DEBT AND DEVELOPMENT CO-OPERATION:
DEBT RELIEF ACTIONS BY DAC MEMBERS

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT
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EXECUTIVE SUMMARY

The DAC’s Working Party on Financial Aspects of Development Assistance (WP/FA) undertook in 1995/96 an examination of the nature and operation of bilateral debt relief measures. The objective of this work was to share insights and experience on bilateral debt relief policies, implementation and impact. Countries which contributed information include Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Sweden, Switzerland, the United Kingdom and the United States.

Bilateral debt relief plays an important role in alleviating the debt overhang of highly indebted developing countries. This report focuses on bilateral debt relief initiatives based on experience to date: their scope and content, how they work, and the levels of support they provide. In order to situate these bilateral initiatives within the broader debt strategy, the report also looks at the evolution of more concerted approaches, including the Paris Club and the recent agreement in the World Bank/IMF framework on the “Initiative for Highly Indebted Poor Countries” (HIPC).

Section I provides a backdrop to the body of the report, with a profile of the bilateral debt of developing countries and trends in donor policies in response to debt problems.

Section II catalogues the different bilateral debt relief programmes and instruments that are used to cancel, convert or buy-back the debt of developing countries or relieve debt servicing obligations. Findings show that:

− many donors have modified their development assistance policies (e.g. reducing or phasing out ODA loans and increasing grants) in the light of the debt problems experienced by developing countries;

− debt relief has averaged 10 per cent of bilateral aid commitments over the past five years, with the most active area of donor involvement’s being debt forgiveness, totalling $18.5 billion since 1991 (see pp.9-11).

Section III assesses donor experience with debt relief measures. It highlights a number of points:

− Debt relief has an important role to play in promoting sustainable development.

− While all of the various programmes and measures work to improve the debtor countries’ balance sheets, each has its particular impacts and strengths. Debt forgiveness is a relatively straightforward accounting operation. Debt conversion permits targeted support for specific projects. Debt buy-backs have dramatically reduced debt owed to private creditors. Donor assistance to relieving multilateral debt obligations permits renewed access to multilateral funding and Paris Club relief.
− Bilateral initiatives work best when targeted to the poorest, most indebted countries, when tailored to local conditions and priorities and when donors pool funds for concerted action.

− It is crucial to ensure that debt relief promotes (rather than undercuts) financial discipline, that it relaxes serious constraints to development, and that budgetary resources thereby freed are allocated to high-priority sectors and used effectively.
DEBT AND DEVELOPMENT CO-OPERATION: DEBT RELIEF ACTIONS
BY DAC MEMBERS

I. Development co-operation and developing country debt

1. *The developing country debt situation*

1. Concern over high and unsustainable debt burdens has caused many donors to take steps to address the situation. Some donors no longer provide ODA in the form of loans (e.g. Australia, Canada, Denmark, Ireland, Luxembourg, Netherlands, New Zealand, Sweden, Switzerland, the United Kingdom and United States) or are quickly phasing out these operations (e.g. Finland). Increasingly, donors are providing bilateral aid as grants instead of loans to severely-indebted countries in light of their debt situation and financing needs. These trends have already had an impact: a number of DAC Members have no outstanding ODA debt to developing countries. However, concessional loan finance continues to play an important role in the programmes of some donors, such as Japan, which funds its aid from the domestic savings system and believes that repayment obligations engender discipline on borrowers.

2. Almost all DAC Members have been extending debt relief to developing countries. For some, debt relief actions have been concentrated on debt forgiveness, often in the Paris Club context. Indeed, the bulk of bilateral debt relief has taken place through concerted actions of creditors in the Paris Club, which continues to play a key role in treating developing country debt problems. Nevertheless, a steadily growing number of donors have also engaged bilaterally in conversion and buy-back operations and have participated in multilateral debt alleviation programmes. In doing so, they have stimulated the development of innovative debt reduction techniques. Based on information provided by Members, bilateral initiatives are set out in Section II below. [See also Box 1].

3. Debt servicing performance for many of the “severely indebted low-income countries” (SILICs) has been far below contractual obligations, with no realistic hope (until recently; see HIPC Initiative below) -- given present debt levels -- of achieving sustainable levels of debt (although Paris Club debt relief actions over the past decade have enabled them to service their obligations on a year-by-year basis). The largest portion of SILIC debt is official or officially-supported claims. In a significant number of cases, a large proportion of official claims is multilateral.

4. The structure of SILIC debt and severe servicing difficulties makes the debt problems of these countries more intractable than those of middle-income countries, where major write-downs of private debt were possible. Recognising the special problems posed by SILIC debt structures, the international community has agreed to support a special Initiative for highly indebted poor countries (HIPC) devised by the World Bank and the IMF. The HIPC Initiative allows a comprehensive approach to resolving the debt problems of poorer countries: for the first time ODA debt, bilateral credits, private debt and multilateral debt will be dealt with in an overall framework for countries who qualify by virtue of their economic policy performance and degree of indebtedness (See Box 2 for a description of the HIPC Initiative).
5. Debt relief accounts for an appreciable share of total bilateral development assistance efforts. Since 1991, ODA and non-ODA debt relief by DAC Members has averaged more than 10 per cent of total

<table>
<thead>
<tr>
<th>Box 1. Debt relief: mechanisms and modalities</th>
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<tbody>
<tr>
<td>Debt relief is carried out through the following transactions:</td>
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<tr>
<td>• debt forgiveness or cancellation, where debt is expunged by mutual agreement between debtor and creditor;</td>
</tr>
<tr>
<td>• debt conversion, where debt is exchanged for another liability. In a typical debt conversion, debt is partially written off and the remainder is converted into either equity or a local currency “obligation”, the annual servicing of which is commonly used to fund targeted development assistance projects in the debtor country;</td>
</tr>
<tr>
<td>• debt buy-backs, where all or part of a country’s external debt is “purchased” (e.g. retired) from creditors, usually at a discount;</td>
</tr>
<tr>
<td>• financing bilateral and multilateral debt service obligations by providing foreign exchange to cover interest and principal payments.</td>
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Debt relief modalities:

Numerous initiatives to reduce developing country debt have been pursued by bilateral donors. Donors work principally on three fronts:

* eliminating or reducing bilateral official debt;
* converting debt obligations into local currency ODA grants or equity; and
* using ODA to finance buy-back operations for official or private debt.

Bilateral debt relief is accorded either on a unilateral basis or within a multilaterally co-ordinated framework:

• Unilateral debt relief includes:
  * outright debt forgiveness;
  * debt conversion; and
  * debt buy-backs.

• Multilaterally co-ordinated debt relief includes:
  * Paris Club debt rescheduling or reduction, wherein bilateral official creditors accord debt relief on commensurate terms to ensure burden-sharing. Coverage includes concessional (ODA) and non-concessional (export credits/guarantees) debt;
  * Debt buy-backs for private debt held by middle-income countries (Brady-type operations) and low-income countries (the IDA Debt Reduction Facility); and
  * Relief from multilateral debt servicing obligations or clearance of arrears (e.g. IMF “rights accumulation” programmes, the World Bank’s “Fifth Dimension” facility, etc.)

Several donors have launched special debt-reduction initiatives since the beginning of the decade that involve different combinations of debt forgiveness, conversions or buy-backs. These include Canada's “Debt Conversion Initiative for Sustainable Development”, France's “Libreville Initiative”, Switzerland's “Comprehensive Debt Reduction Facility”, and the United States' “Enterprise for the Americas” Initiative. Various elements of these initiatives are described in Section II.
Box 2. The HIPC Initiative

Heavy external debt burdens (including multilateral debt) jeopardise future growth prospects and the tax administrative capacity of many poorer developing countries. At the April 1995 World Bank/IMF Development Committee meeting and subsequently at the Halifax Summit, a consensus emerged for urging the Bretton Woods institutions to develop a comprehensive approach for dealing with this problem.

Subsequently the World Bank and the IMF, in consultation with bilateral donors and the developing countries concerned, devised a phased programme through which these countries could achieve a sustainable debt position. The Heavily Indebted Poor Countries (HIPC) Initiative, agreed in September 1996 at the World Bank/IMF annual meeting, is designed to provide comprehensive and co-ordinated debt relief to HIPCs that have demonstrated a commitment to structural reform and sound economic and social policies, thereby ensuring that the relief provided will be effectively used.

Eligibility for relief under the initiative will be based on specific external debt burden indicators, in relation to exports, after the full use of traditional debt-relief mechanisms, supplemented by consideration of fiscal burdens and other factors pertinent to individual countries. Debtor countries will be required to maintain sustained economic reforms (macroeconomic, structural, and social) to be eligible for the initiative. Generally, this would involve three years of sustained reform prior to the “decision point”, as required for Naples Terms stock-of-debt reduction by the Paris Club, plus an additional period of up to three years of reform under the HIPC Initiative to qualify for enhanced relief, which would be delivered at the “completion point”.

The Paris Club has agreed to provide up to 80 per cent debt forgiveness on a case-by-case basis in the framework of this initiative. IMF participation will take place through the Enhanced Structural Adjustment Facility (ESAF) in the form of grants or highly concessional loans to be used solely for paying debt service falling due to the Fund for eligible countries. A Trust Fund (to which the World Bank has pledged $500 million from its net income) will be established to help fund assistance from some other multilateral institutions, including the World Bank; further contributions to this Trust Fund will be provided by both the World Bank (up to possibly $2 billion) and bilateral donors.

The overall financial requirement of the HIPC Initiative was estimated at around $6 billion at one stage but this is subject to revision as costs become better known. HIPCs will have two years in which to decide whether they want to enter into this six-year process. Some countries will doubtless be accorded accelerated treatment on the basis of demonstrated performance.

Bilateral aid commitments annually, a share that has grown steadily over the past decade (see Table 1). Extraordinary debt relief accorded by several bilateral donors to Egypt and Poland accounted for the sharp rise in aid commitments for debt relief in 1990.
Box 2. The HIPC Initiative (contd.)

The HIPC Initiative has been elaborated on the basis of six guiding principles:

- The objective should be to target overall debt sustainability on a case-by-case basis, focusing on the totality of a country’s debt.

- Action should be envisaged only when the debtor has shown, through a track record of reform and sound policies, the ability to put to good use whatever exceptional support is provided to achieve a sustainable outcome.

- New measures should build, as much as possible, on existing mechanisms.

- Additional action for the problem cases should be co-ordinated among all creditors involved, with broad and equitable participation.

- Any action to relieve the burden of debt owed to multilateral creditors should preserve the financial integrity of the institutions and their preferred creditor status, and be consistent with the constraints of their charters, in order that the institutions can continue to provide financing to all member countries on appropriate terms.

- New external finance for the countries concerned should be on appropriately concessional terms, so as to support their efforts to pursue reform and establish a track record of good policy.

6. Tables 2 to 4 provide some background information on bilateral debt and debt forgiveness. Key features are as follows:

- ODA debt represents about 10 per cent of the debt stock of the developing countries as a whole, although its importance is higher for the low-income countries (LICs) and for Sub-Saharan Africa, as these areas receive comparatively little private debt-related flows (see Table 2a).

- Service payments on ODA debt represent about 5 per cent of actual debt service payments for the developing countries as a whole. But again it weighs more heavily for the LICs and Sub-Saharan Africa (see Table 2b).

- Four major donors (France, Germany, Japan and the United States) together account for more than 90 per cent of the total ODA debt owed by developing countries. An important share of this outstanding ODA debt is held by dynamic, rapidly-growing developing countries in Asia (e.g. China, Indonesia) and Latin America (e.g. Costa Rica, Peru) (see Table 3).

- Bilateral debt forgiven by donor countries over the period 1991-95 amounts to $18.85 billion. The share of ODA debt in this total is 45 per cent (see Table 4 -- DAC Member reporting on debt forgiveness is not always complete or strictly comparable. The DAC is at present undertaking efforts to improve this situation).
7. The different debt relief measures DAC Member countries have undertaken in recent years and levels of finance involved are shown in Table 5, based on information provided by DAC Members.

2. Official bilateral debt -- components and relief mechanisms

8. The outstanding debt of developing countries is composed of official (including officially guaranteed) debt and private debt. Official debt is debt arising from loans provided or guaranteed by a bilateral government agency or a multilateral development agency to a developing country government agency or enterprise. Private debt is debt provided by a private entity (e.g. a bank or consortium of banks, a supplier, or private investors participating in a debenture or bond issue) to a developing country government agency or enterprise. This report focuses only on official debt.

Bilateral debt

9. Bilateral official debt arises from finance provided on concessional or non-concessional terms. Its main components are:

− Official Development Assistance (ODA) loans (minimum grant element of 25 per cent);
− Other Official Finance (OOF) loans (grant element below 25 per cent);
− Officially financed or supported (guaranteed) export credits.

Bilateral official debt that is forgiven or reduced may be recorded by the creditor as ODA, irrespective of the terms on which it was originally granted (see Annex 1 for a description of ongoing DAC work regarding the reporting of debt relief).

Multilateral debt

10. Multilateral official debt may also be concessional (e.g. loans by the World Bank’s IDA affiliate) or non-concessional (e.g. World Bank IBRD and IMF resources). Multilateral debt extended by the major multilateral institutions cannot be forgiven or otherwise reduced (e.g. converted) due to their preferred creditor status. Nevertheless, finance made available to cover related servicing obligations can provide welcome debt relief for this category of debt: this is the modality through which multilateral debt burdens will be reduced in the context of the HIPC Initiative.

II. Donor policies and instruments

1. Introductory remarks

11. Countries have different budget arrangements for funding debt relief, often linked to specific instruments or programmes. For several, one budget -- the ODA budget -- covers all debt actions. For most of the countries where this applies, the budget appropriation for debt relief covers both ODA and non-ODA (e.g. export credits and guarantees) debt. Belgium, however, noted that its ODA debt relief budget allocation is used exclusively to write off non-ODA debt. In some cases, country desks and/or in-country missions have resources at their disposal for supporting debt relief actions. For other DAC
Members, debt relief for non-ODA Paris Club debt is funded wholly, or in part, through other government ministries (e.g. the Finance Ministry). Switzerland has established a free-standing debt relief “facility” funded from outside the aid budget to finance debt reduction activities. Thus some donors fund debt relief from within the “ODA financial envelope” and others from outside it. Some have systematic approaches and programmes for debt relief; for others it is entirely ad hoc. It is not easy in these circumstances to say how much ODA “additionality” is involved in the overall magnitude of debt relief.

12. The principal criteria for choosing among different debt relief options (catalogued below) include the composition of the debt stock, sustainable development objectives, local implementation capacities, and the expected impact on the recipient. Increasingly, “effectiveness” has become an important criterion. Debt reduction actions undertaken on a co-ordinated, multilateral basis (such as Paris Club debt relief or that envisaged under the HIPC Initiative) should, by definition, rank high in this regard, since they will contribute to a definitive return to “debt sustainability”.

13. Donors have considered a number of factors when determining which recipient countries should receive debt relief, such as the nature and extent of the debt servicing problem, the composition of debt (e.g. private, public, bilateral, multilateral), the country’s eligibility for aid, income levels, political/foreign policy considerations, the views of other national agencies involved in international affairs, and availability of funding. The HIPC Initiative creates a structured set of criteria for determining which countries should receive comprehensive debt relief and at what point in time, though a degree of flexibility is built into the scheme.

2. A catalogue of instruments

14. This section describes the specific bilateral debt relief actions of DAC Members and associated levels of support. It is organised according to four main categories of debt relief -- debt forgiveness, debt conversion, debt buy-backs, and relief from multilateral obligations.

A. Debt forgiveness

15. Forgiveness or cancellation of official debt is the extinction of debt, in whole or in part, by agreement between a donor/creditor and a recipient/debtor. This is by far the most active area of donor debt relief, accounting for more than $18 billion since 1991 (as reported by donor agencies to the DAC for statistical purposes).

16. Examples of donor actions (figures have been converted to approximate US dollar equivalents for comparative purposes) include:

- **Australia** has forgiven $195 million of Egypt’s debt (net present value terms) as part of Paris Club debt relief.

- **Austria** announced at the 1995 “World Summit for Social Development” its intention to forgive up to Sch 1 billion ($89 million) of outstanding ODA loans held by severely indebted poor countries. A small share of this debt relief will be converted into debt swaps supporting environmental and social development.
Since 1991, **Belgium** has provided ODA of up to $19 million annually for non-ODA Paris Club debt reduction or debt conversion operations.

**Canada** has forgiven C$ 1.25 billion ($1.1 billion) of official bilateral debt (originally extended in the form of credits from the Export Development Corporation and the Canadian Wheat Board) to ODA-eligible countries.

Between 1978 and 1994 **Denmark** cancelled approximately 30 per cent of its ODA loans held by developing countries. New debt forgiveness guidelines adopted in 1995 led to the full or partial cancellation of approximately Dkr 1 billion ($162 million) of ODA debt owed to Denmark by Angola, Ghana, Nicaragua, Zimbabwe, Egypt and Bolivia. As a result of these more recent cancellations, Denmark’s accumulated forgiveness of outstanding ODA debt now totals 40 per cent of debt disbursed since 1963.

**Finland** has forgiven debt totalling approximately Mk 750 million ($162 million) held by nine developing countries.

**France** cancelled FF 30.5 billion ($5.6 billion) of ODA debt in 1989 and 1991 following its commitment, announced at the 1989 Dakar Summit, to cancel the total stock of its concessional debt to 35 African countries. This was followed in 1994 by further comprehensive debt forgiveness in the wake of the CFA franc zone devaluation (Dakar II), involving FF 25.3 billion ($4.6 billion) of ODA debt to low and middle income countries in the CFA zone. In total, France has forgiven developing country debt totalling approximately FF 58 billion ($10.7 billion) since 1972.

Beginning in 1978, **Germany** cancelled or agreed to cancel ODA debt amounting to more than DM 9 billion ($5.6 billion) held by least-developed countries and other poor countries in Sub-Saharan Africa. In addition, Germany has forgiven a total of DM 1.4 billion ($880 million) in Paris Club operations (for 12 countries under Toronto terms and 18 countries under Trinidad terms). Germany stands ready to write-off a further DM 3.35 billion ($2.1 billion) of commercial debt (held by 23 countries) under Naples terms, and is prepared to reach conclusive stock-of-debt settlements with these countries on condition that they have carried out consistent reform efforts and have met Paris Club obligations.

**Italy** has forgiven ODA debt totalling L921 billion or $651 million held by six African countries (Mali, Mozambique, Nicaragua, Sierra Leone, Tanzania and Zambia).

**Japan**’s general policy stance is that debt **forgiveness** can damage creditors’ perceptions of debtor countries, have negative effects on new inflows of capital and result in "moral hazard". Debt forgiveness should therefore be exceptional, undertaken only in special circumstances, on a case-by-case basis. Nevertheless, Japan has accorded debt **relief** totalling over Y 100 billion ($1.2 billion) for the period 1989-93, with a further $290 million forgiven in 1994. For the least-developed countries (LLDCs), forgiveness was undertaken through the provision of grants in amounts equal to the total principal and interest due on outstanding yen loan agreements.

In 1991, **Mexico** restructured over $1 billion of debt accumulated by Nicaragua under the 1980 San José agreement, which provided concessional loans linked to oil imports. Under the restructuring, repayments are linked to Nicaragua’s export performance. At present the implicit rate of debt forgiveness is over 90 per cent. [Mexico is a Member of the OECD, but not of the DAC].
Since 1990, the **Netherlands** has written off ODA debt amounting to more than Gld 903 million ($505 million). Paris Club debt relief totalled almost Gld 42 million ($23.5 million) between 1993 and 1995.

**Norway**'s debt forgiveness is mainly done within the context of Paris Club debt relief operations (debt reduction option). In one case, Nicaragua, Norway has unilaterally forgiven its remaining claim after Paris Club treatment.

**Portugal** has forgiven debt service for Mozambique ($162 million) and Guinea Bissau ($7.6 million) in various Paris Club operations and has bilaterally forgiven the debt service for São Tomé and Príncipe ($14 million).

**Sweden** has cancelled ODA debt totalling Skr 1.2 billion ($178 million), the largest share of which was carried out in 1978.

**Switzerland** cancelled all outstanding ODA debt during the period 1978-85 and, since 1993, has forgiven more than SF 1.1 billion ($850 million) of officially guaranteed credits.

The **United Kingdom** has cancelled debt totalling approximately £1.2 billion ($2 billion).

Between 1990-96 **United States**' bilateral debt reduction totalled $12.8 billion. Most of this was accounted for by the exceptional $9.5 billion write-off of debt held by Egypt and Poland, the most significant debt forgiveness transactions yet recorded by a DAC Member. This relief was followed by $2.7 billion in ODA debt forgiveness in favour of the poorest nations.

### B. Debt conversion

17. Debt conversion is defined as the exchange of debt for another liability. Typically it involves converting (at a discount to face value) a foreign exchange obligation into local currency (at redemption terms established by the Central Bank), which is then used for a specific programme purpose (e.g. purchasing equity in a local enterprise or capitalising a fund to finance development projects).

18. Initial bilateral debt conversions took place in the context of Paris Club rescheduling operations (when the so-called "swap clause" permitting conversions was included -- see Box 3 for Paris Club terms). More recently, donors have begun implementing unilateral conversion or "swap" programmes, often as a result of special bilateral Initiatives such as Canada's "Debt Conversion Initiative for Sustainable Development", France's "Libreville Initiative", Switzerland's "Comprehensive Debt Reduction Facility", and the United States' "Enterprise for the Americas" Initiative (see below).

- Paris Club swap agreements

19. ODA debt (theoretically in unlimited amounts) and non-ODA debt (up to 10 per cent of claims or $10 million in most cases) are eligible for debt-equity and debt-for-development conversions in Paris Club reschedulings. Use of this facility has been more subdued than initially expected: at the end of 1994, $2.2 billion of Paris Club debt had been converted into local currency. Eight DAC Members (Belgium, Canada, France, Germany, Norway, Sweden, the United Kingdom and the United States) have voluntarily participated in debt swap arrangements. France has been most active in this regard, exchanging a total of $240 million. Egypt alone has accounted for almost half of Paris Club debt conversions to date.
Debt-equity swaps

Several developing countries have actively used debt-equity swaps to retire sovereign debt (most often owed to private commercial banks), among them Argentina ($12.2 billion), Chile ($11.1 billion), the Philippines ($3.5 billion), Mexico and Venezuela. Donor involvement in this process has been generally limited to providing technical expertise and advice to projects supporting privatisation operations and capital market development. Very few bilateral donors have undertaken debt-equity swaps for their own account.

Debt-for-development swaps

A significant number of bilateral donors have converted ODA debt into a variety of debt-for-development swaps promoting poverty alleviation, health, education, conservation and environment programmes, often with non-governmental organisations as partners/executing agencies. In volume terms, however, the impact of these transactions remains relatively modest, estimated at between $750 million and $1 billion to date.

The following examples illustrate recent actions:

- In June 1992, at the United Nations Conference on Environment and Development (UNCED), Canada announced the “Debt Conversion Initiative for Sustainable Development”, to convert up to C$ 145 million ($115 million) of ODA debt held by ten countries in Latin America into local funds to help finance environment and other sustainable development projects. As of December 1996, Canada had signed agreements with Columbia, Costa Rica, El Salvador, Honduras, Peru and Nicaragua. Over C$124 million ($110 million) has been converted.

- Finland is currently converting Mk 107 million ($23 million) of Peru's rescheduled credits, including accrued interest, into funds for nature and social development. Total counterpart funds amount to Mk 28 million ($6 million).

- In 1992, France created the “Libreville Initiative” (endowed with $750 million of ODA credits that had been rescheduled in the Paris Club) for four middle-income, heavily indebted countries (Cameroon, Congo, Côte d'Ivoire, and Gabon). To date, this fund has converted debt service totalling FF 1.2 million ($240 million) into funding for small-scale enterprise, infrastructure, environmental and social development projects. In 1996, France converted FF 400 million ($80 million) of debts into public development projects in northern Morocco (Ref.)

- Over the period 1993-95, Germany earmarked DM 375 million ($236 million) for conversion operations supporting environmental and poverty reduction projects. An additional DM 210 million ($132 million) has been set aside for 1997. As of December 1996, debt conversion agreements have been signed with Bolivia, Cameroon, the Congo, Côte d’Ivoire, Ecuador, Honduras, Jordan, Nicaragua, Peru, the Philippines and Viet Nam.

- Italy’s Parliament has recently agreed a provision allowing the government to provide debt relief through debt conversion operations.

- Since 1991 the Netherlands has funded several innovative debt swaps, including a Gld 5 million ($2.8 million) debt-for-child development swap (Jamaica) in 1991, and a Gld 6.3 million ($3.5 million) debt-for-social-action swap (Pakistan) in 1993.
– **Portugal** has carried out a $10 million debt/equity swap with Mozambique and has entered into a Esc 68 million ($0.50 million) debt-for-development swap agreement with São Tome and Principe.

– Between 1987 and 1996 **Sweden** converted debt totalling Skr 377 million ($56 million) for five countries (Costa Rica, Egypt, Nigeria, Peru, Tanzania and Tunisia).

– Under the “**Enterprise for the Americas**” Initiative, the **United States** has reduced the bilateral foreign and food assistance debt of Argentina, Bolivia, Chile, Colombia, El Salvador, Jamaica, and Uruguay by $875 million. These agreements are expected to generate about $154 million in local currency funds supporting environmental and child development programmes.

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### C. Debt buy-backs

23. A debt buy-back is the repurchase by a debtor country of all or part of its outstanding private debt, usually at a discount. The debtor country reduces its obligations while the creditor receives some payment.

24. Debt buy-back operations have contributed significantly to restoring the creditworthiness of middle-income developing countries (e.g. via Brady-type operations) and to improving the overall debt position of poorer developing countries (e.g. via the “**IDA Debt Reduction Facility**”).

– Brady-type operations

25. Brady deals involve restructuring the commercial debt of **middle-income developing countries** through reducing debt terms and amounts in exchange for financial guarantees on the value of the debt (collateral for the repayment of principal) and limited guarantees on interest payments. These operations may also include debt buy-backs and conversions. By December 1995, 13 developing countries had completed Brady debt restructuring operations covering some $191 billion of commercial bank debt.

26. Donors have provided finance to help debtor countries secure collateral, implement debt buy-backs and meet other up-front costs. Donor finance was particularly important in the Brady-type deals for Costa Rica (47 per cent of total costs), Mexico (29 per cent of total costs), and Venezuela and Argentina (25 per cent of total costs).

– **IDA Debt Reduction Facility**

27. This fund, capitalised with $300 million from World Bank net income between 1989 and 1996, facilitates the buy-back of **low-income countries’** commercial debt by providing a maximum $10 million grant when combined with additional donor grant co-finance. Operations for ten countries have been concluded, liquidating approximately $2.5 billion of commercial bank obligations. The average cost of these transactions has been 13 cents per dollar of debt extinguished. Specific examples of donor support include:

– **France** contributed $10 million towards helping Niger buy back $108 million of its commercial debt.
Box 3. Paris Club Debt Reduction Measures

The bulk of bilateral debt relief has taken place in the framework of the Paris Club, which continues to play a key role in treating developing country problems.

Since 1988, Paris Club members have granted successively greater concessional terms in debt rescheduling operations for poorer developing countries in an effort to ease their debt burdens. These arrangements permit official creditors either to cancel a share of outstanding debt or to reduce interest rates/extend maturities in order to achieve an equivalent reduction in servicing obligations. The range of debt eligible for such treatment is circumscribed.

The general outlines of these agreements are as follows:

- **1988 Toronto terms** permitted, for the first time, forgiveness of part of the debt being rescheduled (33 per cent) or a reduction in interest rates. Toronto terms also extended concessional treatment to non-concessional (e.g. export credits and guarantees) eligible debt.

- **1991 London terms** raised the share of possible debt reduction to 50 per cent and provided for flow reschedulings at interest rates that would reduce future debt service obligations by 50 per cent on a net present value basis. These terms also introduced the debt "swap" option and, as an innovative measure, allowed for a good-will clause (to be applied on a case-by-case basis) according to which, after a period of three years, a possibility for stock-of-debt relief could be implemented.

- **Naples terms** went beyond previous arrangements by according greater concessionality (the possibility of cancelling 67 per cent of eligible debt on a net present value basis or flow reschedulings resulting in equivalent relief (or 50 per cent ) and broadening the range of eligible debt. Naples terms also elaborated procedures for reducing a country's stock-of-debt, permitting an exit from the Paris Club rescheduling process.

Countries eligible for Naples terms are the poorest countries as determined by different criteria. They are, in practice, IDA-eligible countries. Naples terms provide i) two levels of reduction (50 per cent or 67 per cent), the latter being reserved for countries whose per-capita GNP is less than $500 and whose debt/export ratio is over 350% and ii) treatment applied either to the maturities of debt coming due during the period covered by an IMF structural adjustment programme or to the stock-of-debt for those countries sufficiently advanced on the path towards economic recovery.

Paris Club members recently agreed to increase Naples terms up to 80 per cent on a case-by-case basis for countries receiving comprehensive debt relief under the HIPC Initiative.

- **Germany** has provided funding totalling $5 million to Uganda, more than $6.3 million to Zambia and $1 million to Mauritania to help reduce their commercial bank debt through buy-back operations.

- The **Netherlands** has given Gld 37.3 million ($21 million) to support IDA debt buy-backs for Bolivia, Ethiopia, Nicaragua, Senegal and Zambia.
- **Portugal** provided technical assistance for São Tomé and Príncipe’s IDA-supported commercial debt buy-back.

- **Sweden** provided Skr 189 million ($28 million) in co-financing for IDA debt reduction operations for Bolivia, Mozambique, Nicaragua, and Zambia.

- **Switzerland** has provided SF 33.9 million ($24.6 million) for six IDA debt buy-backs (Bolivia, Mozambique, Nicaragua, Niger, Uganda, Zambia) which, cofinanced with other donors and the World Bank, have extinguished commercial debt amounting to $2.1 billion, at an average buy-back price of 9 cents per dollar of debt extinguished.

- The **United Kingdom** has contributed £4 million ($6.6 million) and £3 million ($4.9 million) to IDA commercial debt buy-backs for Ethiopia and Sierra Leone, respectively.

### D. Assistance for relieving multilateral debt obligations

28. Several donors have contributed to the World Bank’s “Fifth Dimension” facility, which provides relief to IDA countries on World Bank debt service obligations. Others have provided funds to help developing countries clear outstanding arrears to the World Bank and/or the IMF (e.g. the IMF's "Rights Accumulation Programme"). The principal contributors to the concessional funds of the international financial institutions (IDA, ESAF) are de facto those who also contribute most to the Fifth Dimension and Rights Accumulation Programme.

- **Australia** has contributed $5 million for clearing Viet Nam’s arrears to the IMF and $2.5 million towards clearing those of Cambodia.

- **Belgium** has made funding available to Niger, Rwanda and Viet Nam to help them clear arrears with various multilateral agencies.

- In 1988 **Canada** contributed approximately C$ 60 million ($48 million) to collective donor efforts which helped Guyana clear outstanding arrears to the IMF, the World Bank and other international lending bodies.

- Since 1990 **Denmark** has contributed a total of Dkr 82 million ($13.3 million) to settle Nicaragua’s and Uganda’s arrears to various international financial institutions. Some Dkr 25 million ($4 million) was granted to Zambia in 1990 for similar purposes. Denmark is currently considering a contribution of Dkr 30 million ($4.9 million) to Uganda’s Multilateral Debt Fund.

- **Finland** has granted Mk 183 million ($40 million) to Zambia and Nicaragua to pay back IMF accumulated arrears.

- **France** has provided assistance to CFA countries to clear arrears with the World Bank.

- The **Netherlands** provided Gld 78 million ($43.6 million) to donor support groups mobilised to clear outstanding multilateral agency arrears on behalf of Cambodia, Haiti, Macedonia, Nicaragua, Niger, Peru, Rwanda and Zambia. A further Gld 277 million ($155 million) has been granted to cover ongoing debt service payments to numerous multilateral agencies on behalf of 17 developing countries.
− Norway has contributed NOK 990 million ($150.6 million) to World Bank Fifth Dimension programmes for Bangladesh, Ethiopia, Malawi, Nicaragua, Tanzania, Uganda and Zambia. Norway provided NOK 10 million ($1.52 million) to clear World Bank arrears for Bosnia. Norway has also supported Uganda’s multilateral arrears through contributions totalling NOK 40 million ($6 million) to Uganda’s Multilateral Debt Fund in 1996 and a further NOK 25 million ($3.8 million) in the context of Uganda’s imminent HIPC Initiative treatment.

− Sweden has contributed to donor support groups organised to clear the arrears to multilateral agencies of Guyana, Peru, Nicaragua, Viet Nam, Cambodia, and Haiti. Sweden has also contributed to alleviating debt service obligations (mainly through the World Bank’s “Fifth Dimension” facility) for countries in Sub-Saharan Africa, as well as for Bolivia and Nicaragua. Total support for multilateral debt relief amounts to Skr 1.145 billion ($170 million) through 1996.

− Resources totalling $54 million from Switzerland’s “Comprehensive Debt Reduction Facility” have been used to help clear multilateral arrears for seven countries since 1991. Furthermore, Switzerland has provided $30 million for the financing of current obligations of five countries via the “Fifth Dimension” Facility and other multilateral debt relief mechanisms, as well as a first contribution of $15 million for debt relief under the HIPC Initiative.

− In 1994-95, the United Kingdom exceptionally granted £25 million ($41 million) programme aid to Zambia to reimburse the servicing of multilateral debt.

E. Technical assistance

29. While not designed to forgive or reduce debt, mention should also be made of the technical assistance programmes to upgrade developing country debt management capacity. This is increasingly a priority area for action by donors. Sound debt recording, management and policy-making capacities in developing countries are key to achieving and maintaining a sustainable debt position.

30. A large share of the technical assistance provided for upgrading debt management has been undertaken through collaborative multilateral assistance packages combining UNCTAD software, World Bank training and advisory services and UNDP financing. In this regard, the Debt Management and Financial Analysis System (DMFAS) of UNCTAD has become the most sophisticated and popular debt management utility, not least because it is fully compatible with the Debt Strategy Module (DSM) of the World Bank (the DSM is a key tool for carrying out the required sustainability analysis under the new HIPC Initiative). Rapid demand for DMFAS has been in large part satisfied because of substantial bilateral donor support. The Commonwealth Secretariat and Canada’s International Development Research Centre (IDRC) provide similar software, advisory and training services.

31. Examples of support in this area include:

− Twelve African countries have organised a regional training and technical assistance programme to upgrade debt management capacity with funding from Canada, Denmark, the Netherlands, and Sweden. This C$12 million ($9.5 million) programme was established in 1994 and is scheduled to end in June 1997.

− Canada is currently developing a C$ 15 million ($12 million) programme to improve the economic management capabilities of a number of southern African countries (Malawi, Mozambique, Zambia and Zimbabwe). Canada’s IDRC has since 1983 provided various forms of technical assistance for
debt management in countries of the Commonwealth and la Francophonie. Since 1990 a total of C$1.9 million ($1.5 million) has been spent on this programme, of which CIDA contributed C$0.8 million ($0.6 million).

- **Sweden** has supported DMFAS and regional debt management programmes with contributions totalling Skr 7 million ($1 million).

- **Switzerland** provided a total of SF 2 million ($1.5 million) to support the implementation of DMFAS in a total of nine countries in Africa, Latin America and in Vietnam.

### III. Assessing experience

32. This section provides a synthesis of donor country views and experience with bilateral Initiatives. It sets out some broad orientations for debt relief policies (see Section III.1) and provides a preliminary assessment of the pros and cons of related instruments and programmes.

33. Bilateral debt relief initiatives have a strong role to play in promoting sustainable development. Debt reduction and broader development co-operation efforts have important complementarities. Donor government budget costs may differ substantially for debt relief as opposed to programme aid. Nevertheless, some donors consider that explicit analysis of the opportunity costs of different uses of aid funds (e.g. debt relief “versus” programme aid) is not always appropriate or meaningful. Given the fungibility of the various types of development assistance, bilateral debt relief initiatives are best considered as one of the forms of bilateral or multilateral assistance contributing to development objectives.

34. Little has been done by way of systematic, comparative analysis of debt relief measures. In part this is due to their complexity. Particularly at a macroeconomic level (e.g. balance-of-payments, foreign exchange management, fiscal policy), but also at the microeconomic level (e.g. environmental protection, improved living standards), it is often difficult to link improvements causally with debt relief, much less to measure impact. The fungibility of financial assistance further complicates assessment efforts. Finally, evaluating debt relief from a value-for-money perspective is inherently difficult.

### I. General framework for bilateral initiatives

35. The following points have been signalled as important for the general framework in which specific initiatives are conducted:

- **"Optimum" debt relief** has to be comprehensive (i.e. covering all major categories of debt held by the recipient/debtor), co-ordinated (i.e. reducing transactions costs) and concerted (i.e. ensuring a critical mass of finance).

- **Relief actions should be targeted** at the poorest, most indebted countries, and future finance should be provided on highly concessional or grant terms.

- **Debt relief should be conditional** on recipient/debtor countries having an appropriate economic policy framework in place and an ongoing structural reform programme (e.g. an active World Bank/IMF lending programme). Where necessary, debt relief should encourage countries to
implement much more extensive market-oriented reforms. This, in combination with adequate debt management systems and capabilities, will help ensure that expected benefits are fully realised.

- **Debt relief initiatives must be tailored** to the country’s situation (e.g. institutional capacity, ongoing reform programme, long-term development strategy, liquidity conditions) and should be incorporated into the public expenditure review process to fit with strategic goals. The appropriate "mix" and volume of debt relief measures must be determined on a case-by-case basis.

- **In a best-case scenario**, debt relief finance should be additional to the ODA budget. “New” money (e.g. ODA grants) provided in conjunction with debt relief can play an important role in advancing debt relief objectives and structural change.

- **Where debt relief is financed from the aid budget**, it is particularly important to weigh carefully the benefits and costs for recipients/debtors of debt reduction against the benefits to them of using the same funds for other development purposes (e.g. programme, project assistance);

- **Careful attention must be given** to the use of local funds freed by debt relief, in particular that they are not used for unproductive purposes, including military expenditure.

2. **General concerns**

36. While debt relief provides needed assistance to developing countries, it nevertheless poses a number of problems that influence donor dispositions to and approaches for providing assistance in this area. Donors cited the following points in this regard:

- Debt relief may be interpreted by debtor countries as setting a precedent for future similar action, thus undercutting financial discipline and possibly jeopardising future financial inflows (the "moral hazard" problem): conditioning debt relief on reform efforts reduces this risk;

- Given the fungibility of money, debt relief may permit the recipient country to service other debt obligations (the "free rider" problem). This led Canada to call on other donors to forgive ODA debt and provide new finance on a grant-only basis to ensure fair burden-sharing;

- Debt relief may mean a reduction in "fresh" aid flows where ODA budget limitations require trade-offs;

- Debt relief may be of limited utility where debt may anyway never have been repaid: and

- Debt relief works best, in a developmental sense, if it sets the stage for a return to creditworthiness and if the resources thereby freed are used effectively or relax otherwise serious constraints to development progress.

3. **Unilateral and concerted actions**

37. Aside from Paris Club reschedulings and Brady operations, most bilateral Initiatives over the past decade have been undertaken on a **unilateral** basis. Consequently, impact has often been widely dispersed and limited, except where the donor concerned has been a major bilateral creditor for a given developing country and the amount of relief granted has been important. Nevertheless, even where cash
flow relief might not have been that significant (given the relatively small scale of some initiatives), improving access to other sources of finance and bringing order into economic and financial management (including debt management) have been significant benefits.

38. More concerted actions have been evolving via the multilateral frameworks introduced by the World Bank and IMF (e.g. “Fifth Dimension”, “IDA Debt Reduction Facility” and now the “HIPC Initiative”), and through greater bilateral co-ordination regarding specific developing countries. **Concerted** debt relief action is particularly effective when:

- an explicit overall debt strategy has been defined;
- key intervention areas (e.g. multilateral debt) have been identified;
- debt reduction efforts take place within an overall macroeconomic and policy reform framework, with continuing commitment by donors to support the development programme;
- donor funds are pooled; and
- the recipient country itself plays a leading role in initiating and co-ordinating action.

The agreement on the HIPC Initiative, which embodies all these elements, reflects a broad agreement in the donor community that only a comprehensive and concerted approach can restore a heavily-indebted country to financial health.

4. **Specific debt relief measures**

- Debt forgiveness

39. Debt forgiveness is a relatively straightforward operation generally effected through accounting procedures. It has immediate beneficial impact on debtor country foreign exchange availability, balance-of-payments positions, fiscal policies and -- provided the relief is sufficiently large -- financial solvency. Attempts to measure impact -- necessarily macroeconomic -- are inherently difficult.

- Debt conversion

40. Debt conversions permit targeted support for specific development objectives, such as conserving natural habitats, improving waste management or providing funds for urban microenterprises. These operations allow creditor countries to engage in new development projects in debtor countries without committing "new" money. In addition, counterpart funds generated through conversions facilitate more rapid and flexible project financing. The locally "owned" and operated character of development projects supported through conversions tends to strengthen impact.

41. Nevertheless, most donors agree that these transactions are limited in scope, complex and management-intensive. Strong commitment by both creditor and debtor to the task at hand is essential. Debt conversions also require a critical mass of institutional capability on the part of the executing NGO and long gestation periods. More specifically, donors cite:

- problems related to the Central Bank's "conversion rate" (e.g. which may result in "harder" terms than the original loan or thwart successful completion of conversion negotiations);
problems related to counterpart funds (e.g. incompatibility with the debtor country’s overall budget/expenditure priorities, auditing and control of "earmarked" funds);

inflation risks (e.g. where funds involved are substantial, such as when several creditors combine forces).

42. Donors also note the following points of concern:

- repayment of the remaining debt with local currency -- which funds the development activity supported by the conversion -- can still be “painful” fiscally, even after the implicit discount: nevertheless, repayment with local currency lessens the balance of payments constraint; and

- debt-for-equity swaps require careful study: where the investment would not be undertaken without the subsidy provided by the conversion, attention must be paid to possible distortions that could damage both local and foreign producers. Where the investment would have been undertaken anyway, the conversion would amount to a windfall for the investor. Where carried out “correctly”, however, debt-for-equity swaps can have very positive effects.

43. Co-ordinating conversion operations in a specific country (i.e. in the context of public expenditure reviews) was stressed as a way of reducing complications and enhancing development impact. Mention was also made of the importance of skilfully managing the negotiating process and careful crafting of the offer in order to minimise donor resource requirements while maximising the volume of debt converted.

44. The potential problems posed by debt conversions led Denmark to note that these operations require careful analysis of the circumstances under which they take place, and that transparency of individual conversion operations is of considerable importance.

45. There are many ways of structuring debt conversion operations, with different associated costs and benefits. Accordingly, greater effort should be given to ex post assessments in this area and to dissemination of results to other interested donors.

- Debt buy-backs

46. Debt buy-backs carried out in a multilateral framework (e.g. Brady-type operations or the IDA Debt Reduction Facility) are considered to be very effective by donors because they extinguish -- in a single, co-ordinated operation -- all outstanding private bank debt of the recipient/debtor country. Brady-type operations have been instrumental in improving the liquidity and solvency position of recipients and helping them re-establish international creditworthiness. The IDA Debt Reduction Facility has facilitated debt buy-backs at steep discounts, thus highly leveraging scarce donor resources. It has also improved access to short-term trade credit and reduced associated costs.

47. Nevertheless, some donors noted difficulties in marshalling political support within their countries given widely-held perceptions that buybacks amount to "bailouts" for private commercial banks (although a Swiss study found that creditors did not realise more benefits than debtors in the case of internationally co-ordinated buy-backs of the private bank debt of severely indebted low-income countries).

- Assistance for relieving multilateral debt obligations
48. Debt relief provided for multilateral obligations was rated highly by many donors where this permitted renewed access to multilateral funding (especially new concessional finance) and Paris Club consideration. A secondary positive effect was the strengthening of the financial position of multilaterals themselves.

49. Bilateral donors will be encouraged to contribute on a voluntary basis and support the policies proposed under the new HIPC Initiative.

- Technical assistance

49. Donor support in this area was lauded as being very cost-effective and making positive contributions to overall debtor country institutional and human resource development.
ANNEX I

DAC guidelines for reporting debt relief: work in progress

The DAC is reviewing its statistical reporting conventions and rules in an effort to increase the breadth, clarity, consistency and comparability of donors' reporting on debt relief. This scrutiny has in part been prompted by greater use made by donors of debt relief measures over the past decade and the evolution of Paris Club agreements, in particular the "concessional options" permitting loan rescheduling through interest reductions and/or longer maturities.

Members are considering a number of changes/clarifications to existing reporting guidelines, including:

– that forgiveness of non-military debt would qualify as ODA if it had a development motive;

– reporting rescheduling as a lump sum (e.g. recording it both as commitment and disbursement in the year the agreement is reached) as opposed to year-by-year reporting; and

– that rescheduling/refinancing of non-ODA loans on market terms of interest would not qualify as ODA (even if longer maturities imply a grant element of 25 per cent or more).

Proposals are also being considered concerning the reporting of debt conversion operations.

The above proposals are aimed at a more flexible treatment of the various Paris Club options, in line with balance-of-payments principles and general DAC reporting conventions.
Table 1. Debt relief as a percentage of bilateral ODA commitments

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Debt relief as a percentage of bilateral ODA commitments

- a. 1995 data are incomplete.
- Source: DAC Secretariat.
### Table 2a. Total disbursed debt of developing countries at year-end 1991-95

(\$ billion)

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### Table 2b. Total annual debt service of developing countries at year-end 1991-95 (a)

(\$ billion)

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(a) Actual, not scheduled debt service.
Source: DAC Secretariat
Table 3. Outstanding ODA debt held by developing countries

($ billion)

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<td>Total</td>
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<td>138.7</td>
<td>147.6</td>
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<td>173.1</td>
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</table>

(1) Outstanding ODA debt less than $ 55 million.

Source: DAC Secretariat.
Table 4. Official bilateral debt forgiveness by DAC countries, 1991-1995 (1)

($ million)

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<td>of which: ODA</td>
<td>Total</td>
<td>of which: ODA</td>
<td>Total</td>
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<td>4137.9</td>
<td>2996.2</td>
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1. The total includes forgiveness of official and officially supported claims not originally reported as ODA.
2. Reporting of ODA debt forgiven is incomplete for 1995.
3. Debt forgiveness reported for 1991-92 includes a large amount of Egyptian military expenditure debt.

Source: DAC Secretariat
Table 5. DAC donor debt relief by debt category
1970-1996 ($ million) (1)

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<tr>
<th></th>
<th>Debt Forgiveness</th>
<th>Debt Conversion</th>
<th>Debt Buyback (IDA)</th>
<th>Multilateral Debt Relief</th>
<th>Support for Debt Management</th>
<th>Debt Service Relief</th>
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</table>

(1) Debt relief reported in this table reflect different time periods for different donors; most statistics refer to the period 1989-1996, when the largest share of debt relief was recorded. Nevertheless, for those who accorded debt relief before this time, coverage extends from 1970.

(2) Paris Club debt reduction.

(3) Total expenditure allocation.

(4) Belgium provides up to $19 million annually for non-ODA Paris Club debt relief.

(5) 1994 debt relief.

(6) Debt relief accorded to Egypt and Poland and forgiveness of military expenditure debt.

Note: Amounts in bold indicate debt relief that has been converted to the US dollar equivalent (at an average exchange rate for the period 1990-1995), for comparative purposes only.