Peterson Institute for International Economics

Policy Brief

NUMBER PB11-17 NOVEMBER 2011

Debt Relief for Egypt?

John Williamson and Mohsin Khan

John Williamson, *senior fellow, has been associated with the Institute since 1981. His numerous publications include* Reference Rates and the International Monetary System *(2007) and* Dollar Adjustment: How Far? Against What? *(2004).* **Mohsin Khan** *has been a senior fellow at the Peterson Institute for International Economics since 2009. Before joining the Institute, he was the director of the Middle East and Central Asia department at the International Monetary Fund (IMF) from 2004 to 2008. The authors are grateful to Svetlana Milbert for excellent assistance in preparing this policy brief.*

Note: Support for this policy brief was provided by the US Chamber of Commerce (USCC). An earlier version was presented at the joint meeting of the US-Egypt Business Council and the Egypt-US Business Council in Washington on October 25. The analysis in the policy brief has benefited from the comments of the participants at the Joint Council Meeting as well as discussions with the staff of the USCC (Middle East Affairs).

The current government of Egypt has frequently stated that external financial assistance is necessary in the present economic situation and has expressed a strong preference for receiving it in part via debt relief. The question asked in this policy brief is whether there is a case for debt relief and if so what form this relief should take. This policy brief reviews a number of cases in which debt relief has been granted to draw out the lessons and implications for Egypt.

When the Latin American debt crisis exploded in the early 1980s, it was taken for granted that a sovereign country would always finance its debt. History, which provided numerous counter-examples, had been forgotten. The Latin American debt crisis dragged on for some eight years and was resolved only by the granting of a form of debt relief on the part of the commercial bank creditors through multilateral organizations creating Brady bonds.[1]

Debts to public-sector creditors (largely official development assistance [ODA], export credits, and exports insured by public-sector bodies) have traditionally been handled in a multilateral setting by the Paris Club.[2] Debt relief on a bilateral basis is handled directly through negotiations between the creditor and the borrower. Currently the Paris Club requires that a country make the case that its balance of payments position would be unviable without a reduction of public-sector debt; present a proposed program of debt reduction; be implementing an International Monetary Fund (IMF) arrangement; and ensure that private creditors grant comparable terms. Prior to 1988 the Paris Club engaged only in debt reprofiling, i.e., an extension of maturities at similar interest rates and therefore not involving debt relief (defined as a reduction in the present value of debt). But in 1988 the Paris Club began granting debt relief for low-income countries, following the decision of the Group of Seven (G-7) at Toronto, and this was subsequently made more generous by decisions reached at various G-7 summits as noted in box 1.

The policy of writing down multilateral debt owed by low-income countries first arose with the Heavily Indebted Poor Countries (HIPC) Initiative in 1996, which was subsequently amplified by the Enhanced HIPC Initiative of 1999. Then, in 2008, the complementary Multilateral Debt Relief Initiative was established. HIPCs were allowed more generous Paris Club treatment under the "Lyons terms" (1996) and the "Cologne terms" (1999). In principle, multilateral debt relief is granted only to low-income countries. However, there have also been a number of instances of multilateral agreement for providing

1. US Treasury Secretary Nicholas Brady proposed in 1989 that the debt-laden countries should be enabled to convert their bank debts into bonds with lower nominal interest or partial debt forgiveness in which the principal and one or two years of interest payments were collateralized by US Treasury zero-interest obligations, subject to approval of the details by the International Monetary Fund.

2. The Paris Club is an informal group of official creditors whose role is to find coordinated and sustainable solutions to the payment difficulties experienced by debtor countries. At present, the Paris Club has 19 permanent members. See www.clubdeparis.org/en.

Box 1 The terms of debt relief for low-income Paris Club borrowers at G-7 summits

Summit	Terms
Toronto 1988	33 1/3 percent debt relief for low-income countries
Houston 1990	Longer-term rescheduling (20 years for official development assistance [ODA] and 15 years for other debt) and conversion of official debt into equity or local currency to finance development for lower middle-income countries
London 1991	50 percent debt relief for low-income countries
Naples 1994	66 2/3 percent debt relief for low-income countries

debt relief for middle-income countries' sovereign debt. In addition to the Brady bonds, whose creation resolved the debt crisis, one should note the Egyptian and Polish deals of 1991; the Ecuadorian debt relief and reorganization of 2000; Iraq's debt reduction in 2004; and the writedown of the outstanding stock of debt in 2005 of both Argentina and Nigeria (which was originally classified as a lower middle-income country). The Paris Club was not involved in the East Asian crisis of 1997, because no sovereign debt was forgiven in the course of that crisis.[3] Debt relief can no longer be considered a taboo subject, although countries that the market considered guilty of opportunistic restructuring ("won't pay" rather than "can't pay") have found foreign borrowing again difficult.

This policy brief is exclusively concerned with the restructuring of sovereign and sovereign-guaranteed debts. It outlines the nature of the Egyptian debt deal of 1991, because it provides a precedent for what may be possible this time. It also discusses the cases of other middle-income countries[4]—Iraq, Argentina, and Nigeria—that benefited from debt relief, as well as the loan guarantees provided by the United States to Israel. It concludes with examples of how a new debt relief program for Egypt could be designed.

EGYPT, 1991

On May 25, 1991, Egypt's willingness to assume a leadership role in the First Gulf War was rewarded when an agreement was signed to reschedule and reduce its debt to the 17 members of the Paris Club. Debt service obligations were locked in at the reduced level for the first three years, providing a minimum of 15 percent (net present value) relief. The full implementation of debt restructuring/rescheduling achieved the equivalent of a 50 percent reduction in the net present value of eligible debts.

The scope of debt relief was wide. The debt eligible for rescheduling covered: (1) all concessional public and publicly guaranteed debt owed to the participating Paris Club creditors contracted prior to October 21, 1986 and having an original maturity of more than one year; (2) medium- and long-term commercial credit insured by the participating creditor countries contracted prior to the same cut-off date; (3) nonconcessional medium- and long-term bilateral debt owed to participating countries; and (4) repayments due under the previously rescheduled debt as of May 22, 1987. The bulk of this debt resulted from long-term official borrowing from bilateral sources. Overall, the 1991 Paris Club debt relief package amounted to a total of $19.6 billion and enabled Egypt to save an average of over 2 percentage points of GDP a year in debt service payments from 1992 to 1997 on debt owed to Paris Club creditors. Additional savings on the servicing of debt due to Arab countries and institutions and on US military debt meant that the benefits from the debt rearrangement were conservatively put at about 4 percent of GDP annually in the 1992–97 period.

Prior to the agreement, in mid-May 1991, the IMF approved a Stand-By Arrangement for Egypt of $372 million. As part of the Stand-By Arrangement the government increased energy prices, reduced subsidies, unified the exchange rate, increased interest rates, partially liberalized foreign trade, reduced the growth of credit, reformed the tax system, and cut government spending and the budget deficit. The IMF agreement was a necessary condition for Egypt to obtain a deal from the Paris Club, which enabled it to obtain favorable terms on its debt to member countries. In addition, the World Bank agreed to lend Egypt $300 million and the African Development Bank agreed to lend $250 million. A $600 million Social Fund was also created with foreign assistance to help cover the social costs of structural change and to compensate workers laid off as a result of privatization. In mid-June 1991 the World Bank approved an additional $520 million loan to Egypt. Finally, private creditors agreed to give $10 billion in debt relief. Altogether, roughly

3. A limited amount of private debt, principally of Indonesian entities, was written down.

4. Although the key to Nigeria gaining access to Paris Club debt relief was its reclassification as a low-income country.

Table 1 Iraq: Estimated external debt stock, 2004–08 (billions of US dollars)[a]

	2004			2007			2008	
	Before debt reduction		First and second stage of Paris Club debt reduction			Third stage of Paris Club debt restructring		
Creditors	Stock	In percent		Stock	In percent		Stock	In percent
Paris Club official creditors[b]	50.9	35.8	30.5	20.4	19.9	9.8	10.6	32.7
Non-Paris Club official creditors[c]	69.6	49	7.5	78.4	76.7	60.4	18	55.7
Private creditors	20.7	14.6	17.7	3	2.9	0	3	9.3
Multilateral creditors and others	0.9	0.6	0.4	0.5	0.5	0	0.7	2.3
Total debt	142.1	100	56.1	102.3	100	70.2	32.3	100
In percent of GDP	551.5			164			33.2	

a. Based on actual data as of 2007.
b. Includes Russia's original stock of debt against Iraq amounting to $12.9 billion.
c. Assumes debt reduction comparable to the 2004 Paris Club agreement for creditors with whom a debt agreement has been signed. For the remaining non-Paris Club creditors, such debt reduction is assumed to take place by end-2008.

Sources: Iraqi authorities; IMF staff estimates and projections.

$20 billion of Egypt's sovereign foreign debt of $48 billion was forgiven.

The first two stages of debt relief, each comprising a reduction of 15 percent of the net present value (NPV), were accomplished in July 1991 and October 1993, respectively; the third stage comprising a reduction of 20 percent was completed in 1996. In October 1990, regional creditors that were not members of the Paris Club, namely Kuwait, the United Arab Emirates, Qatar, and the Gulf Organization for the Development of Egypt forgave $2 billion, $255 million, $121 million, and $3 billion, respectively. This was followed in December 1991 by Saudi Arabia, which cancelled $1.1 billion, and the Arab African International Bank, which cancelled $279 million. In total the Gulf Arab States wrote off about $6.6 billion, none of which was being serviced.

In December 1990, the United States cancelled 100 percent of the bilateral military debt of $7.1 billion, relieving Egypt of annual repayments amounting to more than $700 million. Other creditor countries limited their participation to the terms agreed with the Paris Club. Together the US and Arab donors cancelled $13.7 billion of Egypt's external debt, resulting in an annual saving in debt service of about $1 billion for the following five years.

IRAQ, 2004

At the time of the 2003 invasion, Iraq's external debt was among the highest in the world. After an elaborate debt reconciliation process that was necessary because of the lack of documentation, the total external debt stock, including late interest, was estimated at $142 billion in mid-2004, or about 5½ times Iraq's GDP at the time (table 1).

Iraq is a middle-income country with substantial oil reserves, and therefore some observers argued that Iraq would be able to service its existing debts once its petroleum industry was functioning again. This suggested that Iraq was a good candidate for "debt flow" treatment, involving rescheduling its official debts until it had the capacity to repay instead of cancelling them completely as is done for the poorest countries, which lack any natural resources that can be used to generate external revenues. On the other hand, others asserted that if Iraq's future oil revenues were used to fund repayment of old debts, not enough would remain to fund its current and future economic needs.

Discussion of cancelling Iraq's debt began soon after the ouster of the Saddam Hussein regime. Led by the George W. Bush administration, a consensus was reached that Iraq would receive debt relief on terms that were unique in light of its economic resources but not unprecedented given the political situation. Debt relief has been provided bilaterally to countries for political and economic reasons. The United States, for example, has provided special bilateral debt relief to Egypt, Pakistan, Jordan, and Poland, and several other countries.

In mid-2004, most of Iraq's external debt (some 85 percent) was in the hands of official creditors. An additional 14½ percent was held by private creditors, including foreign commercial banks, while multilateral obligations merely accounted for ½ percent of the total debt stock. Kuwait had an additional claim against Iraq of $28 billion (as of 2008). This remained from an original claim of $52.4 billion, which was awarded by the

Box 2 Paris Club agreement with Iraq

Iraq signed the Paris Club debt reduction agreement on November 21, 2004. The details of the three-stage debt reduction process are as follows.

The first phase comprised:

- immediate cancellation of 30 percent debt stock (as of January 1, 2005);
- 100 percent deferral of remaining maturities until the approval of an IMF program no later than December 31, 2005; and
- 100 percent capitalization of moratorium interests.

The second phase came into effect when the Executive Board of the IMF approved the first Stand-By Arrangement on December 7, 2005. This phase comprised:

- 30 percent debt stock cancellation;
- rescheduling of the remaining debt under Naples terms (23 years repayment period with a 6-year grace period and progressive payments); and
- 100 percent capitalization of moratorium interests until the third phase of the rescheduling, no later than December 31, 2008.

The third and last phase materialized upon the completion of the final review under the current Stand-By Arrangement by December 2008. The details of the final phase were:

- 20 percent debt stock cancellation;
- rescheduling of the remaining debt under Naples terms; and
- 90 percent deferral of moratorium interest in 2008, 73 percent in 2009, and 47 percent in 2010.

Source: Paris Club, www.clubdeparis.org/en.

United Nations Security Council in 1991 in compensation for losses resulting from Iraq's invasion and occupation of Kuwait in 1990–91. Since May 2003, this debt has been serviced by a transfer to Kuwait of 5 percent of the export proceeds of Iraqi crude oil.

The debt relief granted by Paris Club creditors on November 21, 2004 was the largest in the club's history and a milestone in Iraq's postwar reconstruction efforts. The core of the agreement was to reduce the stock of debt owed to Paris Club creditors by 80 percent in NPV terms in three stages (box 2). Under the first stage, Iraq was granted immediate relief of 30 percent of debt reduction (in NPV terms), and interest deferral on the outstanding debt stock to ease the liquidity problem. This first phase was intended to reduce late interest accrued between 1990 and 2003, which the Paris Club estimated at about 36 percent of the original debt stock. The second stage, also comprising 30 percent of debt reduction in NPV terms, was granted upon the approval of a Stand-By Arrangement with the IMF on December 7, 2005. The third stage comprised an additional 20 percent debt reduction in NPV terms and was granted upon completion of the final review of the Stand-By Arrangement by the Executive Board of the IMF in 2008. Although large in absolute terms, Iraq's Paris Club debt relief was comparable as a percentage of GDP to the multilateral debt relief agreed for some other countries, such as Egypt and the former Yugoslavia. By 2008, all 18 Paris Club creditors had signed a bilateral debt agreement with Iraq, bringing the total tally of Paris Club debt relief, after the first two stages of the restructuring, to $30.5 billion ($25.8 billion excluding capitalized interest).

Iraq also made progress in restructuring its debt with non–Paris Club creditors. To encourage the conclusion of bilateral agreements with non–Paris Club creditors, Iraq established a Special Purpose Vehicle in March 2007. This initiative was launched to provide single securitization of structured debt to official creditors, in order to avoid a multiplicity of different securitization processes. The Special Purpose Vehicle issued US dollar-denominated notes in exchange for rights under bilateral agreements between one or more sovereign creditors of Iraq.

The substantial debt reduction received from Paris Club and non–Paris Club official creditors as well as from private creditors reduced Iraq's external debt significantly (see table 1). After the full Paris Club debt relief, and assuming that debt reduction comparable to the Paris Club agreement applied to all outstanding non–Paris Club claims, the latest estimates would put the stock of debt (excluding the implied obligation to Kuwait) at some $41 billion (about 33 percent of GDP) as of end-2010. In sum, the effort of the international community succeeded in significantly improving Iraq's external debt sustainability.

ARGENTINA, 2005

In the 1990s, following its stabilization program (the "Convertibility Plan"), which involved a rigid peg to the dollar and a number of free-market reforms, Argentina became able to borrow large sums from the international capital market. In fact, at one stage because of the size of its outstanding debts it constituted some 25 percent of the Emerging Markets Bond Index (EMBI).[5] But the rigid peg to the dollar posed a major danger for an economy that had relatively weak real links with the United States, and it was not reinforced by a large fiscal surplus as many judged to be necessary. When Brazil devalued the real in 1999 and the value of the dollar escalated in the late 1990s, Argentine prosperity evaporated. Output hit a local peak in 1998 and decreased thereafter, and by 2001 it had fallen over 8 percent. Despite taking on two IMF loans (in December 2000 and August 2001), tightening fiscal policy (though still missing targets), and reinstating the legendary Domingo Cavallo as finance minister, there were bank runs of increasing severity in 2001, major losses of international reserves, and higher interest rates, all against a background of falling output.

By late November 2001 the run on Argentine banks escalated and the government announced their closure. It said that when they reopened, the right to withdraw money from them would be limited to $250 per week. With unemployment of nearly 20 percent as a result of three years of recession and the prospect of limited access to bank deposits, riots broke out. They were forcibly suppressed, but Minister Cavallo and the president both resigned. There were three interim presidents in 10 days, one of whom suspended debt service payments to external creditors. When Eduardo Duhalde finally took office 10 days later, he immediately confirmed this default and ended the rigid link to the dollar. In addition he announced that bank loans would be converted to pesos at a 20 percent discount while bank deposits were converted 1:1, imposing severe capital losses on the banking system though nominally compensating these by the issuance of BODENs (special government bonds). A month later Argentina adopted a unified floating exchange rate.

President Duhalde promised future negotiations with external creditors when he confirmed the suspension of debt service payments. In fact the negotiations with foreign bondholders were extremely limited, not even starting until 2003. The creditors rejected the first two offers made in 2003–04 (which would have involved a writedown of about 75 percent), though the second offer was markedly more favorable than the first in allowing something for past due interest. They were then essentially confronted with a take-it-or-leave-it offer in 2005.

This envisaged that 152 varieties of bonds with a nominal value of $81.2 billion (excluding past due interest) previously issued by Argentina, including the 47 percent held by Argentines, would be replaced by three new bond issues with a present value of 30 percent of the replaced bonds (allowing nothing for the past due interest), plus growth-linked warrants. These bonds promised to pay 5 percent of the resulting higher level of GDP for every 1 percent that the Argentine growth rate exceeded 3 percent (provided the level of GDP exceeded a stated sum, which it has). Bondholders were so skeptical of the GDP-linked warrants (presumably because they were accustomed to fixed interest rates) that they initially valued them at near-zero and sold them for a song to investment banks and hedge funds, which have subsequently made a mint since Argentine growth has in fact been strong. The new bonds are dollar-denominated, as had been part of the replaced bonds, with the other major currency being the euro. Despite the initial skepticism over the growth warrants, some 76 percent of the creditors voted in favor of accepting this offer.

Debt to international organizations was repaid in full after 2005 when Argentina was relatively prosperous. The remaining sovereign debt acknowledged by Argentina consisted of loans that the Argentine government assumed in exchange for sovereign debt when it was striving to avert collapse in 2001, loans of the provincial governments assumed by the federal government subsequent to the collapse, and BODENs.[6] All these are expressed in Argentine pesos.

The restructuring left two components of Argentina's sovereign debt in dispute. There were the 24 percent of the bondholders, who owned $19.4 billion, and comprised in part some of the original owners and in part vulture funds that had bought Argentine sovereign debt cheap in the hopes of ultimately profiting through a more generous rescheduling. Argentina renounced this portion of its debt, but the owners never gave up hope that it would ultimately be settled, and Argentina subsequently announced (in 2010) that it was reopening the offer on the previous terms. As of now, 92.6 percent of the originally outstanding debt has been restructured. Second, there was $4.8 billion of bilateral debt (the original sum, now augmented by interest) owed to the Paris Club creditors. Argentina has since

5. Most of the Argentine debt was to international private lenders.

6. BODENs are bonds issued by the Argentine government to banks to compensate them for the asymmetrical pesification imposed at the time of Argentina's crisis in 2001–02.

Table 2 Nigeria: Total public debt, 2005–09 (billions of US dollars)

Debt	2005	2006	2007	2008	2009
External debt stock	20.5	3.5	3.7	3.7	3.9
Domestic debt stock	11.8	13.8	18.6	17.7	21.9
Total	32.3	17.3	22.3	21.4	25.8
External debt service	8.9	6.7	1.0	0.46	0.43
Domestic debt service	1.2	1.3	2.2	3.6	1.9
Total	10.1	8.0	3.2	4.1	2.3

Source: Nigeria Debt Management Office, www.dmo.gov.ng.

2008 expressed the desire to repay this sum. The rules of the Paris Club say that a debtor either has to have an IMF program (which Argentina neither needs nor desires) or repays arrears in full and immediately. It therefore presumably has no option but to plan full repayment. In any event, it is doubtful whether the Paris Club would be prepared to grant debt relief to a middle-income country like Argentina without a compelling reason. To date the Paris Club and Argentina have not agreed on the exact sum involved and Argentina is still maintaining that the Paris Club's insistence on a bullet repayment is unacceptable.

Argentina's actions were not taken well by its creditors. This was partly because of the style of negotiation, which was essentially the tabling of take-it-or-leave-it offers, partly because of the extremely unfavorable terms on which Argentina insisted, partly because evidence suggested that it commanded the resources to make a substantially better offer, and partly because the creditors attached minimal value to the warrants attached to the bonds. No attempt at compromise was made by either party. The value of the Argentine restructuring is in learning the actions to be avoided.

NIGERIA

The Nigerian external debt, which has been estimated at about \$20.5 billion in 2005, was the product of foreign borrowing in the 1980s and 1990s, coupled with failure of the succeeding military governments to service debt and the consequential accumulation of arrears and penalties. The stock of total Nigerian debt during 2005–09 is contained in table 2 and its composition is indicated in figure 1.

In 1998 the military president died, and the interim president almost immediately asked for debt relief. However, the Paris Club required an agreement with the IMF, which was not feasible for an unelected interim president. Elections followed early in 1999, when Olusegun Obasanjo was elected the new democratic president. The initial obstacles to a Paris Club deal were the lack of an IMF agreement and a realistic reform program, but it soon transpired that the biggest obstacle was that Nigeria was at that time classified by the World Bank as a "blend" country rather than an IDA-only country.[7] This meant that it qualified neither for the HIPC Initiative nor for debt relief by the Paris Club (to whose governments most of the debt was owed, see figure 1). In 2003 the president appointed Ngozi Okonjo-Iweala as finance minister, presumably motivated in part by hopes that her former ties to the World Bank would be helpful in securing a change in this classification. Whether her appointment was critical or not, it is certainly true that during her tenure Nigeria was reclassified.[8] It deserved such reclassification on the grounds of per capita income, which was then below the critical threshold despite the oil revenues that had at one time placed it securely in the category of "blend" countries and given it relatively high borrowing ability.

In 2005 the increase in oil receipts gave Nigeria adequate reserves to strike a deal with the Paris Club, once the reclassification took effect. The deal was on near-Naples terms, i.e., forgiveness of close to two-thirds of the debt in exchange for a one-time cash payment of the remainder.[9] Overall, Nigerian debt was reduced by about \$29 billion, consisting of \$17 billion debt relief and a \$12 billion bullet repayment.

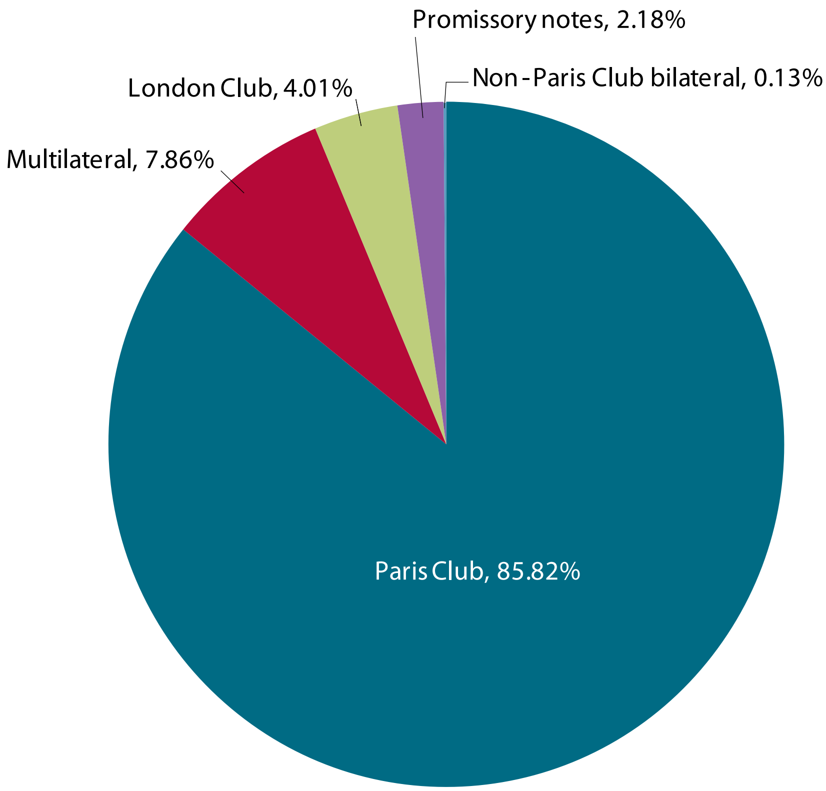
Nigeria had little private debt. The big problem in winning international agreement for a reduction in its debt to other sovereign holders was gaining recognition that it had regressed to low-income country status in terms of the crucial variable of per capita income in the previous 30 years. Once Nigeria had won this recognition, there was no great difficulty in its

7. "Blend" countries are those with intermediate per capita incomes, which are thereby judged to be capable of servicing a certain amount of debt on normal World Bank terms while qualifying to receive a certain amount of International Development Association (IDA) debt on highly concessional terms.

8. The reclassification occurred in 2005 following a study by the Center for Global Development, which laid out the facts.

9. Naples terms' reduction of two-thirds applied to the outstanding debt stock, while the past due interest was settled in full.

Figure 1 Nigeria's external debt, by creditor, 2004



Source: Nigeria Debt Management Office, www.dmo.gov.ng.

obtaining Paris Club debt relief, which is now accepted as normal for countries in Nigeria's position.[10]

ISRAEL LOAN GUARANTEE PROGRAM

President Barack Obama in his speech of May 19, 2011, offered Egypt $1 billion in loan guarantees. Such guarantees, which have been provided by the United States to Israel since 2003, can be an alternative to debt relief, allowing the country to borrow in international capital markets on more favorable terms. At the height of the 2002 recession, the Israeli government approached the US administration and asked for loan guarantees that would enable Israel to raise capital internationally. Gross external debt of the public sector at that time was $27.1 billion. In exchange for these guarantees, Israel was asked to pay a risk premium in advance. The guarantees were approved in April 2003 for borrowing through 2005 for $9 billion. In 2007 the program was extended until 2011. The notes issued by Israel under US government guarantees enjoy a credit rating similar to US government bonds. The maximum of $9 billion in US loan guarantees is directed towards increasing growth and easing the public debt burden, not increasing the budget deficit, according to the detailed loan agreement between Israel and the United States, signed on August 20, 2003. In 2003 Israel issued a total of $2.35 billion, out of which $450 million were for 30 years and $1.9 billion were for 20 years. In 2004 Israel issued a total of $1.75 billion for 20 years.

Fourteen of the largest investment banks in the world were invited to carry out these issuances through a competitive bid. Under this system, each bank placed a bid for underwriting all the bonds. The bank with the best proposal in terms of lowest yield-per-issue won the auction and purchased the whole amount of bonds offered. The auction was carried out via electronic submission through a designated website built by the Ministry of Finance that was open for the participants for 15 minutes until the auction closure. After approval by the US

10. It is worth noting (1) that Nigeria has still not been labeled as a HIPC and (2) that it had little debt outstanding to the private sector.

Agency for International Development, the results were delivered to the banks directly following the auction.

At the end of 2009, government foreign-currency debt stood at $29 billion, which comprised 19 percent of total government debt. The foreign-currency debt contains a large share (45 percent) of US government-guaranteed bonds, 28 percent of bonds issued by the Israel Bonds Organization, a growing amount (now some 20 percent) of sovereign unguaranteed bonds, and other loans. The government of Israel obtains more favorable terms on US government-guaranteed loans relative to other foreign-currency funding channels.

At the end of December 2009, the share of US dollar-denominated debt in Israeli government's foreign currency debt was 91 percent. This high share is attributable to the US government-guaranteed debt and US investors' dominance in the purchase of Israeli government bonds.

DID DEBT REDUCTION SUCCEED?

In terms of reducing debt service payments, debt reduction was certainly successful. In each case debt service payments after the debt relief were substantially less than before. The agreement of 1991 enabled Egypt to reduce its external debt by $20 billion. The case of Iraq was more dramatic with external debt reduced from $142 billion in 2004 to $32 billion by 2008. The 2005 agreement (plus the supplementary agreement of 2010) enabled Argentina to reduce its external debt from $86 billion (plus that owed to the IMF, subsequently repaid in full) to $29.7 billion. Nigeria's external debt was reduced from $21 billion in 2005 to $3.5 billion in 2006 (at the cost of a bullet repayment of $12 billion). While the US loan guarantee program with Israel did not lead to a reduction in total external debt, the government of Israel was able to obtain very favorable terms of its international borrowings as a result of this.

But this is not the only criterion of success. One might want to achieve debt reduction in order to free up the balance sheet to borrow more, and in that case one would need to weigh the effect of the stronger balance sheet against the possible reluctance to lend to a country that had exhibited that it did not include the duty of paying its debts amongst its highest priorities. Or one might want to examine the effect of a lower debt level on still more fundamental variables, like the growth rate. We shall not attempt the latter sort of enquiry, but it is possible to form a judgment of whether debt relief frees up borrowing capacity by examining the historical record. In fact, in all the cases of debt relief examined here the countries did not add significantly to their debts following debt relief.

THE CURRENT SITUATION IN EGYPT

Egypt faces severe financing problems following its democratic revolution. In place of the previously expected current account surplus of $2.7 billion, the present IMF projection is for a current account deficit of $6 billion in 2011, the deterioration being explained primarily by lost tourist earnings, and an $11 billion overall financing gap. Egypt is already the largest debtor country in the Middle East and North Africa, and the government has unveiled a $38 billion development plan. Both meeting the immediate financing requirement and fulfilling the development plan will require heavy borrowing.

Egypt's total external debt (public and private) was $34.5 billion (14.7 percent of GDP) at end-December 2010 (table 3). It should be noted that there is also an extensive internal public debt comprising 57 percent of GDP (gross), though most of this is held by state-owned banks. Over 90 percent of the external debt ($32.8 billion) is owed by the public sector, while the private sector accounts for $2.2 billion (6.4 percent of total external debt stock). The bulk of external debt has long-term maturities ($31.4 billion, or 89.7 percent of external debt). Medium-term debt amounts to $439.6 million (1.3 percent of total external debt), short-term debt to $3.1 billion (9.0 percent), and nonguaranteed medium- and long-term debt to $57.4 million (0.2 percent).

In 2010, medium- and long-term debt service payments amounted to $2.3 billion. The ratio of external debt to GDP declined to 14.7 percent at end-December 2010, compared with 15.1 percent a year earlier. External debt service on medium- and long-term publicly guaranteed loans is expected to amount to $2.9 billion in 2011, representing about 6 percent of exports of goods and services and transfers. About two-thirds of the debt is denominated in US dollars and euros (figure 2, page 10). Almost half of Egypt's external debt is owed to four countries: Japan, France, Germany, and the United States, with the government (central and local) being the primary debtor with $26.8 billion outstanding (figure 3, page 11). The bulk of the debt (77 percent) is that of central and local governments (figure 4, page 11).

In his speech on May 19, 2011, President Obama offered $1 billion in debt forgiveness and another $1 billion in loan guarantees supposedly similar to the loan guarantees offered by the United States to Israel. The debt forgiveness component may be a first step towards cancelling Egypt's $3.6 billion debt owed to the United States. The United States has also encouraged other G-8 countries to authorize a debt swap, which involves converting debt into investments to foster entrepreneurship. Although a formal Paris Club debt process has not been scheduled yet, Egypt already sought debt relief at end-February 2011

Table 3 Egypt's external debt profile, 2010 (billions of US dollars)

Debt	Stock	In percent
Total external debt	34.5	14.7
A. Public sector	32.3	93.6
B. Private sector	2.2	6.4
Maturities (end-September 2010)		
A. Long-term debt	31.4	89.7
B. Medium-term debt	0.4	1.3
C. Short-term debt	3.1	9
D. Nonguaranteed medium and long term	0.6	0.2
i. Bilateral loans (rescheduled and nonrescheduled) to		
Paris Club members	17.2	49.2
Non-Paris Club members	0.9	2.6
ii. International and regional organizations	10.5	30.1
iii. Egyptian bonds and notes	3.1	8.8
Sovereign bonds (due 7/2011)	0.2	
Guaranteed notes (due 9/2015)	1.3	
EG pounds eurobonds (due 7/2012)	0.4	
Sovereign notes (due 4/2020)	1.2	
Private-sector debt (nonguaranteed)	0.5	

Source: Central Bank of Egypt, www.cbe.org.eg.

(at least on interest payments) from the European Union on its outstanding $9 billion debt to EU member states. It would seem clear that a multilateral debt reconstruction through the Paris Club is to be preferred to a series of individual agreements like that which the United States has offered, not only because it will cover more of the debt than a series of individual agreements would be likely to but also because of its greater administrative simplicity. But if the other countries are unwilling, then negotiations with a series of creditor countries would be required.

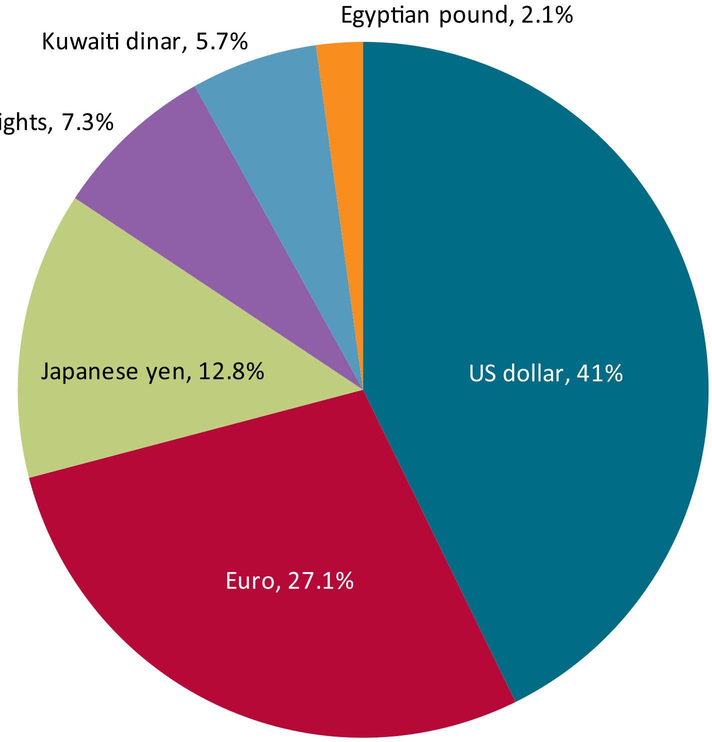
Egypt has already received substantial pledges of financial assistance to assist its transition to a democracy (see box 3, page 12). There are other more tenuous offers of financial support, but these (with the possible exception of Qatar) appear to be the relatively dependable ones. Since they sum to more than $11 billion, Egypt appears to have enough financing available in the short run. However, experience with other debtor countries would suggest that only a proportion of these pledges will be fulfilled in the short run. Presumably tourist revenues will recover so that future needs (even including the need to finance the development plan) will be smaller than this year's $11 billion gap. Note that the two components of the US offer ($1 billion loan guarantees plus $1 billion debt relief) have very different abilities to effect a short-run transfer to Egypt: The loan will increase the transfer directly, while the debt relief will lower requirements in future years (or increase the ability of Egypt to borrow).

The problem is more the ratio of debt to GDP, which is 74 percent in total and 15 percent external, than the short-run ability to secure a transfer. The key question is whether in light of this it is desirable for the financing for Egypt to include debt relief. Debt relief would presumably be limited to what Egypt spends in servicing medium- and long-term debt, since short-term debt is not rescheduled by tradition. This means that the maximum sum available on a flow basis would be some portion of the $2.9 billion spent on servicing debt in the recent past.

Past debt relief has never exceeded 80 percent,[11] and there has never been debt relief from multinational organizations for a middle-income country like Egypt. Hence the maximum that could be looked to on a continuing basis from this source is slightly over $1.5 billion per annum (21.2/31.4 x 2.9 x 0.8), assuming that the Paris Club made an offer that matched its previous best and that all other creditors except international organizations were persuaded to make similar offers. Of course, if international organizations follow suit then savings on debt servicing would be correspondingly larger.

11. Currently the United States has offered about 30 percent debt relief.

Figure 2 Egypt's external debt, by currency, 2010



Source: Central Bank of Egypt, www.cbe.org.eg.

Debt relief could of course yield more in the short run if it enabled increased borrowing. The purpose of debt relief would then be to maintain the capacity to borrow rather than reducing debt service payments, though as previously noted this assumes that lenders are more interested in seeing a moderate debt service ratio than they are deterred by a debtor who is unable to pay its debts. The sort of official bodies that have pledged additional assistance to Egypt are exactly the type that are impressed by debt/GDP ratios rather than the prospect of being repaid, suggesting that debt relief could be a highly helpful form of transfer.

An issue that will surely be considered by at least some members of the Paris Club in weighing a request for debt relief is the likelihood of setting a precedent. The factor that has led to Egypt being considered a candidate for debt relief is the success of its democracy movement in taking the reins of power. By giving debt relief to Egypt the Paris Club will be setting a precedent: It will commit the Paris Club to providing debt relief for every country that can claim it has undergone a democratic transition. Since the Paris Club consists of a group of democracies, it is conceivable that they will decide that this is a good cause, but one should be under no illusion that the act of setting a precedent will not be considered relevant by some.

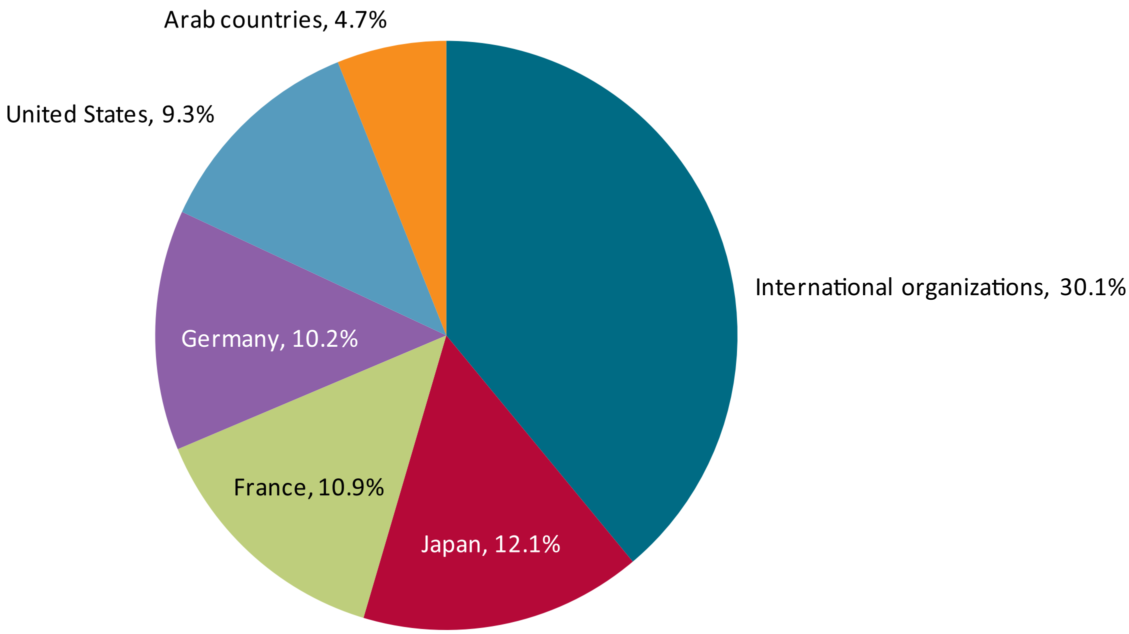
Without a measure of debt relief in the package, debt would likely increase to explosive levels given the expected financing needs of Egypt over the next few years. Therefore, some measure of debt relief is needed to diminish this danger.

POSSIBLE US APPROACHES

The US policy on debt relief for Egypt was outlined in President Obama's speech of May 19, 2011. In that speech, the president stated that the United States did "not want a democratic Egypt to be saddled by the debts of its past." Therefore, the United States would provide $1 billion in debt forgiveness and a further $1 billion in loan guarantees that would allow Egypt to tap international financial markets. President Obama also urged other countries to assist Egypt in meeting its financial needs.

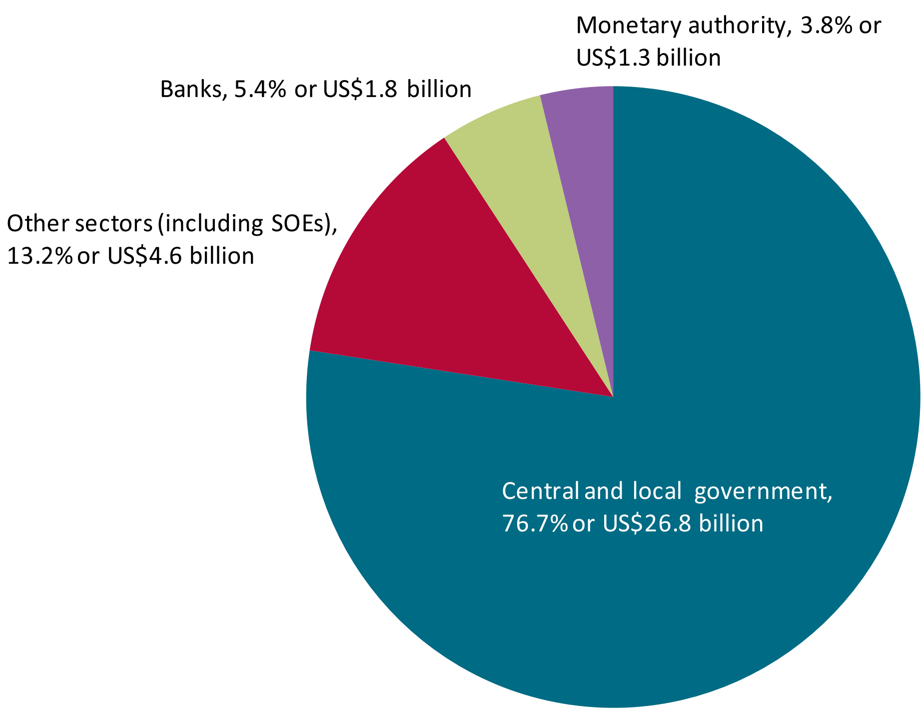
There are three fundamental determinants of US policy. The first is that many other countries are anxious to help Egypt's democratic revolution (box 3, page 12). The second is that the country is currently facing a large financing gap, estimated at $11 billion in 2011 and also a large one in 2012. The third is that Egypt has expressed a preference for receiving part of this financing in the form of debt relief.

Figure 3 Egypt's external debt, by creditor, 2010



Source: Central Bank of Egypt, www.cbe.org.eg.

Figure 4 Egypt's external debt, by debtor, 2010



Source: Central Bank of Egypt, www.cbe.org.eg.

Box 3 Pledges to Egypt, 2011

Donor	Pledge
International Monetary Fund	$3 billion
World Bank	$4.5 billion over two years
Saudi Arabia	$4 billion (including $1 billion deposit at the Central Bank of Egypt)
Qatar	$10 billion
United States	$2 billion (in $1 billion guarantee plus $1 billion debt relief)
African Development Bank	$1 billion
European Bank for Reconstruction and Development	$140 million to $280 million
United Kingdom	£120 million (about $175 million) over four years

The traditional approach to debt relief would be through a Paris Club debt rescheduling. The United States could call for the Paris Club to meet to consider Egyptian debt, use its influence to persuade the Egyptians to request a meeting, and then call on its partners to make offers similar to those that President Obama already made in his speech. An advantage of this approach is that it would involve a commitment of all the major countries to contribute proportionately to their outstanding debts and that normal Paris Club procedures would involve similar concessions on the part of all other creditors. This would imply Egypt obtaining stock debt relief of over $10 billion and the prospective flow relief of $1.5 billion. A major potential obstacle is that the procedures of the Paris Club require the debtor country to have an IMF agreement. Agreement was in fact reached on June 5, 2011, between the government of Egypt and IMF staff on a 1-year Stand-By Arrangement amounting to $3 billion. However, a few weeks later on June 24 Egypt decided not to proceed with the arrangement because of domestic political opposition.[12] Therefore, the new government that takes office after the elections will have to decide if it wishes to pursue the Paris Club option, and if so, it will need to reach an agreement with the IMF. A second possible problem is that Egypt is not a debt-distressed country, since both its external debt to exports ratio (under 130 percent) and its external debt to GDP ratio (about 17 percent) are moderate by international standards. This might well lead some countries to object to the Paris Club approach.

An alternative, and perhaps more promising, approach might be for the United States to use its convening power in order to persuade other countries ("Friends of Egypt") to make debt relief arrangements similar to those that the United States has already offered to Egypt. Under this approach, the major creditor countries could be asked to match the offers made by the United States. Since the United States presently holds about 10 percent of the outstanding stock of external Egyptian debt, similar offers on the part of all of the other countries would be capable of yielding debt stock relief of over $10 billion. Egypt would then be able to translate some of this into additional borrowing in order to meet its liquidity needs, if it so wished. Since the United States expected to gain domestic-currency deposits for the foreign exchange–denominated debt, other creditors could likewise make debt swaps in exchange for equity, the environment, education, or any other area they prefer.

Complementary to the process of using the "Friends of Egypt" to make debt relief arrangements, the United States could also urge other major creditors to provide loan guarantees similar to those that it itself has offered. To the extent that loan guarantees were issued, it would enable Egypt to borrow at cheaper interest rates than it can itself enter the international market for and would therefore permit it to choose between the liquidity benefits of additional borrowing and the stock benefits of a lower accumulation of debt.

12. The government also decided not to go ahead with the World Bank loans on the same grounds.