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Indebtedness of East European countries*

*Since last year, the East European countries have entered a period of historic transformations. By opening a large new area of the world to market-induced improvements in efficiency, real possibilities for expansion in both East and West will increase. However, these long-term beneficial effects can only occur if political and economic reforms in Eastern Europe succeed which can by no means be taken for granted. The initial impact of these reformatory changes on the region's financial position has been obviously negative and a further worsening seems inevitable before any improvement occurs. In this connection, it is appropriate to draw some conclusions concerning the level of indebtedness of East European countries. This question is of crucial importance for capacity of these countries to incur new debt and to attract foreign investment, both indispensable for a successful implementation of rigorous adjustment policies and deep structural reforms.

Evaluation of the indebtedness of East European Countries

Key debt figures for the following eight East European countries are presented in tables 1-8: Poland, Hungary, Yugoslavia, Romania, Bulgaria, USSR, GDR and Czechoslovakia. Data for Albania is not available. These figures include eight chosen measures of indebtedness: gross external debt, net external debt (gross debt less reserves), share of debt owed to private banks, debt/GNP ratio, debt/exports ratio, interest/exports ratio, debt service/exports ratio and debt-service/GNP ratio. More details on these debt indicators are given in the footnotes to the tables. Due to the general lack of reliable, consistent and comparable data on Eastern European external debt from debtor countries' sources, two sets of data produced by international organizations are used in this paper. OECD data is available for seven from among the eight countries (for all expect Yugoslavia). World Bank data is available for four countries: Yugoslavia, Romania, Hungary and Poland. The main advantage of the adopted approach is that data from each source is to a large extent comparable. The main differences between the two sets of data are explained in the footnotes to the tables. It is also important that World Bank indicators can be directly compared with corresponding indicators for other heavily indebted countries.

Two additional indicators from other sources are included in the tables: country creditworthiness rating and debt prices in the secondary market.

According to OECD criteria based on debt-to-exports, interest-to-exports and debt-service-to-exports ratios, four categories of countries can be distinguished (Markets, 1990 p.21-27):

The first category includes one country only, namely Poland whose debt burden is comparable to those of the very heavily indebted Latin American countries. The authorities are unable to service the debt and must constantly negotiate with foreign creditors. Payments to service the debt, if made in full, would absorb such a large share of export receipts and budget expenditures that not only economic reforms but even the very functioning of the economy would be virtually impossible. This statement remains true even in the case only full interest payments are taken into account.

The second group comparises Hungary and, since recently, Bulgaria. In these countries, the debt level is such that the debt cannot be significantly increased which may constitute a constraint on the future domestic growth. According to OECD experts, the existing debt is near the country's debt servicing limit, but still manageable. In our opinion, this is not so sure; we think

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that only interest payments, but not principal repayments, can be met by these countries in the coming years.

The third group consists of countries with moderate debt burden. Yugoslavia, USSR and GDR can be categorised as such countries. According to OECD experts, they have some capability for incurring additional debt as part of a medium-term growth strategy. However, such a strategy should be carried out with great caution, since the situation can worsen very quickly and get out of control, as recently shown by the Bulgarian case.

Of course, in this group, the situation of GDR is rather special in view of the imminent German reunification.

The last category includes countries with light debt burden: Czechoslovakia and Romania, though in the case of the latter the forced repayment of debt has been disastrous to the economy.

The World Bank classifies the debtor countries on the basis of four indicators: the ratio of debt to GNP, the ratio of debt to exports, the ratio of interest to exports, the ratio of debt service to exports. A country is considered to be severly indebted if at least three out of these four indicators fall above critical levels calculated as unweighted 1988 means of each indicator for a group of countries identified as experiencing recent debt servicing difficulties: a debt/GNP ratio of 50 percent, a debt to exports ratio of 275 percent, a ratio of scheduled interest ro exports of 20 percent and ratio of scheduled debt service to exports of 30 percent. If at least three of our observed values exceed 60 percent of the above critical value, the country is classified as moderately indebted (Measurement, 1989 p.1).

According of these criteria, the World Bank classifies Poland and Hungary as Severely Indebted Middle-Income Countries (SIMICs) and Yugoslavia as Moderately Indebted Middle-Income Country (MIMIC). If we apply these criteria to other East European countries not covered by the world Bank categorisation, Bulgaria will be identified as Moderately Indebted Middle-Income Country.

Although the above classification should not be taken as an automatic criterion of eligibility for officially supported debt service reduction, a more detailed analysis of the level of different indicators as well as of the overall economic situation of individual countries permit to draw some conclusions.

Firstly, the indebtedness of East European countries is extremely differentiated. Different situations require different remedies. There can not be any unique solution to Eastern European debt problem.

Secondly, the unprecedented transformation of centrally planned economies back to market economies will require a substantial inflow of resources. However, rather than traditional debt finance , equity capital will be sought. There are both internal and external reasons for this evolution. The internal ones include a shortage of domestic capital needed to carry out the privatization of the economy as well as a dramatic need for Western advanced technology and managerial skills. The external reason is the outstanding foreign debt burden discussed above. Not only for Poland, but for Hungary, Bulgaria and Yugoslavia, too, there is not much room for an increase in the traditional external debt. Of course, foreign direct investment can also constitute a burden to the country's balance of payments because of the possibility of profit repatriation, but this at least implies the profitability of the investment. Whereas, when investments are to be financed by debt, interest on that debt has to be paid irrespective of the profitability.

Thirdly, for several countries even such an equity capital inflow coupled with resources from official sources (loans from international financial institutions, especially the IMF, World Bank, BIS and European Investment Bank, guarantees, from export credit agencies and loans and grants from individual governments) will not be sufficient without a substantial reduction in the outstanding debt. What more, without debt relief, private investors may avoid such countries because the continuously growing debt overhang constitutes a threat to the country's economy and, in particular, to the freedom of repatriation of profits and of the invested capital itself. Practically, everybody agrees that this is just Poland's case but this recognition does not alter the fact that nobody knows how such reduction in the polish debt can be actually achieved.

However, in our opinion, Hungary too has become eligible for debt relief, both because of its indebtedness level and its commitment to adequate economic reforms. In the near future,

also Bulgaria and perhaps Yugoslavia can need debt reduction, but especially in the case of the former an additional but fundamental condition for obtaining such relief would be a move toward an appropriate adjustment program.

Prospects for debt reduction

It looks like a paradox that a meaningful debt reduction seems to be most difficult for that East European country which obviously needs it most, namely Poland. Poland's eligibility for debt and/or debt service reduction is evident. This results from the level of relevant indebtedness indicators, the implementation of a model adjustment program approved by the IMF[1], the evident progress towards democracy, as well as from excellent political relations with the main creditor governments. Practically all our creditors already recognize the need of a reduction in the polish debt, although not necessarily on such a scale as recently proposed by the Polish government i.e. by 80 percent. This proposal seems to be realistic from the point of view of the polish debt service capability (at a level of about 10 percent of export earnings), especially in the face of implementation of an extremely radical stabilization program and deep structural reforms, as well as because of the present prices for the Polish debt in the secondary market (15-18 cents on one dollar). However, actual chances to obtain the proposed reduction seem less realistic. The point is that, at present, a substantial debt reduction for middle-income countries is available with respect to debt owed to private banks only, especially under the Brady Plan. Whereas the bank debt share in the total Polish debt amounts to about 20 percent only.

At the beginning of June the creditor banks preliminarily agreed to cover the total Polish bank debt, including arreas, by such a deal. In our opinion, the conclusion of such a deal would be useful for Poland, although it would by no means constitute a comprehensive solution to the Polish external debt problem.

An examination of our deals already concluded under the Brady Plan by Mexico, Philippines, Costa Rica and Venezuela, and especially an analysis od their effectiveness, show that with a skillful formulation of the agreement we could expect a 75-80- percent reduction in the present value (i.e. inclusive of the debt service reduction) of our bank debt which amounts to about USD 9 billion. But the actual reduction in the total debt would be somewhat less, since the deal would have to be at least partially financed by new loans from the IMF, the World Bank and bilateral sources. The cost of the deal would amount to about 1.5 billion of which about one half could come from the above-mentioned official sources and the rest from Polish own international reserves. Apart from beneficial effects to the country's balance of payments (also because of lower principal repayments), a normalization of relations with commercial banks could be an additional advantage.

However, the problem of our USD 22 billion long-term debt to official creditors would still remain unsolved. Since 1982, Poland practically did not service that debt. In last March the Paris Club dispensed Poland from all payments on their claims (including interest) for one year, till March 1991. This strategy, in spite of a meaningful temporary relief for our balance of payments, does not solve the problem, since it is evident that in the next year Poland will be equally unable to service this debt, the more so as the debt is growing because of capitalized interest. As already mentioned above, this debt overhang seriously hampers the inflow of private capital especially in the form of direct investment, since even a capital flow liberalization, inclusive of profit repatriation, can not be credible under such circumstances. As yet, there has not been any definite debt reduction initiative addressing the severely indebted middle-income countries (SIMICs) whose debt is primarily owed to official creditors: here Poland, Marocco and Senegal would be specifically meant. Some proposals to widen the principle of debt relief are to be discussed during the July world economic summit in Houston. However, these proposals are likely to adress rather the so-called lower middle-income countries such as Nigeria, Ivory Coast and Gabon whose debt is also owed to a great extent to official creditors. On the other hand, there also appeared to be a consensus in favour of further widening the Toronto terms to poor countries outside Africa. So, none of these new proposals will meet the needs of countries mentioned above, among them Poland.

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[1]In this respect, different reservations aroused by this program in Poland itself are of less importance.

Of course, different proposals can be put forward to set up special funds or trusts which would take over the Polish debt to official creditors. Such proposals have been actually made, but they remain unrealistic as long as the official creditors continue to insist that their claims are still worth 100 percent of their face value. The creditors do not seem to be ready to create a precedent of which all the other countries more or less indebted to the Paris Club would immediately wish to avail themselves. And this is just the difference from the sometimes quoted case of West Germany whose debt to official creditors was partly written off in 1953. At the time, only one country was concerned and now they are many and it is difficult to find a solution which would not create a wider precedent. Hence the present deadlock.

A widely debated problem is the advisability to use debt-to-equity swaps. We believe that this technique can be very useful indeed not only for Poland but for some other East European Countries too, however rather as a tool to attract foreign investment than as a debt reduction instrument. So, other debt reduction techniques, if available, should be used first because they generally alow the debtor country to capture a substantially larger part of the secondary market discount than in the case of debt-to-equity swaps which leave the main part of this discount in the hands of the investor. That's why all the countries having already negotiated officially supported debt reductions suspended debt-to-equity swap programs till the conclusion of the agreement. We think that the East European countries, especially Poland and Hungary, should follow this example i.e. first negotiate comprehensive bank debt reduction and only next launch a debt-to-equity swap program for the remaining and/or new debt instruments. If, however, such a comprehensive agreement were not to be reached in forseeable future, it would be advisable to admit debt-to-equity swaps as soon as possible.

These swaps are often regarded to be pro-inflationary. This is true, but they are not more pro-inflationary than other capital inflow. Moreover, if used in connection with privatization, debt-to-equity swaps will exert no inflationary influence at all.

As far as East European countries other than Poland are concerned, it seems that debt reduction for Hungary, and later perhaps Bulgaria and Yugoslavia, will be easier to achieve due to the structure of their debt. All these countries owe the bulk of their external debt to private banks and for this kind of debt appropriate debt reduction mechanism already exist and are expected further to develop.

Finally, debt-to-equity swaps can be widely used by all the above-mentioned countries, and perhaps also USSR, as soon as their debt will be actively traded in the secondary market which seems imminent (see tables 2, 4, 5).

Table 1

Poland

	OECD data		World Bank data
	1988	1989[a]	1988
1. Gross external debt (USD millions)	39,116	41,000	42,137
2. Net debt (USD millions)[b]	35,572	37,520	.
3. Debt owed to private banks (percentage share of total debt)	19.0	.	22.1
4. Debt/GNP ratio (percent)	.	.	65.0[c]
5. Debt/Exports ratio (percent)	504.0[d]	532.0[d]	498.6[e]
6. Interest/Exports ratio (percent)	40.0[f]	49.0[f]	30.5[g]
7. Debt service/Exports ratio (percent)	76.0[h]	88.0[h]	72.5[i]
8. Debt service/GNP ratio (percent)	.	.	9.3[j]

Memorandum items				
	Rank	Credit worthiness index[k]	Six months change	One year change
9. Country creditworthiness rating (March 1990)	77	19.0	0.2	0.9

	March 29, 1990	May 15, 1990
10. Debt prices in the secondary market (cents on one USD)	14,0 - 15,0	16.0 - 18.0

[a] Preliminary
[b] Gross debt less reserves
[c] Gross debt/GNP
[d] Net debt/Exports (goods only) in convertible currencies
[e] Gross debt/Exports (goods and services) in convertible currencies
[f] Scheduled net interest/Exports (goods only) in convertible currencies
[g] Scheduled interest/Exports (goods and services) in convertible currencies
[h] Scheduled debt service/Exports (goods only) in convertible currencies
[i] Scheduled debt service/Exports (goods and services) in convertible currencies
[j] Scheduled debt service/GNP
[k] Rating based on information provided by international banks which grade each country every six month on a scale from 0 to 100

Source: Market, 1990 p.19-27; Measurement, 1989 p.9-11; World, 1989 vol.2; Investor, 1990 p.70; Prices 1990a; Prices 1990b; Sheet 1990a, Sheet 1990b.

Table 2

HUNGARY

	OECD data		World Bank data
	1988	1989[a]	1988
1. Gross external debt (USD millions)	17,305	20,600	17,561
2. Net debt (USD millions)[b]	15,926	19,446	.
3. Debt owed to private banks (percentage share of total debt)	57.0	.	.
4. Debt/GNP ratio (percent)	.	.	70.3[c]
5. Debt/Exports ratio (percent)	290.0[d]	326.0[d]	296.3[e]
6. Interest/Exports ratio (percent)	21.0[f]	20.0[f]	24.3[g]
7. Debt service/Exports ratio (percent)	54.0[h]	45.0[h]	61.8[i]
8. Debt service/GNP ratio (percent)	.	.	12.6[j]

Memorandum items	Rank	Credit worthiness index[k]	Six months change	One year change
9. Country creditworthiness rating (March 1990)	42	43.6	-0.9	-0.9

	March 29, 1990	May 15, 1990
10. Debt prices in the secondary market (cents on one USD)	-	70.0-75.0[l]

[l] Indicative prices.
All the remaining footnotes as in Table 1.

Source: see Table 1.

Table 3

YUGOSLAVIA

	OECD data		World Bank data
	1988	1989[a]	1988
1. Gross external debt (USD millions)	.	.	21,684
2. Net debt (USD millions)[b]	.	.	.
3. Debt owed to private banks (percentage share of total debt)		–	57.7
4. Debt/GNP ratio (percent)	.	.	36.4[c]
5. Debt/Exports ratio (percent)	.	.	108.5[c]
6. Interest/Exports ratio (percent)			12.0[d]
7. Debt service/Exports ratio (percent)			23.0[f]
8. Debt service/GNP ratio (percent)	.	.	7.7[f]

Memorandum items				
	Rank	Credit worthiness index[k]	Six months change	One year change
9. Country creditworthiness rating (March 1990)	66	27.1	1.3	0.3

10. Debt prices in the secondary market (cents on one USD)	March 29, 1990 58.25 - 59.00	May 15, 1990 60.25 - 61.50

All the footnotes as in Table 1.

Source: see Table 1.

Table 4

BULGARIA

	OECD data		World Bank data
	1988	1989[a]	1988
1. Gross external debt (USD millions)	7,946	9,500	.
2. Net debt (USD millions)[b]	6,16	8,260	.
3. Debt owed to private banks (percentage share of total debt)[c]	71.0	.	.
4. Debt/GNP ratio (percent)	.	.	.
5. Debt/Exports ratio (percent)	196.0[d]	263.0[d]	.
6. Interest/Exports ratio (percent)	12.0[f]	14.0[f]	.
7. Debt service/Exports ratio (percent)	39.0[h]	40.0[h]	.
8. Debt service/GNP ratio (percent)	.	.	.

Memorandum items				
	Rank	Credit worthiness index[k]	Six months change	One year change
9. Country creditworthiness rating (March 1990)	43	43.1	-2.5	-3.4
	March 29, 1990		May 15, 1990	
10. Debt prices in the secondary market (cents on one USD)	-		20.0 - 40.0[l]	

[l] Indicative prices.
All the remaining footnotes as in Table 1.

Source: see Table 1.

Table 5

USSR

	OECD data		World Bank data
	1988	1989[a]	1988
1. Gross external debt (USD millions)	40,856	48,000	.
2. Net debt (USD millions)[k]	25,601[l]	32,778[l]	.
3. Debt owed to private banks (percentage share of total debt)	62.0	.	.
4. Debt/GNP ratio (percent)	.	.	.
5. Debt/Exports ratio (percent)	90.0[d]	113.0[d]	.
6. Interest/Exports ratio (percent)	6.0[f]	7.0[f]	.
7. Debt service/Exports ratio (percent)	23.0[h]	23.0[h]	.
8. Debt service/GNP ratio (percent)	.	.	.

Memorandum items				
	Rank	Credit worthiness index[s]	Six months change	One year change
9. Country creditworthiness rating (March 1990)	25	62.1	-2.2	-2.8
10. Debt prices in the secondary market (cents on one USD)	March 29, 1990		May 15, 1990	
	-		-[m]	

[l] Gross debt less known reserves.
[m] Increasing offers of both loans and bonds.
All the remaining footnotes as in Table 1.

Source: see Table 1.

GDR

	OECD data		World Bank data
	1988	1989[a]	1988
1. Gross external debt (USD millions)	19,501[i]	21,200[i]	.
2. Net debt (USD millions)[b]	9,593[i]	11,260[i]	.
3. Debt owed to private banks (percentage share of total debt)	67.0	.	.
4. Debt/GNP ratio (percent)	.	.	.
5. Debt/Exports ratio (percent)	106.0[d]	118.0[d]	.
6. Interest/Exports ratio (percent)	8.0[f]	8.0[f]	.
7. Debt service/Exports ratio (percent)	72.0[e]	70.0[e]	.
8. Debt service/GNP ratio (percent)	.	.	.

Memorandum items	Rank	Credit worthiness index[k]	Six months change	One year change
9. Country creditworthiness rating (March 1990)	31	57.1	-1.2	-11.7

	March 29, 1990	May 15, 1990
10. Debt prices in the secondary market (cents on one USD)	-	-

[i] Includes intra-German debt.
All the remaining footnotes as in Table 1.

Source: see Table 1.

Table 7

ROMANIA

	OECD data		World Bank data
	1988	1989[a]	1988
1. Gross external debt (USD millions)	2,8110	1,000	2,790
2. Net debt (USD millions)[b]	2,001	-60	.
3. Debt owed to private banks (percentage share of total debt)	19.0	.	15.1
4. Debt/GNP ratio (percent)	.	.	4.7[c]
5. Debt/Exports ratio (percent)	32.0[f]	-1.0[d]	.
6. Interest/Exports ratio (percent)	4.0[f]	1.0[f]	.
7. Debt service/Exports ratio (percent)	23.0[h]	15.0[a]	.
8. Debt service/GNP ratio (percent)	.	.	7.1[j]

Memorandum items				
	Rank	Credit worthiness index[k]	Six months change	One year change
9. Country creditworthiness rating (March 1990)	52	33.3	0.7	0.7

	March 29, 1990	May 15, 1990
10. Debt prices in the secondary market (cents on one USD)	-	-

All the footnotes as in Table 1.

Source: see Table 1.

Table 8

CZECHOSLOVAKIA

	OECD data		World Bank data
	1988	1989[a]	1988
1. Gross external debt (USD millions)	5,721	6,900	.
2. Net debt (USD millions)[b]	4,049	5,370	.
3. Debt owed to private banks (percentage share of total debt)	59.0	.	.
4. Debt/GNP ratio (percent)	.	.	.
5. Debt/Exports ratio (percent)	78.0[d]	95.0[d]	.
6. Interest/Exports ratio (percent)	5.0[f]	5.0[f]	.
7. Debt service/Exports ratio (percent)	6.0[g]	7.0[g]	.
8. Debt service/GNP ratio (percent)	.	.	.

Memorandum items	Rank	Credit worthiness index[k]	Six months change	One year change
9. Country creditworthiness rating (March 1990)	36	53.7	-1.0	-0.7

	March 29, 1990	May 15, 1990
10. Debt prices in the secondary market (cents on one USD)	-	-

All the footnotes as in Table 1.

Source: see Table 1.

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List of previous issues

No 1
Witold Małecki
DEBT CONVERSION TECHNIQUES AND POLISH DEBT STRATEGY

No 2
Karol Lutkowski
SOME CRUCIAL ASPECTS OF THE IMF ADJUSTMENT PROGRAMS
THEIR RELEVANCE TO POLAND'S ECONOMIC PROBLEMS

No 3
Grzegorz W.Kołodko
STABILIZATION POLICY IN POLAND
CHALLENGES AND CONSTRAINTS

No 4
Wojciech Felberg
SUPPLEMENTARY SOURCES OF FINANCING DEVELOPMENT VENTURES
AND THEIR ROLE IN THE PROCESS OF RESTRUCTURING
THE POLISH ECONOMY

No 5
Danuta Gotz-Kozierkiewicz
ROLE AND PLACE OF EXTERNAL SECTOR IN ECONOMIC EQUILIBRIUM

No 6
Witold Walkowiak
THE DIRECTIONS OF OWNERSHIP REFORM
AND CAPITAL MARKET DEVELOPMENT
IN THE POLISH ECONOMY

No 7
Grzegorz W.Kołodko
CRISIS, ADJUSTMENT AND GROWTH
IN SOCIALIST ECONOMY
POLITICAL CHALLENGES AND THE DILEMMAS
OF ECONOMIC SCIENCES

No 8
Jerzy Bielawny
LEGAL ASPECTS OF MONOPOLIZATION
OF AGRICULTURAL PRODUCTS PURCHASING IN POLAND

No 9
Iwona Antowska-Bartosiewicz, Witold Małecki
THE BRADY PLAN AND THE POLISH DEBT

No 10
Grzegorz W.Kołodko
POLISH HYPERINFLATION AND STABILIZATION 1989-1990

Nr 11
Danuta Gotz-Kozierkiewicz
Grzegorz W. Kołodko
STABILIZATION IN VIET NAM

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