POLICY RESEARCH WORKING PAPER 1409

Restructuring Uganda's Debt

The Commercial Debt Buy-Back Operation

Kapil Kapoor

Uganda's experience is used to illustrate how resources from the International Development Association's Debt Reduction Facility can be used to buy back, at a significant discount, a country's commercial debt obligations — as an integral part of a viable external debt strategy.

The World Bank
Eastern Africa Department
Country Operations Division
January 1995

Summary findings

Uganda's commercial debt buy-back operation was financed by the International Development Association's Debt Reduction Facility (IDA Facility), with cofinancing from the governments of Germany, the Netherlands, and Switzerland and the European Union.

Commercial debt service is a serious burden to many low-income economies. Yet, although the IDA Facility has existed since 1989, only a handful of countries have been able to avail themselves of its resources. That is not altogether surprising: commercial debt buy-backs can be extremely complex, requiring substantial preparation for a well-articulated external debt strategy based on comprehensive data.

One objective in describing Uganda's operation is to discuss the requirements of the IDA Facility and to shed light on how Uganda satisfied them and on which areas needed special attention.

Uganda's offer to buy back its uninsured commercial debt at a discount of 88 percent of face value was extremely successful. Of the total eligible debt of US$188 million, Uganda bought back debt worth US$153 million, reflecting a participation rate by creditors of 80 percent. As a result, most of Uganda's commercial debt has been eliminated. The remaining commercial obligations accrue to creditors that either have work in progress or that hold some form of security or collateral for their claims.

Uganda's debt problems are far from resolved. Much of the country's Paris Club debt is ineligible for rescheduling because it was contracted after the cutoff date. Arrears owed to non-OECD bilateral creditors have continued to mount, as these creditors have resisted restructuring Uganda's obligations to them. And servicing that part of multilateral debt that is nonconcessional or less concessional also is a burden.

Resolving Uganda's external debt problem will require concerted action on several fronts:

- Continued economic reform.
- Vigorous pursuit of export diversification and growth.
- No letup in seeking creative ways to restructure the debt portfolio. Uganda must find grant funding wherever possible, or contract only the most concessional debt.

This paper — a product of the Country Operations Division, Eastern Africa Department — is part of a larger effort in the department to help Uganda address its debt problems. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Edith Spano, room J10-169, extension 35538 (30 pages). January 1995.

The Policy Research Working Paper Series disseminates the findings of work in progress to encourage the exchange of ideas about development issues. An objective of the series is to get the findings out quickly, even if the presentations are less than fully polished. The papers carry the names of the authors and should be used and cited accordingly. The findings, interpretations, and conclusions are the authors' own and should not be attributed to the World Bank, its Executive Board of Directors, or any of its member countries.

Produced by the Policy Research Dissemination Center

Restructuring Uganda's Debt

The Commercial Debt Buy-Back Operation

Kapil Kapoor

Restructuring Uganda's Debt

The Commercial Debt Buy-Back Operation

Table of Contents

	Page
Introduction	1
IDA-Only Debt Reduction Facility	1
Uganda's Medium-Term Economic Reform Program	3
Restructuring Uganda's Debt	5
Uganda's External Debt Situation	5
Developing an External Debt Strategy	7
Paris Club Debt Eligible for Rescheduling	9
Paris Club Debt Ineligible for Rescheduling	11
Non-OECD Bilateral Creditors	12
Uninsured Commercial Debt	13
Multilateral Debt	15
External Debt Management	16
The Buy-Back of Commercial Debt	19
Preparing the Data Base	19
Negotiating a Price	19
Seeking Financing	20
Recruiting Legal Advisors	23
Nature of Creditors	23
Minimum Participation Level	26
The Offer	27
The Results	28
Conclusion	29

Restructuring Uganda's Debt

The Commercial Debt Buy-Back Operation

Introduction

The principal objective of this paper is to describe briefly Uganda's Commercial Debt Buy-Back operation, which was financed jointly by the IDA-Only Debt Reduction Facility (Facility), with co-financing from the Governments of Netherlands, Switzerland, and Germany and the European Economic Community (EEC). Although the Facility has been in existence since August 1989, and servicing commercial debt presents a serious burden to several low income economies throughout the world, particularly in Africa, only a handful of countries have so far been able to avail themselves of the Facility's resources. This is not altogether surprising since commercial debt buy-backs can be extremely complex, requiring substantial preparatory effort to come up with a well articulated external debt strategy based on a comprehensive and detailed external debt data base. Therefore, one of the objectives in describing the operation is to discuss the requirements of the IDA Facility and to shed some light on how these were satisfied in the Ugandan context and the areas which needed particular attention.

IDA-Only Debt Reduction Facility

The introduction of the Brady Plan in 1989 resulted in a heightened awareness, both among creditors and among the donor community, of the need to reduce the commercial debt exposure of developing economies. While commercial debt in low income economies constitutes a relatively small proportion of their total debt, its non-concessional nature often imposes severe

cash-flow constraints on low-income countries like Uganda. Accordingly, the IDA-Only Debt Reduction Facility was created in 1989, financed by a US$100 million transfer from IBRD net income, to help severely-indebted IDA-only countries reduce their long-term commercial debt. In September 1993, an additional US$100 million were transferred to the Facility from IBRD's net income and the life of the Facility, which was initially set up for a three-year period, was extended to July 31, 1995.

Funds from the Facility are provided to eligible countries on a grant basis, largely to finance the cash-buy back of commercial debt. Due to the limited availability of funds, the Facility normally provides a maximum of US$10 million to any one country, unless exceptional circumstances exist to warrant an increase. However, participating countries are urged to supplement these resources by seeking co-financing from other donors. In the past, bilateral co-financiers have included Canada, France, Germany, Netherlands, Sweden, Switzerland, U.S.A, and the EEC and, to date, five countries have been able to take advantage of the Facility, including Niger, Mozambique, Guyana, Bolivia, and Uganda.

While commercial debt was originally interpreted by the Facility to mean commercial bank debt, this definition has since rightly been expanded to cover short-term suppliers and trade credits which have been in arrears for some time. Such credits represent an important share of African countries commercial debt exposure. Furthermore, since the preparation of a buy-back operation can be quite expensive, the Facility now also provides technical assistance grants to help finance the fees of legal and financial advisors. Both of these factors have contributed greatly to increasing the use of the Facility's resources during the past two years.

Eligibility Criteria

In order to be eligible for support from the Facility, the country must be an IDA-only country and must have[1]:

(i) a medium-term economic program acceptable to the World Bank, i.e a structural adjustment program or an IMF ESAF program; and

(ii) a comprehensive debt management strategy which not only incorporates substantial debt relief from official bilateral creditors through an agreement with the Paris Club, but also includes a program for resolving the country's commercial debt problem. In addition, the country has to demonstrate that the debt relief strategy will materially enhance the country's growth and development prospects.

Uganda's Medium-Term Economic Reform Program

Ever since 1987, soon after the assumption of power by the National Resistance Movement (NRM) Government, Uganda has been implementing a far-reaching Economic Recovery Program (ERP) whose key objectives are to bring about internal financial stability by lowering the rate of inflation and reducing the imbalances in the economy and to lay the basis for the alleviation of poverty by promoting rehabilitation and growth. The ERP has been supported by two Economic Recovery Credits (ERC I and ERC II) and two Structural Adjustment Credits

---

[1] For further details, see "Operational Guidelines and Procedures for the Use of Resources of the Debt Reduction Facility for IDA-Only Countries" (R89-156, IDA/R89-103, July 13, 1989); and "Review of Progress under the Debt Reduction Facility for IDA-Only Countries" (R92-33, IDA/R92-26, March 9, 1992).

(SAC I and SAC II) from IDA; several arrangements under the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF) from the IMF; and assistance from other multilateral and bilateral donors. Under the ERP umbrella, a great deal has been accomplished on the policy front. The exchange and trade regime is now largeiy market-based, and export and import procedures have been fully liberalized. Competition has been introduced into the marketing of coffee and other crops. Price controls, which were few to begin with, have been eliminated. To demonstrate its commitment to foreign investors, the Government is aggressively tackling the very difficult issue of Asian properties expropriated by the Amin regime. Uganda has passed a new Investment Code and established the Uganda Investment Authority to promote investment. With the establishment of the Uganda Revenue Authority, the poor tax collection effort is finally being addressed. Public expenditure controls have been improved, and a structural shift has been affected in the composition of expenditures away from defense and towards economic and social services. A significant portion of the economic and social infrastructure has been rehabilitated. The number of ministries has been substantially reduced and a major effort to restructure and streamline the civil service is underway. Finally, the Government, with considerable donor support, has embarked upon an ambitious program of demobilizing a significant percentage of its armed forces.

The impact of these policies has manifested itself in economic growth which has exceeded 5 percent on average since the Economic Recovery Program was introduced; these growth rates have enabled real per capita income to grow by about 2 percent annually. The engine of growth remains agriculture which still contributes over 50 percent to GDP. Overall growth has also been facilitated by the rapid expansion of the private service sector and the buoyant manufacturing sector.

Restructuring Uganda's Debt

Despite the favorable developments discussed above, macro-economic stability in Uganda has continued to remain fragile, largely because of the inability of the economy to generate adequate resources, i.e. tax and non-tax revenues on the domestic front and export revenues on the external front. As a result, the economy has experienced severe cash flow problems during the past few years, which have been aggravated by the severe external debt burden.

Uganda's External Debt Situation

Using the ratio of present value of total debt service to GNP and the ratio of present value to total exports, Uganda is classified as a Severely Indebted Low Income Country (SILIC) by the World Bank's Debtor Reporting System[2].

As summarized in Table 1, Uganda's stock of debt outstanding and disbursed (DOD) was estimated at US$2.65 billion as of June 30, 1992, of which approximately US$583 million was in arrears. The stock of debt had grown significantly from about US$1.2 billion in 1985, and largely reflected the vast reconstruction needs of the war-torn Ugandan economy. Approximately 66 percent of this debt was owed to multilateral organizations, with the World Bank and the IMF accounting for about 76 percent of multilateral debt. Bilateral debt accounted for about 25 percent of DOD, with OECD bilaterals accounting for about 11 percent and non-OECD bilaterals 14 percent. The remaining 9 percent of DOD was owed to commercial

[2] For further details see *World Debt Tables, 1993-94*, Appendix 1, The World Bank, Washington, D.C.

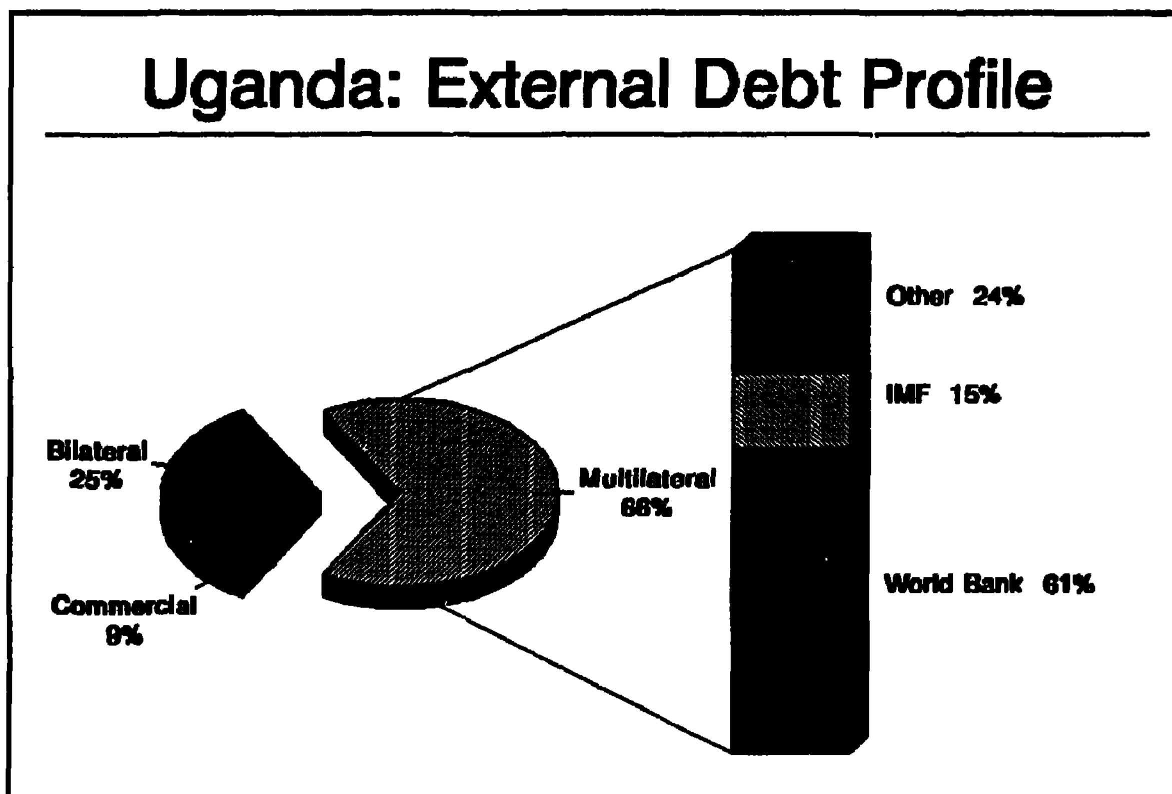
Table 1
Uganda: External Debt Profile
(Millions of US Dollars; As of June 30, 1992)

	DOD	o/w Arrears	Debt Service Due 1991/92	1992/93
Multilateral	1756.8	86.3	86.9	79.6
World Bank	1067.2	0.0	18.2	19.3
IMF	271.1	0.0	41.7	22.6
OECD Bilaterals	278.8	80.8	45.7	25.9
Non-OECD Bilateral	376.9	193.2	81.5	35.1
Commercial Banks	15.5	15.1	6.2	0.3
Commercial Non-Bank	226.1	207.8	9.0	4.7
Penalty Interest	-	-	20.0	30.0
Total	**2654.0**	**583.2**	**249.3**	**175.7**

Source: External Debt Management Office, Bank of Uganda

creditors. Commercial creditors accounted for the largest proportion of arrears, about 38 percent of the total; followed by non-OECD bilaterals, 33 percent; multilateral creditors, 15 percent; and OECD bilaterals, 14 percent. Total DOD was over 122 percent of gross domestic product and the principal and interest payments necessary to service this debt, estimated at US$176 million in 1992/93, implied a debt-service ratio of about 80 percent, on a commitment basis, excluding any servicing of the outstanding arrears which represented an additional 265 percent of the export of goods and non-factor services in 1992/93. The debt-service ratio for 1991/92 was 128 percent, largely reflecting the higher payments due to the IMF in that year.

Given the magnitude of the problem, and the gravity of the external debt situation, the Government, using resources from an ongoing World Bank technical assistance project, recruited a team of international financial advisors (S.G. Warburg & Co.) in 1990 to (i)



undertake an exhaustive inventory of Uganda's external debt by individually contacting every major creditor; and (ii) assist the Government in developing a viable external debt strategy. At the same time, the World Bank was formally requested to collaborate closely with the consultants and the Government's team within the central bank and the Ministry of Finance.

Developing an External Debt Strategy

An analysis of the composition and profile of Uganda's DOD and debt service obligations revealed the extremely difficult external financial position that the country found itself in. First, it became abundantly clear from the high debt-service ratio that the existing level of foreign exchange earnings of the economy was insufficient to service the stock of outstanding debt. This was notwithstanding the fact that most recent debt had been contracted on highly concessional terms, with the average interest for new commitments in 1992 of 1.7 percent and

an average maturity of 35 years with 9 years' grace, representing an overall grant element of 68 percent. The grant element of new commitments had increased from 40 percent in 1987. Second, the preponderance of multilateral debt severely limited the benefits that the country could achieve through traditional rescheduling, since multilateral organizations do not reschedule debt. Third, of the $279 million owed to Paris Club (OECD bilateral) creditors, 42 percent (US$118 million) was contracted after the cut-off date of July 1, 1981; Paris Club does not reschedule or reduce any debt which has been contracted after an agreed cut-off date. Fourth, there was very little precedent for rescheduling the US$377 million owed to non-OECD bilateral creditors, who accounted for the largest portion of non-multilateral debt outstanding. Finally, of the level of uninsured commercial debt (US$242 million), about US$41 million could not be rescheduled or reduced on highly favorable terms as a number of loans were owed to contractors who had work in progress or the loans were secured in various ways.

Once the inventory of the stock of external debt was completed, work commenced on developing an external debt strategy. It was agreed that the objectives of the strategy were to

(i) restore normal working relations with creditors by clearing the bulk of the accumulated principal and interest arrears which were resulting in legal action against the Government, including threats to seize assets to satisfy claims and the imposition of sanctions on disbursements and the disruption of development projects;

(ii) stop the increase in outstanding debt resulting from the accumulation of penalty and late interest charges; and

(iii) to reduce annual contractual debt service due to a level commensurate with Uganda's ability to pay, i.e. about US$130 million annually.

The strategy developed was based on the general principle that all creditors would be treated fairly but that precedence in debt service payments would be given to multilateral creditors, who represented the main source of new concessional financing for Uganda, and those creditors who provided a positive flow of funds into the country. In the early stages of developing the strategy, it was also agreed that Government would try and seek grant financing to the extent possible and limit all new borrowings to highly concessional loans, i.e. those with an average grant element of at least 75 percent. A five pronged strategy was then articulated, which is discussed below.

Paris Club Debt Eligible for Debt Forgiveness/Rescheduling

The first element of the debt strategy focused on Paris Club debt which was eligible for rescheduling. Over the years, Uganda has benefitted from a number of debt cancellations granted by Paris Club creditors (Table 2). These included cancellations from France, Germany, UK and USA on loans originally provided on concessional terms. According to the precedent established by OECD donors, concessional loans made to low income countries are eligible for complete write-off, in addition to Paris Club reschedulings. For Uganda, the profile of debt outstanding to this group of creditors as of June 30, 1992 indicated that all concessional debt had already been written off with the exception of recent concessional loans from Austria and France and mixed credits from Spain, all of which were still in the process of being disbursed.

In addition to the cancellations discussed above, Uganda had rescheduled its Paris Club debt on four previous occasions, including the reductions obtained under the 1989

Table 2
Uganda: Paris Club History

	Amount Consolidated (US$ Million)	Maturity (Years)	Grace (Years)	Consolidation Period (Months)
November 1981	63	9	4.5	12
December 1982	16	9	4.5	12
June 1987	105	14	6.0	12
January 1989	86	Toronto Terms: 1/3 write-off of maturities		
June 1992	50	Enhanced Toronto Terms: 1/2 write-off[1]		

[1] Under the "enhanced Toronto-Terms", a creditor can choose (i) cancellation of 50 percent of the maturities being consolidated; (ii) halving of interest rates on non-concessional debt; (iii) stretching of export credits and concessional debt repayments further; and (iv) capitalizing reduced interest rates such that the end result, in net present value terms, is equivalent to the other options.

rescheduling on Toronto terms. As shown in Table 1, analysis revealed that approximately US$279 million was outstanding to Paris Club creditors of which US$81 million represented arrears and penalty charges; US$26 million of principal and interest payments were due in 1992/93 to Paris Club creditors. The Paris Club does not reschedule or reduce any debt which has been contracted after an agreed date, which in the case of Uganda is unusually early at July 1, 1981 (the cut-off date). Of the total amount outstanding to Paris Club creditors, about 42 percent (US$118 million) was contracted after the cut-off date. Therefore, of the outstanding arrears of US$81 million, US$46 million were ineligible for rescheduling while US$11 million of the US$26 million of 1992/93 maturities on post cut-off date debt remained due for payment. Consequently, only about US$50 million in arrears and current maturities due in respect of pre cut-off date debt was eligible for rescheduling with Paris Club.

Notwithstanding the limited gains to be made from Paris Club rescheduling, it was decided that Uganda would seek year-by-year **rescheduling of eligible Paris Club debt** on the most generous terms possible. Accordingly, on June 17, 1992, the Government was granted "enhanced Toronto" terms (i.e. a 50 percent write-off on a net present value basis of maturities during the consolidated period - Table 2) by the Paris Club on the amounts due in this category of debt, which represents the most favorable terms currently granted to debtor nations. The debt that was rescheduled included all eligible arrears as of June 30, 1992 and maturities up to November 30, 1992. It was further agreed that maturities up to November 30, 1993 would also be restructured under this agreement, subject to Uganda agreeing a fourth year ESAF arrangement with the IMF. One implication of the year-by-year rescheduling approach adopted by the Paris Club under these terms is that Uganda will have to return to the Paris Club on a regular basis for the foreseeable future.

Paris Club Debt Ineligible for Debt Forgiveness or Rescheduling

The second element of the debt strategy addressed the issue of Paris Club debt which was not eligible for debt forgiveness or rescheduling, i.e. post cut-off date arrears. It was decided that Uganda would try and seek **annually the maximum deferral possible of such arrears.** There had only been a few instances of such deferrals being granted by Paris Club in the past. Of the deferrals that had been granted, the associated terms had been quite stringent, with no grace period, short repayment periods, and no reduction of principal and interest. Moreover, debt service coming due is not deferred and arrears once deferred are not eligible for any future deferrals.

Uganda's debt service profile showed that the short repayment period associated with the deferrals would serve to increase the debt service due in future years to levels that Uganda might find difficult to service, but which it will not be able to re-defer or reschedule. However, given the extremely tight foreign exchange situation brought about by the decline in the international price of coffee, it was agreed that this element of the debt strategy would serve to buy Uganda some time in which to mobilize additional export earnings, i.e. via the promotion of non-coffee exports. Accordingly, this request was made and Paris Club agreed to accept payment with respect to the post cut-off date arrears (US$46 million as at June 30, 1992), over a two year period, i.e. 1992/93 and 1993/94.

Non-OECD Bilateral Creditors

The third element of the strategy focussed on non-OECD bilateral creditors who were owed a significant amount of arrears and penalty charges. As of June 30, 1992, these totalled US$193 million and the principal and interest payments due to them in 1992/93 are about US$35 million. It is important to emphasize that there are few precedents for rescheduling non-OECD bilateral debt and, unlike the Paris Club, no forum exists where the issue of non-OECD bilateral debt can be addressed. Most of the arrears owed under this category were due to creditors such as India, Tanzania and Yugoslavia who, because of their own financial constraints, find it difficult to accept long-term reschedulings and reductions of the amounts immediately due. Notwithstanding this constraint, it was decided that the Government would initiate discussions with **non-OECD bilateral creditors requesting either a complete write-off or a long-term rescheduling of arrears and the entire stock of debt outstanding to try to obtain at least equivalent treatment of creditors, as is required in the Official Minute of the Paris Club agreement.** The creditors would be asked to reschedule the total stock of debt, regardless of

whether it was incurred after the Paris Club cut-off date, and to maintain the concessional or semi-concessional interest rates that applied to the underlying loans for the rescheduling.

As in the case of disbursing loans from Paris Club creditors, it was agreed that there were a number of loans in this category which it would not be appropriate to reschedule and which would continue to be serviced as far as possible. These represented highly concessional loans whose terms were more beneficial than the proposed rescheduling terms; loans which were currently disbursing or represented work in progress; and loans which had recently been subject to rescheduling.

Buy-Back and Restructuring of Uninsured Commercial Debt

As outlined in Table 3, about US$242 million of debt (consisting of about US$210 million in principal and US$33 in past due interest) was outstanding to uninsured commercial creditors at September 30, 1992. Approximately US$226 million of this category of debt represented obligations to non-bank commercial companies, mostly in respect of trade arrears and suppliers' credits, while the remaining US$16 million represented recent obligations to commercial banks. Accordingly, as part of the fourth prong of the strategy, it was agreed that the Government would try and restructure its commercial debt by converting some of the debt into equity; rescheduling a portion of the debt; and discharging the remainder in a buy-back operation at a significant discount to face value using resources from the IDA-Only Debt Reduction Facility and other co-financiers.

Analysis of the commercial debt revealed that the only amounts which could be converted into equity, approximately US$13 million, mainly included arrears due to the private

Table 3
Uganda: Uninsured Commercial Debt
(Millions of US$, as of September 30, 1992)

	Principal	Interest	Total
Eligible for Buy-Back	161.2	27.2	188.4
Debt for Equity Swap	9.0	4.1	13.1
Ineligible for Buy-Back (for rescheduling)	39.5	1.3	40.8
Total	208.7	32.6	242.3

sector joint venture partner of the Government in the Toro Mityana Tea Company and an American investor who intended to set up a project that could make a significant contribution to the generation of non-traditional exports. The Government accordingly commenced discussion with these creditors to swap these arrears for Government assets in accordance with the privatization program.

Analysis further revealed that approximately US$41 million of commercial uninsured debt was owed to creditors who had current work-in-progress or held some form of security; it would therefore be inappropriate to offer these creditors a cash settlement at a deep discount to face value, as proposed in the buy-back operation. Notwithstanding this, Government agreed to try and negotiate, on an individual basis, the most favorable terms of rescheduling possible with these creditors.

It was agreed that the Government would request the IDA-Only Debt Reduction Facility for financial assistance to buy back the remaining debt of US$188 million (representing US$161 million of principal and US$27 million of past due interest) at a deep discount to face value. Details of this operation are described below.

Multilateral Debt Service

The fifth and final element of the Government's debt strategy suggested that increased effort be made to try and mobilize bilateral donor assistance for servicing multilateral debt, which accounted for about 45 percent of debt service due in 1992/93 (Table 1). Under the ongoing *Fifth Dimension* program, IDA has annually allocated a portion of its reflows to provide supplementary credits to countries that are currently IDA-only borrowers and that have outstanding IBRD debt. These credits are provided in proportion to the interest payments due to IBRD. In Uganda, Norway and Sweden have additionally been providing Government with resources equivalent to finance all remaining IBRD repayments. It was agreed that Government would request these donors to explore the possibility of setting up a similar facility for servicing the non- or less-concessional debt of other multilaterals, notably the African Development Bank for which debt service due in 1992/93 was in excess of US$15 million. Furthermore, it was agreed that efforts would continue to be made to restructure the arrears due to certain regional multilaterals, such as the Arab Bank for Economic Development in Africa, the East African Development Bank and the Islamic Development Bank. Of these, the East African Development Bank represented the biggest challenge with arrears in excess of US$45 million, or about 8 percent of total arrears.

External Debt Management

In addition to the five prongs outlined above, there was agreement that a concerted effort was also needed to improve external debt management within the country. Accordingly, again with the assistance of its financial advisors, the Government began reviewing the institutional arrangements for contracting, recording and monitoring external debt. This review highlighted certain weaknesses which, the Government recognized, had compounded the problems of the external debt burden and resulted in the fragmentation of the aid coordination function.

The review revealed that the responsibilities for aid coordination and debt management were shared, in varying degrees, by the Aid Coordination Unit in the Ministry of Finance; the Commissioner/Treasury Officer of Accounts; the External Debt Management Office (EDMO) in the Bank of Uganda; Foreign Exchange Operations in the Bank of Uganda; and the Aid Coordination Unit in the Prime Minister's Office. The exact role of each institution was not clearly defined and backed by full legislative authority. Furthermore, the flow of information between units was weak, which had led to poor coordination and record keeping, and inefficient verification and monitoring of debt.

In Uganda, the Minister of Finance has been vested with the authority to manage the country's external debt portfolio by the External Loans Act of 1962 and the Loans (Guarantee) Act of 1958. This task of contracting and managing external loans is split within the Ministry of Finance between the Aid Coordination Unit and the Treasury. The Aid Coordination Unit within MOF serves as the Minister's Secretariat and assists in the negotiation of new loans and facilitates the flow of aid-related funds into the country. The Treasury, as stipulated in the External Loans Act, authorizes all disbursement requests and also authorizes all debt service

payments and therefore has a comparative advantage in maintaining up-to-date external debt related information. Despite this comparative advantage, the financial advisors determined that the Treasury was institutionally weak and did not have adequate capacity to perform this debt reporting function. As a result, in recent years, the responsibility for debt reporting had been taken over by EDMO within the Bank of Uganda. Dependence on EDMO had been further increased by capacity constraints within MOF's Aid Coordination Unit and its apparent inability to "take charge" of the country's aid portfolio, as authorized by law.

As a result of insufficient information and poor coordination, the Government had not been able to ensure that all new debt was contracted on terms compatible with the country's external debt burden and its ability to service and repay this debt in the future. Since the mid-1980s, while the Government had been largely successful in ensuring that implementing ministries did not sign loan agreements independently of the Minister of Finance and most new borrowings had been contracted on concessional terms, there had nonetheless been several instances where implementing ministries had conducted negotiations with lenders and suppliers directly, without the early involvement of the Ministry of Finance or the Bank of Uganda. In several cases this had meant that financial commitments had to be accepted on terms that were unfavorable. There had also been exceptions to the exclusive authority of the Minister of Finance in incurring debt, particularly in respect of debts other than project loans. These included supply contracts, supplements and extensions to contracts and projects where there had been pressure to begin work urgently. In the past, arrears had been accumulated on the current expenditures of implementing ministries either due to overspending or overestimation of the foreign exchange allocated to them. These arrears eventually became medium-term debt, carrying expensive terms.

Another area which the financial advisors felt needed urgent attention was the absence of a clearly articulated policy defining a strict order of priority in which creditors should be paid, although the Government had been successful in ensuring that amounts due to the IMF and the World Bank group were always serviced. The foreign exchange budgeting system frequently overestimated the funds available for debt servicing, thereby compounding the problems of not having a well-defined payments policy. As a result of this situation, creditors who applied persistent pressure, but who did not necessarily provide the maximum future benefits to Uganda, had sometimes been paid in preference to other creditors. Furthermore, on occasion, the Bank of Uganda had to resort to borrowing under short-term commercial facilities to make payments to key multilateral creditors.

Recognizing these weaknesses, the Government agreed to commence putting in place a set of institutional arrangements which would enable it effectively to take charge of the external debt function. It was agreed that the functions of the various units at the operational level would, to a large extent, be eventually centralized in order to pool the limited resources and technical expertise available; improve control and coordination of policy; eliminate duplication of effort; and ensure the efficient transfer of information. It was agreed that a number of detailed changes would be implemented to improve the systems for (i) ensuring that all Government foreign exchange obligations are approved by the Minister of Finance; (ii) monitoring disbursements; (iii) verifying, on a priority basis, receipt of goods; (iv) verifying creditor's claims for payment; (v) authorizing and making payments; and (vi) recording and analyzing debt and aid flows. It was also agreed that the centralized debt unit and the other institutions involved in debt management would be vested with the necessary legal authority to undertake their tasks effectively.

The Buy-Back of Commercial Debt

Preparing the Data Base ...

Preparations for the Buy-Back commenced in earnest in early 1992, with the financial advisors preparing a comprehensive inventory of uninsured commercial creditors. Included in the information set were details identifying the name of the creditor; the creditor's nationality; the purpose for which the loan had been originally made; the date of the contract; the originally anticipated repayment period; the number of years the loan had been in arrears; and the amount of principal and interest which was outstanding. Once the data base was complete, the financial advisors started the process of contacting each individual creditor in order to ascertain their willingness to participate in the buy-back and to get a sense of the price they might be willing to accept. An important factor which made this process manageable was that only 26 suppliers accounted for the majority of Uganda's non-bank commercial debt.

Negotiating a Price ...

At the time the preliminary discussions were taking place, the bid and offer price of Ugandan commercial debt was being quoted in the secondary market at 17 and 25 cents to the dollar, respectively. Some trading of commercial bank debt had in fact taken place during the second half of 1991 at 20 cents to the dollar. Furthermore, the Government of Uganda's tendency of making sporadic payments at full value to certain aggressive and persistent commercial creditors had also contributed to increasing the secondary market price of the debt well beyond what would otherwise have been justified by the country's economic situation. Nevertheless, the disparate group of creditors and the small amount of debt involved implied that, *de facto*, there

was no real secondary market and/or regular trading in Ugandan debt. After considerable effort and protracted negotiations, the initial results of the financial advisers' soundings suggested that a price of about 15 cents per dollar of principal and interest might be realizable, at which price about 70 percent of the commercial creditors would be willing to participate in the buy-back. However, for the buy-back offer to be credible, the financial advisors recommended that the Government resist any further pressure from commercial creditors for debt service payments; cease such payments with immediate effect; and send a strong signal that all future payments would be negotiated within the context of the buy-back offer. At this point, the World Bank also advised the financial advisors that the country's balance of payments situation did not warrant a price of 15 cents to the dollar and strongly recommended that a still deeper discount would need to be negotiated during final deliberations with the creditors.

Seeking Financing ...

Once it became clear that a certain critical mass of commercial creditors were willing to participate in the buy-back, the Government formally requested the World Bank to initiate the process of mobilizing resources from the IDA-Only Debt Reduction Facility. On July 22, 1992, an Information Memorandum was submitted to the Executive Directors of the World Bank through which they were advised of the Government's intention to seek resources from the Facility[3]. Included in the Memorandum was a discussion of Uganda's medium-term adjustment program; a description and evaluation of the country's debt problem and the efficacy of its debt

[3] See "Uganda: Allocation of Resources of the Debt Reduction Facility for IDA-Only Countries for a Proposed Debt Reduction Operation and Grant from the Facility for Legal Advisors for the Preparation of the Proposed Operation", July 22, 1992, IDA/R92-110, International Development Association.

strategy; and an analysis of the material impact of the debt reduction operation on the development of the country.

In this context, it was pointed out that the buy-back operation, if completely successful, would eliminate about one-third of the total external arrears of the country as of June 30, 1992; 78 percent of the total commercial debt (the remainder being ineligible for the buy-back and intended to be restructured in other ways as discussed above); and over 7 percent of the total stock of debt. Furthermore, a successful buy-back would be beneficial to the country in that the creditors involved were a very aggressive group who continued to apply persistent pressure for payment and some of whom had taken or were currently contemplating legal action against the Government. Such actions have proved disruptive to the country's commercial operations and had weakened its ability to obtain operational banking facilities. Potential foreign investors and exporters and importers were also concerned about possible disruptions arising from these disputes and about the ability of the Government to meet current obligations in view of the arrears. The urgent settlement of this problem was therefore considered essential for Uganda to resume normal commercial operations.

While concern has sometimes been expressed that buy-back operations at a deep discount could affect a government's ability to obtain access to short-term credit on reasonable terms in the future, in the case of Uganda the magnitude of these arrears, and the Government's inability to settle them, had already reduced the Government's access to short term credit and trade lines. Most of the eligible debt had been in arrears for several years (an average of 5 years) and the fact that the Government was trying to resolve the problem and start afresh would undoubtedly serve to improve the country's image and its creditworthiness. Moreover, with the return of security to the country, the improved economic environment, the enactment of the new

investment code, the establishment of the Uganda Investment Authority and the acceleration of the return of Asian properties expropriated by Idi Amin, the Government was actively trying to attract foreign investors and promote Uganda as a profitable place to invest. For these efforts to bear fruit, it was imperative that Uganda be able to start with a clean slate and be free of some of the financial encumbrances referred to above.

In addition to approaching the World Bank the Government, through the Consultative Group meeting for Uganda, held in Paris in May, 1992, briefed the donors about its external debt strategy, advised them of the Government's intentions of proceeding with the debt buy-back, and formally requested co-financing assistance. Positive indications for financial assistance were received from the Governments of Netherlands, Switzerland and Germany and from the EEC. Switzerland, which is a co-financier to the IDA-Facility, authorized use resources from its existing contribution to the Facility. The Government of Netherlands decided to make a specific contribution to the Facility for the Uganda buy-back. Grant agreements were negotiated between the Bank and the Governments of Netherlands and Switzerland and it was stipulated that the amounts contributed to the Facility for the operation, including IBRD, would be disbursed on a pro rata basis. The contribution agreement between the Association and the Government of the Netherlands provided that any unused portion of its contribution would be returned. Under the framework agreement for the Facility between the Association and the Government of Switzerland, any unused portion of the Swiss funds were be retained in the Facility for use in other operations. The Government of Germany indicated that, rather than contributing to the Facility, it would make its contribution for the operation directly to the Government while the EEC indicated that a certain amount of its existing STABEX funds could be used to finance the buy-back.

Recruiting Legal Advisors ...

Also included in the Initiating Memorandum to the World Bank's Board was a request to provide a grant of up to US$500,000 to finance legal advisors to assist the Government of Uganda in the preparation of the operation. The document was submitted on a no-objection basis and the Board's no objection was registered in the Board Minutes dated September 1, 1992. The financial advisors then assisted the Government in drawing up detailed terms of reference for the legal advisors and, using the World Bank's guidelines for the hiring of consultants, tenders were invited from several internationally reputable legal companies. Once the tenders were received, a short list was developed, and the contract awarded to Clifford Chance, a company specializing in external debt and international finance.

Nature of the Creditors

Prior to commencing final negotiations with creditors, it became readily apparent that there were several aspects of the operation which warranted special attention and which needed to be highlighted for the information of the Board of the World Bank as well as for other participating co-financiers.

(i) First, while the Board had approved, in principle, the buy-back of **suppliers and trade credits**, the Uganda commercial debt buy-back was, in fact, the first operation of its kind in the Bank, in that most of the commercial debt consisted of such credits rather than debt owed to commercial banks. This significantly increased the number of parties with whom negotiations had to be conducted, thereby complicating the operation. In other countries, where the number of suppliers and trade creditors could be much larger, such an approach may not be practicable.

(ii) Second, the review of the commercial loan portfolio of the Government of Uganda by their financial and legal advisors revealed that the portfolio contained two large loans which had been made to the Ministry of Defence in October 1986 and September 1987 by the Bank for Foreign Economic Affairs of the former Soviet Union. Although insufficient information was available in Uganda to confirm the exact purpose of these loans, it was entirely possible that these loans may have been for military equipment. These two loans, which amounted to US$24 million and accounted for approximately 10 percent of Uganda's commercial debt, had since been sold to a Swiss commercial trading company by the former Soviet Union. This Swiss company also held other loans with respect to non-armament supplies to the army (e.g. uniforms and cooking oil, etc.). The remaining commercial loan portfolio was non-defence related.

It was recommended that the two loans mentioned above be included in the buy-back. While the original loans might possibly have been for military equipment, they were, at the time, simply debt instruments legally held by a commercial third party. The Facility funds would be disbursed simply to reduce Uganda's existing commercial debt and not for the acquisition of any hardware, defence or otherwise, of any nature. The reduction of this debt, like all other eligible debt under the operation, would be in the best development interest of Uganda. The financial advisors felt that the exclusion of these two loans from the buy-back operation would be very disruptive in that the Government of Uganda would have to make a separate settlement with the creditors involved and, given their influence within the country, would not be in a favorable negotiating position.

(iii) Third, of the total estimated amount of the buy-back of US$188 million, approximately US$96 million (including the two military equipment and other defence-related loans referred to above) was owed to the Swiss trading company mentioned above which had

purchased the debt from the Bank of Foreign Economic Affairs of the former Soviet Union and from two other Russian suppliers. While this debt was originally official bilateral debt, the Swiss company, which was a long-standing trading partner of Russia, had purchased it over a period of time in return for goods supplied to the Soviet Union. The legal advisors had examined the relevant documents from the Interstate Council for Supervision of Debt Servicing and the Utilization of Assets of the former Soviet Union and had found the documents to be in order. The Swiss company had been pressuring the Government of Uganda for payment and had business interests and contacts in Uganda which could enable it to obtain more favorable terms of settlement if they were excluded from the buy-back. The Swiss company had, however, indicated to the financial advisors their willingness to accept the buy-back offer on the understanding that this was an equitable global offer to all commercial creditors and that no bilateral arrangements would be made with the Government.

Legal advisors to the operation determined that neither the World Bank's Board resolutions, nor the guidelines pertaining to the Facility defined explicitly what was meant by the term "commercial debt". Therefore, in making the determination as to whether the debt is commercial or official, it was decided that the primary test would be the identity of the current holder. If that entity was a commercial bank or another commercial entity, the debt would be considered commercial and therefore eligible for Facility resources.

(iv) Fourth, it was determined that approximately US$18 million of the commercial debt was owed to former German Democratic Republic (GDR) companies with respect to uninsured suppliers' credits extended by these companies to Uganda. The debt was held by Treuhandanstalt, a German Government holding company, which was one of the agencies involved in restructuring and rationalizing former GDR owned companies and assets. While the

German Government had not yet finalized its position as to whether it intended to treat this debt as commercial debt or include it as official debt for future Paris Club deliberations, it was proposed that this debt be included in the buy-back despite the fact that the current holder of the debt was an official entity. This was because the German circumstances were unique as a result of the German unification process.

(v) Finally, approximately US$5 million was owed to a **Serbian company** and, under the sanctions imposed by the United Nations, while the Government of Uganda could make this offer to the Serbian company, it would not be possible for IDA to make a payment to close the offer till such time as the sanctions were lifted. It was therefore proposed that this debt be included in the offer and that, subject to the creditor acceptance, the relevant funds be held in an escrow account by the closing agent for payment to be made upon lifting of the sanctions.

Minimum Participation Level

Although the financial advisors felt reasonably confident about a high degree of participation, as indicated by their discussions with the creditors, they felt that the creditors were a very mixed group of companies whose debt had been incurred at different times, mainly beginning in the early 1980's up to the start of the Government's Economic Recovery Program in 1987. They therefore had arrears outstanding to them for varying periods and had different expectations about the ability of the Government of Uganda to pay them in full. Furthermore, there was no readily available forum, such as a Bank Advisory Committee, for conducting negotiations with these creditors which, as mentioned above, were principally non-bank institutions. Suppliers and trade creditors were also unlikely to have made provisions for losses in the same way as banks and it was possible that a number of creditors, in the final analysis,

might be unwilling to accept the write-offs on their balance sheets that a discounted buy-back would require.

In view of these factors, it was difficult to be certain of the exact level of debt that would be tendered. Consequently, it was decided that a minimum acceptance level of 60 percent of the eligible debt would be required. This conservative minimum acceptance rate would ensure the success of the transaction in a situation where the Government's inability to settle with creditors who accept the offer would damage its credibility and prove very disruptive. Furthermore, even at a 60 percent acceptance level, the Government would successfully manage to settle with a key number of creditors who were disrupting the Government's normal commercial operations. Alternative methods of settlement, such as reschedulings, on terms which the Government could afford in its current financial position were not possible and the ability to settle even 60 percent of the outstanding eligible debt was determined to be critical to the Government's debt strategy.

The Offer

Following the recommendations of the financial advisors, the operation was structured as a cash buy-back and it was decided that the Government would offer to pay commercial creditors 12 cents for every dollar of eligible debt in satisfaction of all amounts owed with respect to such eligible debt, including principal and all unpaid interest penalties and commissions up to September 30, 1992. The amount of interest arrears represented less than 15 percent of the face value of the debt, but its inclusion in the calculation of the settlement price was considered by the financial advisors to be critical to achieving a successful level of acceptance of the offer.

The World Bank's appraisal report for the operation was submitted to the Board on November 17, 1992 and the project was approved. The grant agreement for the operation, accompanying the President's Report, spelled out in some details the manner in which the funds from the Facility would be disbursed for the purchase of eligible debt. A provision was also made in the grant agreement to finance any incidental costs incurred by the Government during the operation, up to a maximum of US$ 100,000.

Details of the Government's offer were outlined in an Offer Document which was issued on December 16, 1992 by the legal advisors, on behalf of the Government of Uganda. As specified in the Offer Document, creditors were given until January 29, 1993 to respond to the offer and it was announced that the Closing Date for the operation would be February 26, 1993. However, legal provisions were made in the Offer Document to defer the Acceptance and Closing dates at the discretion of the Government of Uganda. It was further specified that creditors accepting the offer would have to submit an Acceptance Telex to the Closing Agents (in this case the Government's financial advisors) and that the acceptance would have to relate to <u>all</u> eligible debt held by that creditor. Eligible debt denominated in a currency other than U.S. dollars would be paid either in U.S. dollars based on exchange rates prevailing on February 9, 1993 or in the original currency at the choice of the creditor, provided the original currency was either Pound Sterling, Japanese yen, Italian Lira or Deutschmarks.

The Results

The offer by the Government of Uganda to buy-back its uninsured commercial debt at a discount of 88 percent of face value was extremely successful and, of the total eligible debt of US$188 million (Table 3), debt worth US$153 million was bought back, reflecting a

participation rate in excess of 80 percent. As a result of the operation, most of Uganda's commercial debt has been eliminated, with the remaining commercial obligations accruing to creditors who either have work in progress or those who hold some form of security or collateral for their claims.

Conclusion

Notwithstanding the significant progress that Uganda has made in tackling its external debt problem, the situation is far from resolved. A large proportion of Paris Club debt remains ineligible for rescheduling since it was contracted after the cut-off date; arrears owed to non-OECD bilateral creditors have continued to mount in the face of resistance from non-OECD creditors to restructure Uganda's obligations owed to them; and servicing that part of multilateral debt which is non- or less-concessional continues to take up a significant amount of Uganda's foreign exchange earnings.

Resolving Uganda's external debt burden will require concerted action on several fronts. First, continued progress in implementing its economic reform program will be essential. Not only will this be essential for maintaining macroeconomic stability but this will also serve to increase Uganda' credibility within the international community in general and its creditors in particular. Second, export diversification and growth will need to be vigorously pursued. This will not only increase the country's creditworthiness and its ability to service its financial obligations but, more importantly, lay a sound foundation for long term sustained development and poverty reduction. Third, there should be no let up in seeking creative mechanisms for restructuring the debt portfolio. This will necessitate maintaining the existing policy of seeking grant funding wherever possible or contracting debt only on the most concessional terms.

In the case of Paris Club debt, Uganda should seek a reduction in the total stock of debt, as was discussed during the 1992 Paris Club rescheduling. Paris Club has stated its willingness to consider such reductions on a case-by-case basis provided the country in question continues to implement a World Bank/IMF supported adjustment program over a period of time. For non-OECD bilateral debt, given its existing foreign exchange constraints, Uganda has little option but to continue to accumulate arrears if these countries are unwilling to enter into a dialogue about its external debt situation. However, this should not deter Uganda from constantly pressing non-OECD creditors for substantial debt relief. For non- and less-concessional multilateral debt, such as that owed to IBRD, it will be necessary to maintain and, indeed, augment IDA *Fifth Dimension*-like mechanisms, particularly to include organizations like the African Development Bank. A similiar approach for highly-concessional multilateral debt, such as IDA, would not be warranted. While Uganda's exposure to IDA is substantial, seeking IDA rescheduling or forgiveness, even if this were possible, would be less advantageous for Uganda -- given the high degree of concessionality of IDA credits -- than a continued orderly relationship involving moderate volumes of new lending for priority purposes.

It needs to be emphasized that while Uganda's debt problems are large, they are not insurmountable. Timely intervention by the donor community and concerted action on the part of Government will go a long way in easing the country's debt burden and facilitating the economic recovery program.

Policy Research Working Paper Series

	Title	Author	Date	Contact for paper
WPS1384	Fiscal Decentralization and Intergovernmental Finances in the Republic of Albania	David Sewell Christine I. Wallich	November 1994	G. Langton 38392
WPS1385	Fiscal Federalism Dimensions of Tax Reform in Developing Countries	Robin Boadway Sandra Roberts Anwar Shah	November 1994	C. Jones 37754
WPS1386	EU Bananarama III	Brent Borrell	December 1994	G. Ilogon 33732
WPS1387	Fiscal Decentralization and the Size of Government: An Extension with Evidence from Cross-Country Data	Jaber Ehdaie	December 1994	C. Jones 37699
WPS1388	Does Voice Matter? For Public Accountability, Yes	Samuel Paul	December 1994	B. Moore 35261
WPS1389	Ruble Overhang and Ruble Shortage: Were They the Same Thing?	Patrick Conway	December 1994	L. Suki 33974
WPS1390	Regional Integration and the Baltics: Which Way?	Piritta Sorsa	December 1994	J. Ngaine 37947
WPS1391	Where in the World Is Population Growth Bad?	Jeff Kling Lant Pritchett	December 1994	S. Fallon 38009
WPS1392	Some Economic Consequences of the Transition from Civil War to Peace	Jean-Paul Azam David Bevan Paul Collier Stefan Dercon Jan Gunning Sanjay Pradhan	December 1994	C. Jones 37699
WPS1393	The Interface of Trade, Investment, and Competition Policies: Issues and Challenges for Latin America	J. Luis Guasch Sarath Rajapatirana	December 1994	J. Troncoso 37826
WPS1394	Macroeconomic Reform and Growth in Africa: *Adjustment in Africa* Revisited	Lawrence Bouton Christine Jones Miguel Kiguel	December 1994	R. Martin 39026
WPS1395	A Typology of Foreign Exchange Auction Markets in Sub-Saharan Africa	Janine Aron Ibrahim Elbadawi	December 1994	R. Luz 39059
WPS1396	Foreign Exchange Auction Markets In Sub-Saharan Africa: Dynamic Models for Auction Exchange Rates	Janine Aron Ibrahim Elbadawi	December 1994	R. Luz 39059

Policy Research Working Paper Series

	Title	Author	Date	Contact for paper
WPS1397	Are Private Capital Flows to Developing Countries Sustainable?	Uri Dadush Ashok Dhareshwar Ron Johannes	December 1994	J. Queen 33740
WPS1398	The Cost of Air Pollution Abatement	Raymond S. Hartman David Wheeler Manjula Singh	December 1994	E. Schaper 33457
WPS1399	How Important to India's Poor is the Urban-Rural Composition of Growth?	Martin Ravallion Gaurav Datt	December 1994	P. Cook 33902
WPS1400	Technical and Marketing Support Systems for Successful Small and Medium-Size Enterprises in Four Countries	Brian Levy with Albert Berry, Motoshige Itoh, Linsu Kim, Jeffrey Nugent, and Shujiro Urata	December 1994	D. Evans 38526
WPS1401	Colombia's Small and Medium-Size Exporters and Their Support Systems	Albert Berry Jose Escandon	December 1994	D. Evans 38526
WPS1402	Indonesia's Small and Medium-Size Exporters and Their Support Systems	Albert Berry Brian Levy	December 1994	D. Evans 38526
WPS1403	Small and Medium-Size Enterprise Support Policies in Japan	Motoshige Itoh Shujiro Urata	December 1994	D. Evans 38526
WPS1404	The Republic of Korea's Small and Medium-Size Enterprises and Their Support Systems	Linsu Kim Jeffrey B. Nugent	December 1994	D. Evans 38526
WPS1405	Growth and Poverty in Rural India	Martin Ravallion Gaurav Datt	January 1995	WDR 31393
WPS1406	Structural Breaks and Long-Run Trends in Commodity Prices	Javier León Raimundo Soto	January 1995	R. Luz 31320
WPS1407	Pakistan's Agriculture Sector: Is 3 to 4 Percent Annual Growth Sustainable?	Rashid Faruqee	January 1995	F. Willie 82262
WPS1408	Macroeconomic Management and Intergovernmental Relations in China	Jun Ma	January 1995	C. Jones 37754
WPS1409	Restructuring Uganda's Debt: The Commercial Debt Buy-Back Operation	Kapil Kapoor	January 1995	E. Spano 35538