-T/T	0.648	0.396	0.448	0.408	0.302	0.331	0.262	0.208	0.239	0.434	
I	0.067	0.056	0.072	0.065	0.069	0.062	0.046	0.058	0.069	0.038	0.060
rt – i	-0.148	0.012	0.150	0.061	0.129	0.134	0.185	0.047	-0.041	-0.093	
(G-T/T)/ (rt-i)	-4.378	3.30	2.987	6.688	2.341	2.407	1.416	4.425	-5.829	-4.667	

Note: three years averages.

The average growth rate in tax revenue collection has been considerably higher than the average interest rate on public and publicly guaranteed debt.

The increasing gap between public expenditures and tax revenues has been financed in the first years of the decade with the income from the privatisation process and in later years increasingly by domestic borrowing.

4.3 Poverty indicators

In the absence of a direct flow effect attributable to debt relief, it is not possible to prove any causal relation between debt relief and public investment in the social sectors or otherwise, that may have had an effect on poverty reduction. However, most likely new multilateral loans became available as an indirect effect of debt relief. These loans were partially used for poverty alleviation, such as for the social investment fund FONCODES. Assuming that this fund was successful in achieving its objectives, then debt relief contributed to that achievement. Poverty indicators are presented here since these are an important objective for development assistance.

In 1996, some bilateral creditors allowed debt swaps for the benefit of FONCODES. The government's own expenditures in the social sectors, mainly education, water supply and housing increased substantially.

As can be appreciated from Table 4–3 all social and poverty indicators improved over the decade. However, this improvement is at the best an indirect effect of debt relief.

In the Paris Club exit agreement poverty alleviation was a condition, but not a firm one. Poverty alleviation hardly played a role in the Brady arrangement. Some bilateral creditors attached poverty alleviation conditions to new loans, such as the German KfW.

To the Netherlands' Ministry of Foreign Affairs, the arguments used for forgiveness of debt service were economic stabilisation and structural adjustment rather than poverty alleviation.

Table 4–3 Poverty Indicators

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Poverty										
National Headcount index		55.1			49.6				37.3	
..urban headcount index		50.3			44.0				26.5	
..rural headcount index		68.0			61.0				57.4	
.. Andes highlands					88.1				62.0	
Education										
Primary enrolment (% net)	..	..	..	86.5	..	90.8	91	94	94.5	
Gender equality in primary enrolment (F/M ratio)						0.99			0.965	
School enrolment, primary, female (% net)	..	..	..	..	..	90.3	..	..	..	..
School enrolment, primary, male (% net)	..	..	..	..	..	91.2	..	..	..	..
Literacy (% adults: age 15 and above)	85.6	86.1	86.6	87	87.5	87.9	88.3	88.8	89.2	89.6
Illiteracy rate, adult total	14.4	13.9	13.4	13	12.5	12.1	11.7	11.2	10.8	10.4
Gender equality in literacy (F/M ratio)	0.87	0.86	0.88	0.88	0.87	0.89	0.89	0.89	0.89	0.90
Illiteracy rate, adult female	20.8	20.1	19.4	18.7	18.1	17.4	16.8	16.2	15.7	15.1
Illiteracy rate, adult male	7.9	7.6	7.4	7.1	6.8	6.5	6.3	6	5.8	5.6
Gender in secondary enrolment (F/M ratio)						0.97				
School enrolment, secondary (% net)	..	..	..	46.3	..	53.1	54.6	55.2	..	..
Health										
Chronic malnutrition			48				41			34
Access to potable water	37.1					43			58.8	
Mortality rate, infant (per 1,000 live births)	54	..	52	..	..	43	..	40	..	39.2
Mortality rate, under-5 (per 1,000 live births)	75	..	..	..	..	59	..	52	..	48
Maternal mortality rate (per 100,000 live births)			300			260				
Births attended by health staff (% of total)	78	..	53	..	..	..	56	..	..	..
Contraceptive prevalence (% women ages 15-49)	..	54.7	..	..	..	..	64	..	..	..

Sources: World Bank, 2001. Republic of Peru 1995a, BCRP database, INEI website.

4.4 Debt relief and private investment

There are other indicators of stock effects of debt relief. If debt relief has led to a reduction in the debt stock, then this may have had a positive effect on private investment and on creditworthiness. According to the debt overhang theory, a large debt lowers private investment because of high expected future tax rates and general uncertainty about government policies.

Creditworthiness can be said to have improved if there are inflows of foreign private capital, in the form of foreign direct investment, portfolio equity flows, bonds and new loans. Creditworthiness is also considered based on credit ratings.

As indicated in the previous chapter, debt relief has hardly led to a reduction in the debt stock. In fact, the relief contributed to the contracting of *new* loans.

Debt relief has been instrumental in normalising Peru's position in the financial world. The moment the country's blacklisting was lifted, the psychological effect of the economic changes, including the international recognition, on the Peruvian entrepreneurs has been impressive (Griffith-Jones and Marr, 1998). While between 1985 and 1990 entrepreneurs left the country, they returned, including their capital, with new aspirations from late 1992 onwards. The increase in domestic private investment can be appreciated in Table 4–4

Table 4–4 Gross domestic investment (per cent of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Gross Domestic Investment	16.8	16.7	16.4	18.6	22.0	24.3	23.5	24.6	24.2	22.0
Public sector	2.7	2.7	3.1	3.4	3.9	4.1	3.8	4.4	4.5	4.8
Private sector [1]	14.1	14.0	13.3	15.2	18.1	20.2	19.7	20.2	19.7	17.2

Source: IMF Report 1994, 1997, 2001.
1/ Includes changes in inventories.

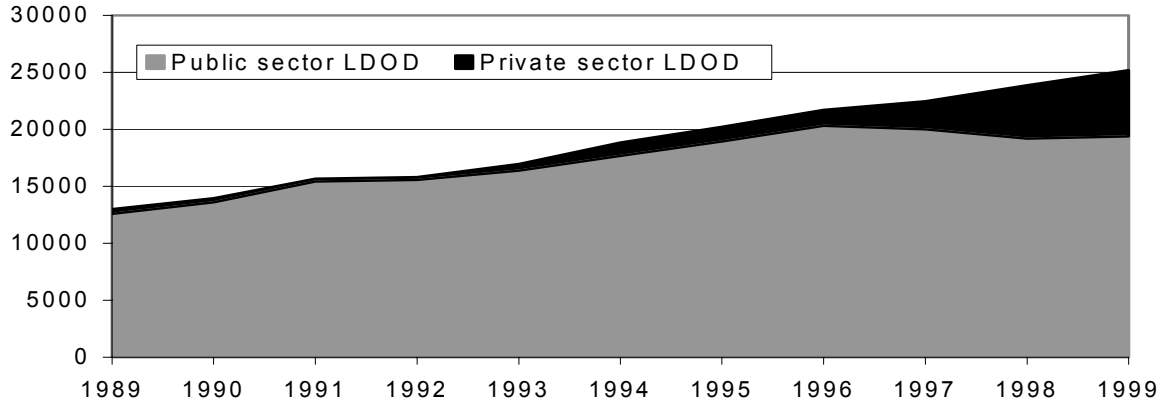
Although the increase in domestic private investment was substantial, possibly half of it went to the construction sector (Griffith-Jones and Marr, 1998:221). Construction has a fairly intensive impact on employment during the first stage, but is poor in generating jobs in the longer run.

Public investment showed a higher growth rate (from 2.7 per cent of GDP in 1990 to 4.8 per cent by the end of the decade), but was mainly in infrastructure (roads and social infrastructure) as well.

It should be noted that there is a certain inverse relationship between the private and public investments during a privatisation process. Part of the investment that previously would have been made by the public sector is now taken over by the private sector. In addition, there was a shift in Peruvian policy: from direct public sector implementation to contracting out to the private sector. So the change in policy did have some impact on the opportunities for the private sector, but this was largely restricted to the construction sector. Some crowding in might have taken place as a result of public-private partnerships in trunk road construction, maintenance and management.

The increase of the private sector investment can also be deduced from the expansion of the private sector long term debt in the total external debt of Peru, as shown in Figure 4–4

Figure 4–4 Public and private medium and long-term debt (USD million)



Source: Based on World Bank, 2001.

The first Fujimori government achieved the re-establishment of confidence, leading to repatriation of capital and to foreign investments. Foreign Direct Investment (FDI) took a high proportion of the capital inflows, while portfolio investment accounted for an increasing inflow as well. However, part of the portfolio flows to Peru went into the informal (parallel) market and had little effect on productive capacity or on lowering the cost of capital. A very high proportion of the FDI flows to Peru (1994 to 1997) went to the procurement of companies being privatised, including new investments in these companies. In 1994, USD 2.1 billion of FDI was for privatisation (Griffith-Jones and Marr, 1998:226). The following table presents the foreign direct investment and portfolio flows.

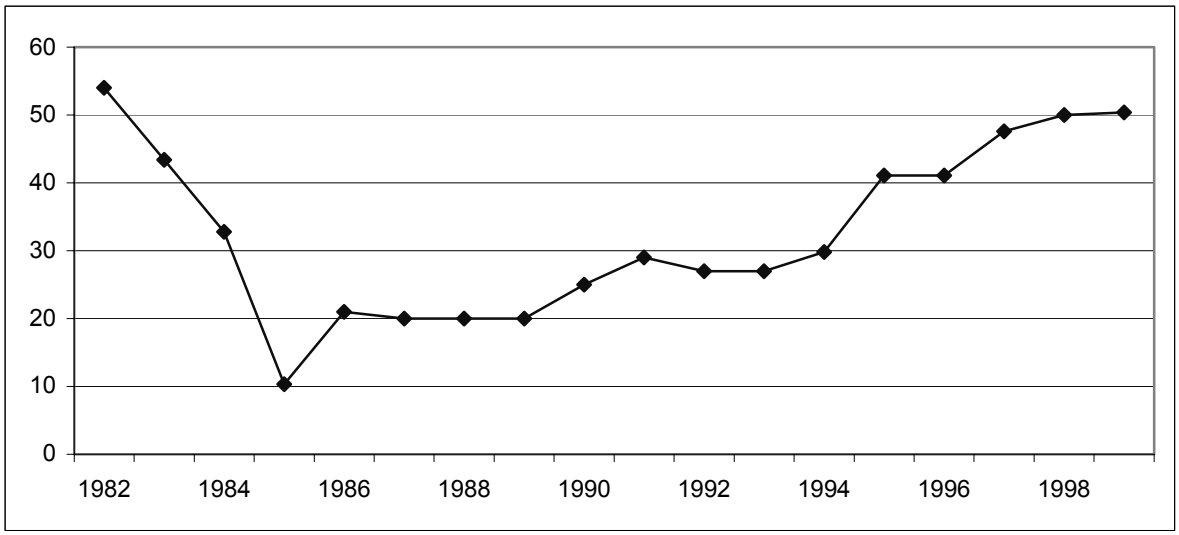
Table 4–5 Foreign direct investment and portfolio flows (per cent of GDP)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
FDI (net inflow)	59.0	41.0	-7.0	150.0	687.0	3108.0	2056.0	3225.0	1781.0	1905.0	1969.0
Portfolio equity flows	0.0	0.0	0.0	0.0	1226.0	976.7	1611.0	2739.9	691.9	174.3	288.8

Source: World Bank, 2001.

The confidence of external investors is also expressed in creditworthiness ratings. In the early 1980s, Peru's creditworthiness rating was high. It reflected the investors' confidence in a country where the economic policy was still different from its neighbours (see chapter 1), while the debt crisis had affected negatively various countries on the continent (IMF, 1991). Peru's relatively small external debt at the time, its lean public sector and its export oriented private sector, opened the financial doors to entrepreneurs. When Peru started to default on its debt service and the economy weakened, creditworthiness declined accordingly, hitting bottom, when Alan García announced the restriction on debt servicing (1985).

Figure 4–5 Creditworthiness Euromoney scores



Source: Euromoney, 2001.

As can be appreciated from Figure 4–5, there was a positive reaction to the1990 introduction of the economic stabilisation programme, although the real confidence returned, once Peru had settled all credit disputes with the commercial banks in 1996 (already expected from 1994 onwards). By 1998, Peru had reached a rating level comparable to that of 1980, but in subsequent years the rating became under pressure. In 1999, the Standard and Poor's downgraded Peru's long term credit risk from BB to BB-, while Moody's kept its rating at Ba3, but lowered its outlook from stable to negative.

4.5 Assessment

Peru's total debt stock (LDOD) increased from USD 14 billion to USD 25 billion during the 1990s. Total debt forgiveness and reduction over the decade was approximately USD 2.5 billion (Table 3–5), or 10 per cent of the total debt stock at the end of the decade. Most of the debt relief consisted of debt restructuring, as shown in chapter 3. Debt rescheduling contributed to the increase in the debt stock as a result of the capitalisation of interest.

Although the total relief (in terms of input) seems modest (Peru, a middle-income country, is only eligible for a limited number of relief instruments) the country achieved its objective, namely the normalisation its relations with all creditors. In addition, in 1996 a large part of the high-interest commercial debt could be taken out of the portfolio.

From that perspective, the instruments have been effective, since by the end of the century, Peru had

- reached an exit agreement with the Paris Club bilateral creditors;
- regularised almost all bilateral debt to non-Paris Club creditors;
- regained access to the IMF;
- contracted various new loans form the World Bank and the IDB;
- normalised relations with commercial creditors (by December 1994 all legal suits initiated against the Peruvian government were lifted [Republic of Peru, 1995a: 9]);
- rearranged its portfolio of debt to private creditors and converted those debts into marketable instruments.

Once Peru's debt service had been normalised by the middle of the decade, its debt service of 35 per cent of exports was the highest in Latin America and well above the

desirable threshold of 20 per cent. Considering the traditional indicators over entire the decade of the 1990s, Peru's debt sustainability indicators have either improved, or showed a more or less constant pattern.

In the long run, Peru does not have a sustainable debt neither in terms of solvency nor in terms of liquidity. As in many countries, the future sustainability will depend largely on the growth of the economy and on the tax revenue system. Although we may conclude that Peru has an unsustainable debt profile, since 1996 it has serviced all debts.

The effect of debt relief on private investment in Peru has been indirect, but important. When Peru's blacklisting was lifted, the psychological effect on investment was impressive. The creditworthiness rating reflects the process in the normalisation of the debt servicing.

All social and poverty indicators improved over the decade. However, these improvements are at best an indirect effect of debt relief. Debt relief aimed at regaining access to new loans, part of which was used for social investment programmes. Some bilateral creditors applied debt swaps for poverty alleviation.

In 1991 and 1992, the Netherlands forgave all arrears accumulated up to 1990, as well as the debt service over the years 1991 and 1992. The Dutch contributions were effective in reaching a normalisation of the relations and in putting Peru 'on-track' in the Paris Club context. The Netherlands' contributions to the Support Group were equally effective, in that Peru regained access to the IFIs. In all subsequent years (1993 – 1999) the Netherlands has forgiven the debt service. The flow effect of that forgiveness is limited. Peru probably would not have paid its debt service until the 1996 Paris Club arrangement. After the 1996 agreement, the Dutch forgiveness seems to have become redundant, because it became the explicit policy of the Peruvian authorities not to request for restructuring or reduction of debt anymore, a policy continued to date (IMF, 2001:16). The Netherlands' contribution might have been welcome, but was not asked for. To the Netherlands' Ministry of Foreign Affairs, the formal arguments used for forgiveness of debt service were economic stabilisation and structural adjustment. Poverty reduction was not the main argument.

5 IMPACT OF DEBT RELIEF: RELEVANCE

Relevance refers to the question whether and to what extent debt relief was targeted at achieving the objectives generally attached to development assistance, namely economic growth and poverty reduction. An assessment is made of the contribution of debt relief to economic growth and –to a lesser extent- poverty reduction.

In Chapter 1 the economic trends before 1990 were described. The following section presents a brief description of the trends during the decade 1990-1999.

5.1 Economic trends during the 1990s

From an economic perspective the first Fujimori government (1990-1995) was different from the second one (1995-2000). The economic programme of the first Fujimori administration had only three immediate objectives: the pacification of society, to end hyperinflation and to normalise the country's relations with the international financial community (Dancourt, 1999:61). The second Fujimori government added to those policies: the increase in productivity and the development of human capital (Republic of Peru, 1995a:1).

The first Fujimori government

The new administration launched strong macro-economic stabilisation measures. The effects were immediate and tangible. While in July 1990, inflation still reached 90 per cent in a single month; this decreased to less than 5 per cent in six month time. GNP, which had decreased with 11.9 per cent in 1989, began to grow by the end of 1992. The government introduced a fierce fiscal and monetary policy, using a free exchange rate system. The fiscal pressure increased from 5 to 10 per cent in a single year. Many liberalisation measures were taken, such as a liberal import regime, the elimination of tariff barriers, and the liberalisation of the capital flows. The economic recovery was a fact by the end of 1992.

The privatisation of state and parastatal enterprises attracted foreign investment in, amongst others, the oil and mining industry, while the public sector was slimmed down. Having reduced the number of state enterprises, fewer public resources were required for productive investment. In consequence, more means became available for investments in the social sectors (FONCODES).

The structural adjustment programme paid little attention to the ailing agricultural sector. The most important factor affecting agriculture was the land policy, which basically re-introduced private ownership of agricultural land. The Agricultural Credit Bank, once 'generator' of approximately 17 per cent of the country's inflation, was closed and the agricultural extension system was dismantled. Substantial food imports, amongst others the American PL 480 deliveries, continued. In 1993, the United States of America and the European Union together donated over 500,000 metric tonnes of grain.

The second Fujimori government

The change of the Constitution, the re-election machinery, the 'media' frontier war with Ecuador, and the social infrastructure programme FONCODES brought Fujimori to power for a second term. The price for that was less prudent management of the national budget. The fiscal deficit increased. Some (including the IMF) feared that the influx of foreign investment and 'flash capital' could overheat the economy. The government decided to slow down economic growth and took demand-restricting measures. At the start of his second period, Fujimori promised that poverty alleviation would have the

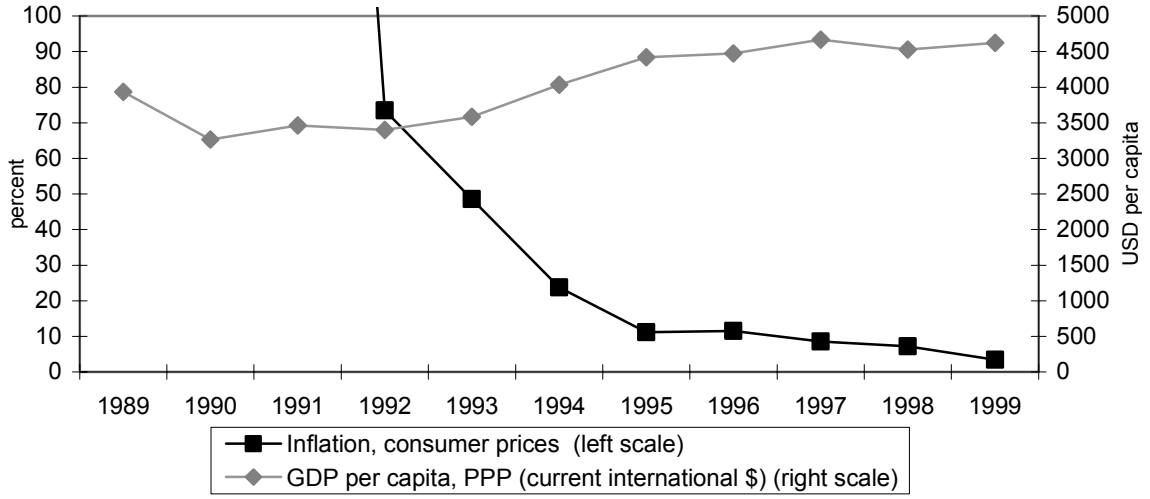
highest priority. During the Consultative Group meeting of October 1995, Peru requested donor support for the social sectors up to a level of USD 750 million per year, about twice the usual level of USD 350-400 million.

The economy started to show some cracks. Foreign direct investments declined, and Peru suffered from the Asia crisis, since its new ties with Asian traders and investors happened to be rather fragile (IMF, 1997c). Insufficient employment could be created. In the meantime, the president became involved in scandals. He changed the juridical system and abolished the autonomy of the High Court. In an effort to regain US confidence, he joined the US War against Drugs in an army-led coca eradication programme (in 1995, Peru produced 60 per cent of the world's raw material for cocaine). Violations of human rights became severe.

The prosperous economic years of the mid-1990s were over. The lack of employment opportunities was felt by all strata of the population and the parallel economy – traditionally the coping mechanism of the poor and jobless – came under pressure as a result of the coca eradication. Fujimori's attempt to become re-elected for a third term through election fraud, open corruption scandals and finally video evidence of bribery by his secret service, marked the end of his regime (2000).

Over the decade, the economic achievements are possibly best characterised by the fact that inflation came under control, while per capita income in purchasing power parity terms (Figure 5–1) increased.

Figure 5–1 GDP per capita (in PPP) and inflation



Source: Based on BCRP, data base and World Bank (WDI), 2001.

The IMF(Article IV Consultations) closely monitors the economic development of Peru. The IMF and other external observers initially applauded the swift changes in the economy, but later expressed concern about the short-term character of some of the economic features. Table 5–1 shows the dynamics of some macroeconomic indicators over the period 1991-1999.

Table 5–1 Macroeconomic indicators, 1991-1999

Indicator	1991	1992	1993	1994	1995	1996	1997	1998	1999
GDP (% change)	2.9	-2.8	6.5	13.1	7.9	2.6	6.7	-0.4	1.4
GDP per capita (% change)	0.3	-2.2	3.0	10.9	6.7	0.7	4.9	-2.1	-0.3
Public investment (% change)	6.4	13.9	12.8	21.9	14.5	-8.5	9.0	3.0	7.2
Private investment (% change)	-0.2	-4.0	9.1	39.4	27.3	-2.2	16.3	-1.9	-16.3
Exports (%change)	6.0	2.5	3.3	17.5	7.0	11.4	16.3	4.5	5.4
Imports (% change)	17.2	8.8	3.8	26.6	26.3	0.6	11.4	0.7	-17.1
Terms of trade/[1]	-6.1	-1.1	-6.9	8.0	6.5	-3.7	5.6	-13.8	-6.6
Trade deficit in % of exports	-8.3	-9.7	-17.0	-21.3	-38.8	-33.9	-30.5	-22.8	-10.1
Current account deficit in % of GDP	-6.30	-5.78	-6.56	-5.68	-9.49	-6.14	-5.17	-6.38	-3.51
Reserves in months of imports	5.8	5.7	6.4	9.6	8.5	10.8	10.4	9.2	9.5

Source: Banco Central de Reserva del Peru, data base and IMF, 2001:22-42, World Bank, WDI 1001.
[1]/: Composite based on nominal prices.

The main features are:

- The economic growth was accompanied by an increase in exports of goods and services during 1994-1997. However, imports of goods and services has grown even faster. This contributed to increasing current account deficits (up to 9.5 per cent of GDP in 1995).
- This current account deficit was compensated by capital inflow (Dancourt, 1999: 62). Gradually this became a potential danger, in particular as the initial inflow of capital as a result of the privatisation process was replaced by the inflow of short-term capital. Since the capital inflows were even larger than the current account deficit, net foreign exchange reserves increased until 1997 and reached a level of equivalent to 11 months of imports.
- The capital inflows were mainly Foreign Direct Investments, initially almost exclusively (91% in 1993) related to the privatisation process, later volatile short-term investment capital (Griffith-Jones and Marr, 1998: 222). However, the short-term capital left the country in September 1997 almost as quickly as it had arrived (Dancourt 1999:69). The government took a series of demand-restricting measures and since then the overall inflow of capital has gone down markedly.
- By the end of the decade the economy had weakened under the influence of the El Niño weather disturbance, a sharp drop in commodity export prices, and a liquidity squeeze stemming form turbulence in international financial markets. Output declined in 1998 and recovered slightly in 1999. Employment fell sharply.
- Domestic consumption, which had boomed by the mid-1990s, contracted and contributed to increasing unemployment.

In 2000, like a decade before, the country passed through an economic recession. The 2000 IMF Article IV Consultation reads as if it were written a decade before: “the overriding strategy for the economic programme is to ensure macroeconomic stability….to promote sustained growth of output and employment…” (IMF, 2001:10).

5.2 Debt relief and poverty reduction

Until 1993, there was no clear social political agenda. Poverty reduction was supposed to be the outcome of economic growth. In August 1991, the National Fund of Compensation and Social Development (FONCODES) was created as the vehicle to improve access to social infrastructure and services. In June 1993, the government elaborated its first Poverty Reduction Strategy, of which the main thrust was strengthening the role of FONCODES. But, strictly speaking, poverty reduction did not belong to the explicit priorities of government. The second Fujimori government launched a new, better targeted, strategy to combat poverty (Republic of Peru, 1995a:11). The objective was to reduce the incidence of extreme poverty from 19.5 per cent in 1995 to 10 per cent in 2000 (Republic of Peru, 1996:5).

Results

Even if economic growth alone is insufficient to achieve poverty reduction, it is a necessary condition to overcome poverty. Economic growth did take place, while poverty indicators show that both extreme poverty and critical poverty diminished during the 1990s. Even in the poorest areas, like the Andean highlands, poverty indicators improved.

Box 5.1 Poverty measurement

The Unsatisfied Basic Needs Index measures poverty as the share of households with unsatisfied basic needs and other basic necessities. It captures the degree of satisfaction of basic needs with regards to minimum standards for quality and access to housing, water supply and sanitation, energy, education, and health.

The Headcount Index measures the proportion of households with income levels below the consumption-based poverty line, which reflects the expenditure necessary to buy a 'minimum food basket' and other necessities.

Overall, access to social services improved over time (as expressed by a fall in the Unsatisfied Basic Need Index), although the urban index improved more than the rural one. In 1998 in the rural areas still 71.9 per cent of the population faced insufficient access to social services. Income levels improved as well, as expressed by the Headcount Index (INEI, 1998). See Table 5–2.

Table 5.2 Share of total population affected by poverty (per cent)

	1991	1994	1998
Poverty			
Unsatisfied Basic Need Index	68.2		42.1
…urban	51.7		25.9
…rural	89.1		71.9
National Headcount index	55.1	49.6	37.3
…urban headcount index	50.3	44.0	26.5
…rural headcount index	68.0	61.0	57.4
…Andes highlands	88.1		62.7
Extreme poverty	23.9	19.5	15.6
…urban			4.6
…rural			36.1
...Andes Highlands			42.9

Sources: Republic of Peru, 1995a; INEI, 1998.

Late 1990, 12 million Peruvians (about half of the population at the time) lived below the USD 1 ppp per day poverty line and the per capita income was comparable to that in 1959 in real terms (IBRD, 1991:1). The 'shock' therapy applied when Fujimori took over caused –initially- an acute deterioration of the poverty situation. In particular the lower middle income classes were severely affected (IBRD, 1991:2).

The level of extreme poverty reduced from 23.9 per cent in 1991 to 19.5 per cent in 1995 and to 15.6 per cent in 1998, while poverty went down from 55.1 per cent to 37.3 per cent in the same period (extreme poverty is defined by those whose total expenditure does not reach the minimum per capita cost of a food basket; poverty [or critical poverty] is defined by the cost of the food basket plus the costs for health, education, clothes and transport) (Republic of Peru 1995a: ChII:3). The 37.3 per cent of the population living in poverty still represents 9.3 million persons (INEI, 1998).

The rural Andes continues to be the area with the highest percentage poor (from 88 per cent of the population in 1991 to 62 per cent in 1998). Since Peru has become an urbanised country (and a rapid rural-urban migration process characterised the decade), the urban data have an increasingly higher weight in the national averages.

The distribution of economic growth has been unequal. During the period of economic expansion, the income disparity –if based on the performance of the lowest 20 per cent income group (the lowest quintile) – diminished, in particular in the urban areas. In later years inequality increased again in the Lima Metropolitan area and the coastal urbanised areas. Out of the three lowest quintiles, the lowest improved more than the others did (three (3) per cent more growth than the average and 8.9 per cent more growth than the one but lowest quintile). However the income distribution is still amongst the worst in Latin America (INEI, 1998, Ch.IV).

The lack of employment opportunities continues to be the Achilles heel. The Peruvian economy still depends on exports of primary commodities, which is relatively labour extensive. Employment is usually found in small industry and the parallel economy. The parallel economy has been under pressure since 1995 (restrictions on street vendors, eradication of coca production, control of smuggling), while the middle class lost strength during the entire decade. Consequently, employment opportunities seem to decline rather than grow. The surveyed levels of underemployment showed the tendency to increase (from 41 per cent in 1994 to 44.1 per cent in 1998 [INEI, 1998]). Of the entire Economically Active Population, only 64.1 per cent performs any form of income generating activity (incl. informal), less than in 1994 (68.2 per cent) (INEI, 1998).

As can be concluded, Peru made progress in reducing poverty over the decade. Poverty has been reduced by half in the urban areas, while extreme poverty disappeared swifter than critical poverty.

5.3 Relevance of debt relief

The impact of debt relief on economic growth cannot be determined in direct terms. As concluded in chapter 3, there was neither a direct flow effect of debt relief, nor a stock reduction (except for the effects of the buyback operation and the Brady deal). Apart from the conditionalities in 1991 and 1992 and to a lesser extent the conditions of the Brady arrangement, there has been no direct impact from debt relief on economic performance.

Although Peru achieved remarkable results in reducing extreme poverty, debt relief never had poverty reduction as an objective or condition. There is no direct impact from debt relief on poverty alleviation.

However, it can be argued that there were indirect impacts. The 1991, 1992 debt relief triggered support first by the IMF and later from other IFIs and Paris Club creditors. The stabilisation programme restructured the fundaments of the economy, the structural adjustment changed the enabling environment. The private sector responded. Confidence was restored and economic recovery was triggered.

Poverty reduction was no explicit priority of the first Fujimori government. Debt relief mechanisms were not directly linked to poverty reduction objectives, although Paris Club creditors could opt for debt-for-development swaps. Nevertheless, Peru did achieve a reduction of poverty in almost all segments of society. It also manages to reduce extreme poverty at a quicker pace than critical poverty.

The relevance of debt relief from the Netherlands

To the Netherlands' development assistance, the Latin America and Caribbean region is of decreasing significance. Nevertheless, the flow to the region still represents about 4 per cent of total Dutch ODA (in 1999: USD 268 million). Prior to 1997, the Netherlands provided support to integrated rural development projects, projects in the health and environmental sectors and by forgiveness of the debt service on bilateral loans. In 1996, the Netherlands started to reduce and after 1998 it phased out entirely its direct bilateral co-operation with Peru, with exception of support to the environmental sector.

Debt relief has been relevant according to the general policies set by the Netherlands in the document *A World of Difference* (Ministry of Foreign Affairs 1991), but -although the Ministry of Foreign Affairs' files give a different impression - debt servicing was not one of Peru's main concerns. The Fujimori administration serviced its debts and was not concerned about future debt service obligations, as long as it could implement its economic programme (Dancourt, 1999) and achieve economic growth. The idea was that economic growth would enable future servicing. The Netherlands support to eliminate arrears in 1991 and 1992 has been relevant to that economic growth. Debt service forgiveness on bilateral loans was hardly relevant for either economic growth or poverty reduction.

An observation in the margin is that the Dutch Ministry of Foreign Affairs was impressed by the remarkable economic performance of Fujimori's first period of government, and maintained that positive opinion during the second period of his regime. Judgements for contributions to debt relief were based on macroeconomic criteria only, even when it became common knowledge that the Fujimori regime violated bluntly human rights and most principles of good governance (see for example, the Appraisal Memorandum for debt relief 1999). After 1998, when the framework system for macro support had been introduced, the proposals for debt relief should not have either skipped or passed the 'good governance' criteria. A remarkable issue is that the Netherlands continued to provide debt relief, even when the Fujimori government had declared (after the Brady deal) that debt relief was no longer a priority and that Peru would service all its obligations.

ANNEXES

ANNEX A GLOSSARY AND MAIN DEBT RELIEF CONCEPTS

Glossary

The concepts regarding debt used in this report are those applied by the World Bank in its Global Development Finance report 2001.

The following concepts are used with reference to "debt" in the present document:

a. (long term) *external (total) debt* (EDT) is defined as debt that has an original or extended maturity of more than one year and that is owed to non-residents and repayable in foreign currency, goods, or services.
   Long-term external debt has three components:
   1. *public debt,* which is an external obligation of a public debtor, including the national government, a political subdivision (or an agency of either), and autonomous public bodies;
   2. *publicly guaranteed debt*, which is an external obligation of a private debtor that is guaranteed for repayment by a public entity;
   3. *private non-guaranteed external debt*, which is an external obligation of a private debtor, not guaranteed for repayment by a public entity.

b. *Public and publicly guaranteed debt* consist mainly of multilateral debt, bilateral debt and (part of) the commercial debt. *Multilateral debt* originates from loans and credits from the World Bank, regional development banks, and other multilateral and intergovernmental agencies (international Financial institutions). *Bilateral debt* originates from loans from governments and their agencies (including central banks), loans from autonomous bodies, and direct loans from official export credit agencies. *Commercial debt or private debt* includes bonds, loans from private banks and private financial institutions, as well as credits from manufacturers, exporters and bank credits covered by a guarantee of an export credit agency. A particular type of both bilateral and multilateral debt is the *concessional debt,* which originates from the receipt of aid from official lenders at concessional terms as defined by the Development Assistance Committee (DAC), that is, loans with (at least) an original grant element of 25% or more.

c. The total *contracted debt* is the sum of contracted loans which may or may not have actually been disbursed by the creditor; *disbursed debt* (or: long-term debt outstanding and disbursed - LDOD) are those loans which have actually been disbursed by the creditor, while the *total debt stock* is the sum owed by a country at any given moment, i.e. the loans which it has actually received and which have not yet been repaid (the net disbursements minus the repayment); the *net total debt* (or: net flows on debt) refers to the repayment of the principal only; the *gross total debt* owing at any given moment refers to the principal plus the servicing (interest, fines, commissions).

d. The (long term) *debt service* (LTDS) is the sum of principal repayments and interest (and commissions, fines) payments actually made over a prearranged period (usually a year). The *total debt service paid* (TDS) is debt service payments on total long-term debt (public and publicly guaranteed and private non-guaranteed), as well as on use of IMF credit. *Total debt flows* include disbursements, principal repayments, net flows and transfers on debt, and interest payments. *Debt stock rescheduling* refers to the formal deferment of payment of the external debt service

through the application of new maturities to the amounts placed. *Debt forgiven* is the amount of principal due or in arrears that was written off or forgiven. *Refinanced debt* is the conversion into a new loan of the debt due to mature or which has already matured. Debt stock reduction is the amount that has been netted out of the stock of debt using debt conversion schemes such as buybacks and equity swaps or the discounted value of long-term bonds that were issued in exchange for outstanding debt. The term *buyback* is used for operations that do not entail local currency on the part of the debtor country. In the event that any payment in local currency forms a part of the transaction, it is referred to as *debt conversion* or *debt swap*. The *grace period* is the period between the coming into force of the loan and the first amortisation of the principal. The creditor may or may not request the payment of interest during the period of grace. The *maturity period* is the period of grace plus the period of amortisation. *Maturities* are the obligations of the principal, interest and commission resulting from the loan agreement signed between the creditor and the debtor; the difference between the sum due for repayment and the sum actually paid represents the *default sum* (arrears).

The *domestic* public debt consists of the State's obligations to private organisations, bodies or individuals belonging to the private sector. Generally speaking, it is a debt in national currency in the form of (short-term) promissory notes (Treasury bills) and investment bonds.

Debt relief concepts

Measures and initiatives taken to address the debt problem, 1980-1990.

Commercial debt:

- suspension of new loans by private banks;
- rescheduling of service obligations;
- buyback of commercial debt titles (and the provision of donor funds for that purpose);
- exchange of debt to private banks for investment bonds;
- temporary suspension of debt service by the debtor countries;
- debt conversion ('debt-for-equity swaps');
- 'menu of options' for transfers into other instruments (Baker Plan);
- new concessional IMF loans, World Bank, grants and conversion into marketable instruments (Brady Initiative).

With the aim to co-ordinate policies vis-à-vis the debtor countries, the private sector banks organised themselves in the Committee of Banks, headed by the Bank of America (later London Club).

Bilateral debt:

- restructuring and rescheduling of the stock of debt and debt service (Paris Club);
- partial or total forgiveness of the stock of debt (incl. Initiative of the America's);
- debt conversion ('swaps').

Bilateral debt to OECD members was dealt with by the Paris Club.

Multilateral debt

Additional lending on concessional terms in order to comply with debt service obligations on non or less concessional loans. Debt forgiveness on multilateral debt was no option until 1996.

The Paris Club: characteristics and principles:
The Paris Club is a creditor interest group, comprising official creditors (OECD countries and since 1997 Russia). Since its first meeting in 1956, it is chaired by France and meets monthly. There is no formal membership and it has no charter. There are special meetings to define policies, next to 'tours de horizon' which review the situation of individual debtor countries. Only a debtor country with an ongoing IMF programme has the right to request for a 'country meeting', which in principle is on a triennial base. IMF and World Bank are observers and provide background information. Decisions are made by consensus, and all credits are subject to equal treatment (no free riders; no bailing out). Each Paris Club agreement has to be implemented through bilateral agreements.

The 'Classic terms'
Classic terms are the standard terms applied to a debtor country coming to the Paris Club. Any country, which has an appropriate programme with the IMF that shows the need for Paris Club debt relief, may benefit from classic terms. Credits (whether ODA or non-ODA) are rescheduled at the appropriate market rate with a repayment profile negotiated on a case-by-case basis.

The standard agreement provides a way of tiding-over a debtor country through temporary balance of payments difficulties (flow relief) and works in the following way:

- The period of time to which the agreement refers is usually the period when the IMF programme shows a financing gap that can only be covered by debt rescheduling. This period is called the "consolidation period".
- Payments falling due to Paris Club creditors in this period and covered by the agreement are then "consolidated" and the payment of these debts is made on a new schedule ("rescheduling").

The standard consolidation period is one year. However, creditor countries have agreed to reschedule debt falling due over two or three years, corresponding with a multi-year arrangement with the IMF that shows a financing gap.

Debt relief
The final aim is to come to a sustainable situation of the debtor country, so that it can ‘exit’ from the rescheduling process. Initially, the ‘preferential treatment’ comprised the restructuring of debt service by extending repayment and grace periods, and lowering interest rates.

Forgiveness on the stock of debt was introduced for IDA-only countries in the 1988:

- 1988: Toronto terms, maximum 33% reduction in NPV;
- 1991: London terms: maximum 50% reduction in NPV. Individual creditors free to grant additional forgiveness on ODA loans;
- 1994: Naples terms: 67% for IDA countries with GDP/capita less than US$ 500;
- 1996: Lyon terms: maximum 80% reduction in NPV for HIPCs only;
- 1999: Cologne terms: maximum 90% reduction in NPV for HIPCs only;
- 2000: Individual creditor countries allowed to grant 100% forgiveness to HIPC I category countries.

Houston terms

In September 1990, Paris Club creditors agreed to implement a new treatment of the debt for the lower middle-income countries, called "Houston terms". These terms grant three substantial enhancements with respect to classic terms:

- *non-ODA repayment periods are lengthened to or beyond 15 years and ODA repayment periods are lengthened up to 20 years with a maximum of 10-year grace;*
- *ODA credits are rescheduled at a concessional rate ;*
- *debt swaps can be conducted on a bilateral and voluntary basis. These swap operations may in principle be carried out without limit on official development assistance (ODA) loans, and up to 20 per cent of the outstanding amount or 15-30 million SDR for non-ODA credits.*

Eligibility for Houston terms is assessed on a case-by-case basis, taking into account the track record of the debtor country with the Paris Club and the IMF and various criteria, including at least two of the following three:

(i) low level of income (GDP per capita smaller than USD 2,995),

(ii) high indebtedness (defined as reaching at least two of the following three criteria: debt to GDP higher than 50 per cent; debt to exports higher than 275 per cent, scheduled debt service over exports higher than 30 per cent);

(iii) *have a stock of official bilateral debt of at least 150 per cent of private debt.*

Source: www.clubdeparis.org.

The Brady Plan

In March 1989, the then US Treasury Secretary Nicholas F. Brady announced a plan to deal with debtor nation's obligations to private banks. The basic idea was to reduce debt by using market mechanisms in combination with support by guarantees (collateral) provided by governments and international Financial institutions. The Brady Plan shifted credit risk from commercial creditors to public ones. Only middle-income developing countries with large commercial debts used Brady instruments. The Plan not only benefited debtors, it was beneficial to creditors as well. For example, Peru's commercial debt was reduced by some 35 per cent, while between 1989 and 1995, one of its main creditors, Citibank, achieved a reduction of over 40 per cent of its debt portfolio owed by middle-income countries world-wide. The basic tenets of the Brady Plan were derived from common practices in domestic US corporate transactions: (1) bank creditors would grant debt relief in exchange for greater assurance of collectability in the form of principal and interest collateral; (2) debt relief needed to be linked to some assurance of economic reform and (3) the resulting debt should be more tradable, to allow creditors to diversify risk more widely throughout the financial and investment community.

Because the rescheduling process is on a case-by-case basis, each Brady issue is unique, but most Brady restructuring included at least two basic options for debt holders: the exchange of loans for either Par Bonds or Discount Bonds. Par Bonds represent an exchange of loans for bonds of equal face value, with a fixed, below-market rate of interest, allowing for long-term debt service reduction by means of concessional interest terms. Discount Bonds represent an exchange of loans for a lesser amount of face value in bonds (generally a 30-50 per cent discount), allowing for immediate debt reduction, with a market-based floating rate of interest. The principal of both Par and Discount Bonds was secured at final maturity by a pledge of zero-coupon instruments that are usually US

Treasury securities. A portion of the interest payable on Par and Discount Bonds (generally from 12 to 24 months coverage) was also secured by the pledge of high-grade collateral, to provide security in the event that the country encountered temporary liquidity problems and was unable to meet its interest payments.

While both Par and Discount Bonds are 30-year collateralised bonds, a number of nations also issued uncollateralised bonds for shorter periods (e.g., 'Floating Rate Bonds' and 'Front Loaded Interest Reduction Bonds'). Some nations issued bonds in exchange for unpaid interest on defaulted loans (e.g., 'Past Due Interest Bonds' or 'Interest Arrears Bonds'). Each country negotiated the specific terms and details of its Brady restructuring during discussions with the commercial bank creditors, who were offered a 'Menu of Options' for their exchange of eligible debt.

Since all these instruments were market-based, a special 'Brady bond market' developed. In fact, the large size of many Brady bond issuances has substantially contributed to providing the Brady bond market with greater liquidity than is found in many other financial market places. The Brady Plan was successful: first, it allowed the participating countries to negotiate substantial reductions in their debt stock and debt service. Second, it succeeded in diversifying risk away from commercial bank portfolios throughout the financial and investment communities. Third, it encouraged many Emerging Markets countries to adopt and pursue economic reform programmes. Finally, it has enabled many Emerging Market countries to regain access to the international capital markets for their financing needs.

The success also marked the end of the Brady system. With the re-access to international capital markets by Emerging Markets countries, the importance of Brady bonds has been gradually eroded. There is no longer a pipeline of Brady restructuring, while much Brady debt has been exchanged or bought back by debtor nations in secondary market transactions. While Brady bond trading accounted for 61 per cent of total Emerging Markets debt trading in 1994 (USD 1.68 trillion), this share had declined to approximately 25 per cent of total trading in 2000 (USD 712 billion).

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ANNEX C: EVALUATION OF DEBT RELIEF 1990-1999, IOB

TERMS OF REFERENCE FOR COUNTRY CASE STUDIES

The evaluation of Dutch debt relief policy and expenditures aims to answer the following research questions:

- to what extent were the political and financial interventions (the inputs) **efficient** in terms of outputs such as debt and debt service reduction (DDSR) and increases in imports an government expenditure?
- to what extent were these inputs and outputs **effective** in producing desired outcomes such as improvement of debt sustainability, improvement of creditworthiness and investment?
- to what extent were these inputs, outputs and outcomes **relevant** by contributing to the longer-term impacts of economic growth and, ultimately, poverty reduction?

Country case studies
In the 8 country case studies, the evaluation questions of efficiency, effectiveness and relevance will all be addressed (see attached Table 1: evaluation matrix). In addition, an in-depth analysis is to be made of the nature of the country's debt problem and therefore of the relevance of debt relief as compared to, for example, new loans or grants.

Debt relief is defined as any action that leads to a reduction in the net present value of the debt. The basic assumption for this evaluation is that IF debt relief contributes to economic growth it does so via a reduction of the debt burden. Two effects are possible:

- The reduction of the net present value of the debt *stock* will increase creditworthiness of the country (according to the debt overhang hypothesis), and thereby lead to more private investment and inflows of private capital. This will enhance economic growth.
- The reduction of the debt *flows* (actual debt service) will lead to additional imports and government expenditure. Increased imports may include investment goods or intermediate goods leading to increased use of existing capital stock, and government spending may imply higher public investment and/or more social expenditure.

Since the effects of *Dutch* debt relief cannot be separated from those of debt relief by other actors, the object for the case studies consists of *all* debt relief received by the country, both from official and commercial sources. Where possible and relevant, special attention will be given to Dutch debt relief. The evaluation period covers 1990-1999, but the analysis of the debt problem has to start earlier, in the 1970s.

The country studies seek answers to five broad questions, each of which is to be dealt with in a separate chapter of the report, with chapters 2 to 5 corresponding to the different levels of the evaluation matrix (inputs, outputs, outcomes and impact), while chapter 1 will provide an introduction and background. In addition to the sources mentioned in the Evaluation matrix, the researcher carrying out the case study is expected to take into account the relevant academic literature on the country as well as pertinent previous evaluations. A minimum selection will be provided by the co-ordinator and her assistant, but the consultation of additional material at the researcher's own initiative will, of course, be welcomed.

1. Debt problem analysis: nature, causes and consequences.

Why had the debt burden become unsustainable by the beginning of the evaluation period, 1990, and what have been the consequences of this unsustainability? Answering these questions involves analytical descriptions of:

1. The build-up of the country's debt, going back to the 1970s, including major creditors, interest rates, degree of concessionality in real terms, that is including any adverse exchange rate effects (see Mistry, 1996: 25-6), etc.
2. Conditionality attached to loans granted before 1990, and degree of compliance (short overview).
3. Trends in GDP, exports, fiscal revenues; causes of slow growth rates: review of important factors such as developments in terms of trade, inflows of foreign aid, loans and FDI, political instability, natural and man-made disasters, adverse policies, etc.
4. Trends in poverty and social indicators before 1990.
5. Debt sustainability indicators: trends in debt/GDP, debt service *due*/exports versus debt service *paid*/exports.
6. Public and private shares of external debt, and changes over time; government take-over of private debt.
7. Extent to which the external debt situation was exacerbated by a domestic debt problem.
8. Net transfers on debt before 1990, and how these compared to aid flows (grants, new loans).
9. Debt relief, if any, provided before 1990 and its influence on debt sustainability indicators. Any bail out of private creditors by official creditors/donors (see Demirgüç-Kunt & Huizinga, 1993).
10. The nature of the debt problem in 1990, in particular, whether the country's inability to pay was caused by insufficient liquidity (short-term problem) or a lack of solvability (long-term problem). Any difference between this ex-post assessment result and the common perception of the debt problem at the time.
11. The consequences of the debt problem in 1990, in particular whether it affected growth rates:
    - through too high transfers on debt leading to lower imports and lower government expenditure;
    - and/or leading to lower growth rates through a heavy debt overhang (high debt stock, so high expected tax on private profits lowering private investment and inflows of private capital).

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2. Inputs: amounts and modalities of debt relief in the period 1990-1999

What were the inputs into the debt relief process in terms funding, modalities and conditions? Answering this question requires the following data:

1. Overview of amounts and modalities of debt relief: by creditor, by type of debt, by framework for debt relief activities (Paris Club, Multilateral Debt Funds, 5th and 6th dimension, HIPC, etc.), extent of forgiveness, interest subsidy, buy-back, etc.
2. Stated objectives of debt relief.
3. Any conditions attached to the different modalities of debt relief, including assessment of *track records* (see attached Table 2 for possible contents of conditions and track records)
4. Special attention to Dutch modalities, motives, conditions, and objectives for debt relief.

5. The extent to which debt relief was *additional* to other inflows (loans or grants); in general, and for Dutch debt relief in particular; according to the HIPC initiative, debt relief should be additional (Andrews et al., 2000: 16) but practice may be different.
6. Amounts and modalities of new loans and grants 1990-99. Dutch loans and grants.

Assessment:
Was the combination of new funding and debt relief modalities consistent with the perceived and the actual nature of the debt problem (as described in 1.10)? Were these inputs suitable for the improvement of debt sustainability (see Cline, 1995: 29 and Hanlon, 2000)?

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3. Outputs of debt relief: efficiency analysis

To determine how efficient the inputs were in producing the intended outputs the following data are to be collected and analysed:

1. Debt service *due* during 1990-1999 as compared to debt service *actually paid* and accumulation versus payment of arrears.
2. The share of (total as well as Dutch) debt relief that effectively relieved the debt burden in that it led to a reduction of actually paid debt service (see Annex 1).
3. The effect of the different modalities of debt relief on actual payment of debt service on the reduced as well as on other debt. Since debt relief usually increases ability and/or willingness to pay other debts, other creditors may benefit. This may be an unintended side-effect and has been established for debt buy-backs (Bulow & Rogoff, 1988), or it may be an intended result: in the context of HIPC agreements, countries may be obliged to start or resume servicing debts that they ignored before.
4. Extent to which debt relief freed resources for the government, with special attention to Dutch debt relief. This follows from 2.6, 3.2 and 3.3. Compare to the amounts of new loans and grants received during the period 1990-1999 (see 2.7).
5. Extent to which debt relief benefited the creditor itself or other creditors (bailing out), with special attention to Dutch debt relief. This follows from 3.2-3.4. Specify whether official or private creditors benefited.
6. Effect of debt relief on the reduction of the nominal debt stock and the net present value (NPV) of debt.
7. Compliance with debt relief conditionality, changes in policies, changes in governance (see Table 2 and Annex 2).
8. To the extent that debt relief was additional and freed resources (3.4): trace its effects in the government accounts (on public investment and social expenditure, in particular) and in the balance of payments (increased imports, if possible broken down by destination: capital goods, intermediate inputs, consumer goods), according to the accounting framework outlined in Annex 3.

Assessment:
How efficient were the chosen modalities of debt relief in reducing the debt burden, in terms of both NPV of debt and actual debt service?

4. Outcomes of debt relief: Effectiveness

The effectiveness of debt relief is to be assessed by collecting / analysing the following data:

1. Trends during the evaluation period 1990-1999 in the debt sustainability indicators: debt/GDP, debt service due/exports, NPV of debt/exports. We focus on trends as most relevant issue for this evaluation. However, the absolute values of these indicators will be compared to subjective sustainability criteria (limits) according to the IFIs (from HIPC documents) but also according to other sources, e.g. Hanlon (2000).
2. Extent to which change in sustainability can be attributed to debt relief. Both the numerators and the denominators of these indicators are not only the result of debt relief, but also of new loans and grants during the period and of the concessionality of those loans (see Annex 4). In addition, the trends in GDP and exports (the denominators) depend on many other factors: policies, political stability, weather conditions, international prices, etc. The possible causes for the developments in the debt sustainability indicators will be analysed.
3. Improvement, if any, of social indicators (see Annex 5) as a result of debt relief leading to policy changes and changes in governance (as analysed in 3.6) .
4. Improvement, if any, of social indicators as a result of debt relief freeing government resources for more public investment and social expenditure (3.7).
5. Increase, if any, in private investment as a result of debt relief freeing resources for more public investment: crowding in.
6. Increase, if any, in private investment as a result of debt relief lowering the debt stock, thereby reducing the debt overhang.
7. Improvement, if any, in the creditworthiness of the country leading to new private capital inflows, as a result of a reduction of the debt stock. This implies an analysis of creditworthiness according to ratings, and of figures on private capital inflows (distinguishing between loans, portfolio investment, FDI). It must be born in mind that other factors such as (expected) economic growth, credibility of government policies, and even conditionality attached to debt relief efforts may also have led to improvements in ratings and increases in flows. Debt relief may, on the other hand, have reduced creditworthiness by lowering expectations on future debt service by the country. According to a recent literature review and additional empirical evidence, policy-based lending and the attached conditionality have only limited effect on private flows (Bird & Rowlands, 2000).

   ***Field studies**:*
   In the field studies, the trends in social indicators (4.3-4.4) and in private investment and private capital inflows (4.5-4.7) can be analysed and explained more thoroughly by having interviews with government officials, NGOs, donors and representatives of the private sector.

Assessment:
How effective has debt relief been in increasing debt sustainability, stimulating private investment and improving social indicators, both via the attached conditionality and via the stock and flow effects of debt relief?

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5. Impact of debt relief: Relevance

Assessment:
Based on the analysis under 1-4, the final impact of the different modalities of debt relief on economic growth and on poverty reduction is to be assessed.

1. Economic growth was already briefly analysed in 4.1 and 4.2 as denominator for one of the debt sustainability indicators, but the analysis can now be broadened, taking into account the other outcomes under 4 (4.3-4.7).

2. For poverty, trends in the usual poverty indicators (P_0, per cent of population below poverty line), and P_1, the poverty gap (total shortfall of income of the persons below poverty line) will be collected (if available). For the analysis, it is important that poverty reduction may be achieved through economic growth, through an improvement of the income distribution or (in the longer run) through an improvement in social indicators.

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Table 1. Evaluation matrix Debt relief

OBJECTIVES-MEANS	INDICATORS	SOURCES	*EVALUATION CRITERIA*
INPUT Debt relief expenditures and modalities; Policy dialogue**.**	Amounts spent, assigned and contributed; Conditions.	Documents for Dutch Parliament **"Macro-exercise", assessment memos for debt relief;** Global Development Finance; National statistics; WB/IMF country reports.	
Comparison outputs and inputs →			***EFFICIENCY***
OUTPUT Reduction debt and debt service; Increase imports and government expenditure; Policy change and change in governance.	Total debt (nominal and net present value); Interest payments and amortizations; Balance of payments; Government accounts**.**	Global Development Finance; World Development Indicators; IMF; National statistics; WB/IMF country reports.	
Extent to which inputs via outputs contribute to outcomes →			***EFFECTIVENESS***
OUTCOME Reduction debt burden; Improvement creditworthiness; Investment.	Debt/GDP; Debt service/Exports; International credit ratings; I/GDP; I_p/GDP.	Global Development Finance; World Development Indicators; IMF; National statistics; Moody's; Standard & Poor; WB/IMF country reports.	
Extent to which inputs via outputs and outcomes contribute to impact →			***RELEVANCE***
IMPACT Economic growth	Change in GDP	World Development Indicators; National statistics.	
Sustainable poverty reduction			

Table 2. Possible aspects of the track record possible policy conditions for debt relief

Area	Policy/target
Macro-economic	Stock of international reserves Government deficit (% GDP) Government expenditure (% GDP) Exchange rate policies (devaluation)
Economic reforms	Tax reforms Public sector reform/civil service reform Composition of expenditure (defence) Privatisation of SOEs, public utility enterprises Liberalisation of goods markets: prices, domestic trade Liberalisation of foreign trade Liberalisation of labour market Financial liberalisation Other sectoral reforms
Political reforms	Elections Multiparty system Human rights observance Independent judiciary Free press
Governance	Transparency of budgeting Transparency of budget execution Accountability, to parliament, local councils, civil society Anti-corruption measures/sanctions Establishment of and respect for Audit Office Decentralisation
Poverty reduction	Social expenditure Social sector reforms Quality of social service delivery PRSP

Annex 1

Effective debt relief

Effective debt relief (DR_e) is debt relief that reduces actual debt service (DS_a)

To be computed from:

$DS_a = DS_d - AA$ (1)

$DR_e = DR - PA$ (2)

Where:

DS = Debt Service
DR = Debt Relief
Subscript *a* = "actual"
Subscript *e* = "effective"
AA = Accumulation of Arrears
PA = Payment of Arrears
Subscript *d* = due

DR_e is still an approximation, since debt relief covering debt service due that would never be paid in the same year, is still included. This often the case with Dutch debt relief on Dutch aid loans. If known, it must be subtracted from the figure for DR_e.

Annex 2

The effectiveness of conditionality

To the extent that debt relief was accompanied by conditionality on future policies, or by conditions regarding past policies or policy outcomes ("track record") the extent of compliance with these conditions must be assessed (with respect to changes in policies and changes in governance, see Table 2). The track record has become important for Dutch debt relief decisions since 1996. The evaluation must therefore investigate whether and to what extent the conditions mentioned in the "macro exercise" were fulfilled in the case of the involved country. A second issue is whether changes in country's policies or governance can be observed since 1996 that go in the direction of improving the "conditions" stipulated in the macro exercise. Evidence for this can be looked for in HIPC documentation on the country, Policy Framework Papers, Implementation Completion Reports of SALs and SECALs of WB.

In field studies, information can also come from interviews. Interviews should also shed light on the issue of whether the fact that the Dutch have used this track record as basis for decision making on debt relief, has to any extent *influenced* governance and policies (see below).

In the context of the HIPC initiative, the track record has become important since 1998 and involves an assessment of whether conditions stipulated in earlier IFI programs have been complied with satisfactorily. This can be found in HIPC documents on the country, but an independent assessment by the evaluator is also necessary. For example, earlier evaluation research showed that countries were not always treated equally. As of 1999, the HIPC conditions include the setting up of a Poverty Reduction Strategy Paper (PRSP). For the desk studies it is too early to investigate whether the HIPC track record or the requirement of a PRSP have induced a change in the country's policies or governance. In the field studies, donor influence on policies and governance can be examined.

Donor influence (field studies only)

One thing is to establish that countries have complied (or not) with conditions set by the donor; another is to conclude on effective influence of donors. An earlier evaluation concluded that domestic political factors are most important in policy changes but there is also some room for donor influence, especially if we take other dimensions of the "policy dialogue" into account, i.e. other than the formal, directive conditions laid out by the IFIs and directly imposed on the recipient country's government (White, 1999).

This means, first, that we have to take on a broad political economy perspective in explaining why reforms have come about. Donors usually tend to overstate their roles. Second, it means that we have to consider the policy dialogue as a process with four dimensions as discovered in the previous evaluation: the degree of formality, the channel of influence (directly to government, indirectly through IFIs or indirectly through contact with other donors), whether conditionality is directive (policy monologue) or non-directive, and which instrument is used (White, 99: 53-54; see also a useful table of possible channels and degree of formality on p. 37). Instruments

can be debt relief, budget support, project aid or technical assistance. The earlier evaluation has shown that there may be some influence from donors, but that this is usually carried out through less formal means, non-directive approaches and often using other channels.

The study of donor influence consists of two parts: i) examining Dutch influence, and ii) examining the impact of the HIPC conditions, in particular, the requirement that countries elaborate a Poverty Reduction Strategy Paper (PRSP) and do so in a participatory manner. On the first, field studies can first investigate whether the Dutch Embassy has an influence strategy that takes the different dimensions into account, and on which particular issues it focused. Second, by having interviews with government officials and with other donor representatives, the effectiveness of that influence strategy can be assessed. Since this may lead to subjective and not very exact statements, the approach will be to single out one or two issues (from the Dutch "track record") on which the Dutch had or have a strong opinion – different from the government's opinion – and examine what happened with this "conflict".
For the second aim, the same interviews with donor representatives and government officials can be used to assess the progress in coming to a PRSP. On this topic, interviews with representatives of NGOs and private sector (civil society) will also be necessary. If possible, also for this part a particular issue on which opinions differ will be singled out and followed, in order to improve the judgement on the extent of influence.

Annex 3

The marginal effect of debt relief: the accounting framework

The approach proposed here is similar to the one described for the Sida Evaluation of Programme Aid (see White, 1999: 94-6). It focuses on the marginal impact of debt relief. This is different from the often used "gap approach" which is considered not very helpful (White, 1999: 89-93). It means that we analyse the influence of effective debt relief (free resources) on balance of payments, internal accounts and on government accounts (a subset of the internal accounts), on the basis of accounting identities.

For the external account, the identity is the following:

$M = AID + PCT + DR_e - DS + X + OKI + \Delta R + EO$ [7] (3)

If DR_e (see Annex 1) increases, one or more of the other items must change. The fact that DR_e is positive, implies that the absolute value of DS (debt service) has reduced (as established in 3.1). The impact of DR on other DS has been established in 3.2 and can be used here. Similarly, it has already been established whether DR was additional, i.e. did not lead to a reduction in aid (2.6). From all these, we can compute the net effective debt relief. It will now be examined whether this net DR_e leads to higher imports and/or reserves, which are the preferred responses for donors. This depends on the effects on OKI, ΔR, EO (often capital flight), X, and PCT. A reduction in X could be a negative effect of AID and net DR_e, for example due to Dutch disease effects. Decreases in PCT, OKI and EO (if capital flight) would also be negative responses to DR_e. Increases in PCT and OKI could be positive second round effects of DR_e.
A next step is to look at the composition of imports. Does the composition of imports change as a result of net DR_e? The preferred outcome would be that imports of capital goods and intermediate goods would increase more than imports of consumer goods. This would point to a higher propensity to invest as opposed to to consume.
For the internal account, the identity is the following:

$I = AID + DR_e - DS + OKI + \Delta R + EO + S$ [8] (4)

The analysis for AID, DS, OKI, ΔR and EO is the same as above. The marginal effect of net DR_e on I depends on what happens to S, domestic savings.

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[7] M = Imports
PCT = Private Capital Transfers
DR_e = Effective debt relief
DS = Debt service
X = Exports
OKI = Other capital inflows
ΔR = Change in reserves
EO = Errors and Omissions

[8] I = Investment
S = Savings

If savings diminish as a result of the additional free resources (as claimed by Easterly, 1999, for example[9]), this would be a negative effect of debt relief. Ideally, DR_e would be accompanied not only by higher I but also by higher S.

The internal account can be broken down further, allowing for separate government income and expenditure. A change in domestic savings is the sum of changes in private saving and changes in government revenues. Investment can be broken down into government expenditure and private investment (see schemes in White 1999: 95).

According to the "fiscal response" literature (White, 1998), the marginal effect of aid (in this case, net effective debt relief) can be to reduce revenues. The analysis of government accounts must therefore begin by looking at what happens to government revenues. A second possible effect that must be examined is the effect on the deficit. If revenues and deficit remain unchanged, the whole effect of net DR_e is on increased expenditure, which is the intended effect of donors (resources should be freed for other – social – expenses). The third step is to look at the composition of expenditure. Does the freeing of government resources lead to increased priority for social expenditure or for public investment? The trends in the share of these sectors within total expenditure will be examined.

[9] Easterly (1999) does not distinguish between debt relief and effective debt relief, however; and his model that stresses "perverse incentive effects" also overlooks that the continued lending by HIPC countries is probably as much the result of (lending) supply factors than of demand factors such as a high discount rate.

Annex 4

Debt sustainability

In the long run, debt service can be sustainable if the following holds (Gillis et al., 1996: 414):

$D/X = a/(g_E - i)$ (5)

Where D = debt, X = exports, a = the trade gap $(M - X)/X$, M = imports, g_E = the growth rate of exports, and i = the average interest rate on debt.

This means that as long as the growth rate of exports is higher than the interest rate, a sustainable debt/exports ratio can be accompanied by a trade gap a (i.e. by increasing debt). A first issue to be examined is therefore whether the growth rate of exports is higher or lower than the average interest rate of the debt stocks over 1990-99 (as computed in 2.7). If it is lower, it can be argued that the country had a solvability problem and not a liquidity problem, and that new loans would not lead to a sustainable debt service.

The next component to analyse is the trend in the trade gap. This trade gap a is constant if the growth rate of imports is equal to the growth rate of exports, but this is not necessary for the analysis. In our study, the trade gap that leads to this increase in debt $a = (M - X)/X$ must be adjusted for the non-loans part of aid (i.e. grants, A) and for net effective debt relief (DR_e, see Annex 1), so we will look at what happens to

$$\frac{M - (X + A + DR_e)}{X}$$

If the growth rates of exports is lower than the interest rate, D/E is only sustainable if there is a surplus, so $M-(X+A+DR_e) < 0$.

Similarly, the debt/GDP ratio can be sustainable in the long run if (Gillis et al., 1996: 415):

$D/Y = (v - s)/(g_Y - i)$ (6)

Where $Y = GNP$, g_Y = the growth rate of Y, $v = I/Y$, the investment ratio, and $s = S/Y$, the savings ratio.
As long as g_Y is above the interest rate, a sustainable debt/income ratio can be accompanied by a continuing and constant savings gap ($v - s > 0$). This savings gap leading to increased debt must also be adjusted for grants (A) and for net effective debt relief (net DR_e) , so we look at:

$v - s - A/Y - DR_e/Y$

If g_Y is below the interest rate, there must be a savings surplus. The evaluation will examine the trends 1990-99 in g_Y as compared to i, and of v, s, A/Y and DR_e/Y

For the government, we can assess sustainability in relation to the tax capacity (Fishlow, 1988: 220-21). In the long run, the debt burden is sustainable if:

$D/T = \{(G - T)/T\} / (r_t - I)$ (7)

Where T = tax income, G = government expenditure, r_t = growth rate of taxes.

In this part of the analysis, the sustainability of the debt burden for the government is not only determined by the external public debt, but also by the internal debt. This is a problem for Jamaica, for example. An average interest rate on total public debt will have to be computed. This average interest rate must then be compared with the growth rate of taxes. The latter will probably be related to the growth rate of GDP, but there can also be an independent effect due to, for example, tax reforms. If the interest rate is higher than the growth rate of taxes, the government must have a surplus (G-T) < 0 for debt service to be sustainable.

Annex 5

Social indicators

Social indicators to be analysed could be taken from the OECD/DAC indicators for social development (Nos. 4-15 of the 21 Indicators for sustainable poverty reduction). These are:

Indicator	**Measure**	**Source**
Children under 5 with underweight	%	WDR (WDI)
Enrolment in primary education (%)	%	WDR (WDI)
Share of people with fourth grade	% of adults	HDR (WDI?)
Alphabetisation	% of adults	HDR (WDI?)
Gender equality in primary enrolment,	F/m, in %	UNFPA or WISTAT
Gender equality in secondary enrolment	F/m, in %	UNFPA or WISTAT
Gender equality in alphabetisation	F/m, in %	HDR
Infant mortality rate	%	HDR
Child mortality rate	%	WDR (WDI)
Maternal mortality rate	%	WDR (WDI)
Deliveries under expert supervision	% of total	UNFPA
Use of contraceptives	% of married women	HDR
HIV ratio	% of adults	UNAIDS

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