

THE WORLD BANK GROUP ARCHIVES

PUBLIC DISCLOSURE AUTHORIZED

Folder Title: Wignaraja, P. - Articles and Speeches (1964) - 1v

Folder ID: 1654930

Fonds: Records of Office of External Affairs (WB IBRD/IDA EXT)

Digitized: February 28, 2014

To cite materials from this archival folder, please follow the following format:
[Descriptive name of item], [Folder Title], Folder ID [Folder ID], World Bank Group Archives, Washington, D.C., United States.

The records in this folder were created or received by The World Bank in the course of its business.

The records that were created by the staff of The World Bank are subject to the Bank's copyright.

Please refer to <http://www.worldbank.org/terms-of-use-earchives> for full copyright terms of use and disclaimers.



THE WORLD BANK
Washington, D.C.

© 2012 International Bank for Reconstruction and Development / International Development Association or
The World Bank
1818 H Street NW
Washington DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org

PUBLIC DISCLOSURE AUTHORIZED

Wignaraja, P. - Articles and speeches (1964)



The World Bank Group
Archives
1654930
A1992-007 Other #: 19 212064B
Wignaraja, P. - Articles and Speeches (1964) - 1v

DECLASSIFIED
WBG Archives

(Copy sent to Paris)

Outline of a Talk to a Group of Visiting Carnegie
Fellows on Bank/IDA Creditworthiness

1. Mr. Noone in his earlier remarks has given you an idea of the Bank as both a development agency and a lending institution and also explained the functions of IDA. The original resources of the Bank consisted of the paid in portion of the countries subscriptions. Subsequently the Bank has relied increasingly on borrowing in the money markets of the world, the funds it relends. For this reason, while promoting economic development, right from the outset the Management of the Bank had as a prime preoccupation to build the Bank's own credit standing in the eyes of the world's money markets as well as promote high standards of morality in public capital dealings in the international community in general and thereby create an atmosphere favourable to international capital movements. IDA funds come mainly from member subscriptions and the problems associated with lending these funds are somewhat different though from the point of view of creditworthiness we make the initial judgement in terms of the Bank group as a whole. After we have decided that a particular country is one in which the Bank can do business we go on to appraising whether it should be given a Bank loan or IDA credit and how much.
2. An essential part in this process has been the avoidance of the possibility of default by any of countries to which the Bank or IDA has lent. Thus an appraisal of the borrowing country's creditworthiness is the necessary prerequisite to any loan operation. In other words we must have a judgement on a country's ability to assume more external debt, without risk of default in order to decide how much can be lent to the applicant, whether the applicant is the government itself or anyone else guaranteed by the government. The care with which the appraisal is made becomes important when we realize that the Bank operates for most part in the so-called grey area i.e. assists countries which do not have direct access to the financial markets.

3. There is no simple formula which will give a complete answer to the question of a country's creditworthiness. We have to go through a similar process to that appraising an individual or a firm's creditworthiness but the process is more complex. Ultimately the appraisal of creditworthiness has to be a mixture of facts and judgements. We have no theory of a country's capacity to service external debt and even if there was a theory, there would still be the problem of the likely behavior of all the major variables and their time path as well as the uncertainties arising from the current economic and financial policies which decision makers in borrowing countries choose to adopt.

4. However difficult, the job still has to be done, and the Bank tries to do this mainly by having an understanding of and maintaining continuous contact with the countries with which it is doing business. There is first, a regular flow of information from the country. It is a major part of the work of the Statistics Division of the Bank to keep track of the external debt obligations of our debtor countries. It is also the responsibility of the economists and operations officers to keep fully informed and up to date on countries which come within their sphere. There are economic missions to countries and creditworthiness reports are prepared on the basis of these missions. A creditworthiness report must precede the granting of a loan.

5. Broadly creditworthiness may be appraised in terms of three sets of considerations:

- (a) the political and psychological risks;
- (b) the relative burden of debt service to the country and the short run liquidity position; and
- (c) the long-term prospects for self sustaining growth and the outlook for a viable balance of payments.

6. A relatively favourable political outlook is basic to a country's ability to assume conventional debt i.e. carrying market rates of interest

and a definite amortization period.

- (a) Internal political instability whether arising from disagreement over forms of social and political organizations or power struggle between contending groups seriously reduce the probability that a country will be able to meet its financial obligations; they cannot maintain monetary and fiscal responsibility and manage the country's economic affairs properly. Political strife could also disrupt production, exports, etc. Thirdly, in the wake of political upheaval new rulers may choose to default or abrogate previous debt. Here quality of leadership, the continuity, the strength of the administration are also factors.
- (b) Apart from internal political consideration there are external factors such as effects of war or threat of war, political occupation or threat of foreign influence.
- (c) I would like to stress two points in this connection:
 - (i) Political considerations do not necessarily mean ideological considerations. The Bank has lent to socialist Yugoslavia, India, Mexico, Japan, Franco Spain and South Africa. What the Bank shuns in general is the politics that destroy or prevents growth.
 - (ii) The Bank goes further than any other lending agency in assuming political risk of the kind mentioned in (a) and (b).

7. Psychological risks are associated with the seriousness with which countries take their foreign debt obligations and the ability of the people to make sacrifices in times of stress and adapt to changing conditions. A country's attitude on these matters can be judged partly by her past debt record, partly by the treatment of foreign investors. A country which nationalises foreign property without compensation would be considered a poor risk. Of course we ask ourselves the questions why did default or non-compensation payment

occur, can a remedy be found, is the situation still negotiable etc.

8. Given the minimum required political stability and psychological stability the next factor which would need looking into is the current liquidity situation, particularly the size of the outstanding debt and burden of debt service already carried by the country. In evaluating this we use as a starting point in our thinking a conventional ratio called the debt service ratio. This reflects the relationship between the interest and amortization payments to be made by a country in any year and its foreign exchange earnings on current account. The thought underlying the use of this ratio is that a country's foreign exchange earnings have to be used for a variety of purposes and the debt service cannot as a rule absorb more than certain percent without becoming burdensome. As was said earlier the ratio is only a starting point in our thinking and its significance is subject to a number of qualifications and it is very necessary to keep these qualifications in mind in using the ratio for appraising a country's creditworthiness.

9. The qualifications:

(a) The ratio changes over time - creditworthiness also depends on Bank's amortization schedule. The Bank used to lend medium term and long term - now there is the new type Bank loan with longer grace periods.

(b) The burden which the ratio represents for a country will vary depending on several short run factors:

(i) exports - export stability - volume and price

- export diversification

- comparative advantage

- direction of trade, as the currency in which repayment is made is also a factor.

(ii) imports - rigidities

- propensity to import

(iii) capital flows and rolling of debt

- (iv) reserves
- (v) compensatory finance IMF and other cushions
- (vi) policies - trade, financial, monetary, investment.

If these factors are favourable a higher ratio may be justified and vice versa.

10. Supplementary to the debt service ratio the Bank makes common use of ratios relating debt service to the rate of domestic saving, volume of revenues of the public sector and the level of total or per capita G.N.P. These ratios can be analytically justified in varying degrees to give a more elaborate picture - but the statistical uncertainties are so great in most of the Bank's debtor countries that all these other ratios can only be very approximate in character. Ultimately repayment has to be made in foreign currency hence external situation and transfer problem ever pertinent.

11. The third set of considerations for appraising a country's creditworthiness is the long term outlook for self sustaining growth and a viable balance of payments.

Economic Factors

Self sustaining growth situation consists of a tolerable balance between domestic savings and the rate of investment required to maintain a reasonable rate of increase in per capita incomes. The long-term growth prospects are enhanced by a large natural resource base and sound plans. In looking at the long-term prospects we look of possible at the rate of return on capital, the plough back of savings into investment, the character and priority of investment and the level of investment and its impact on the long run payments prospect, etc

Sociological-Political factors

Equally we look at the strength, determination and orientation of the government leaders in carrying out the development effort. Eg Guinea. There is also the strength and weakness of the elite group such as the business community, labour force and trade unions etc Eg Mexico. Then we also look at the level of education technical skills in the country Eg Japan, Israel.

In looking to a viable balance of payments in the conventional sense, apart from longer term projections on elements already discussed earlier on the short-run liquidity situation, the Bank also looks to see whether a prospective balance of payments gap is reasonable in relation to capital assistance and also reasonable in relation to future foreign exchange earnings, public revenues and domestic savings.

12. It is becoming increasingly apparent that most underdeveloped countries by their very nature have a deficiency of domestic savings and would require capital imports to achieve a reasonable rate of growth in per capita income. Many countries have adopted development plans which reflect this. Some plans are clearly overambitious but in many cases either population pressure, high social overhead requirements etc. require these inflows. It is also clear that many countries cannot carry additional conventional debt.

13. Bank has a better understanding of development process and can make a better appraisal of creditworthiness. As Banks own credit standing went up and as economic assistance from industrialized countries became more firmly established, the Bank was able to expand its own activities with confidence and diversify its activities and methods to suit different situations. Eg. New Agricultural and Education assistance policy, IDA, new type Bank loans.

14. To an increasing extent the servicing of conventional debt incurred by less developed countries is indirectly financed by grants and other softer loan policies both by the Bank and industrial countries.

15. The institution of IDA itself reflects the Bank's support of the view that many poor countries need capital on terms which would not seriously increase the already heavy debt service burdens. The new type Bank loans have already been mentioned.

16. The institution of IDA has introduced an additional element into the creditworthiness analysis. We first decide whether a country is credit worthy for the whole Bank group. We make up our minds whether this is a country in which the Bank group can do business - then we decide what form and how much to lend.

17. Assistance can now be provided to countries on a greater variety of terms by combinations of Bank loans and IDA credits. We have countries that are Bank worthy, IDA worthy and blend countries. The latter can be further classified into hard blend and soft blend.

18. IDA funds are provided by Governments unlike Bank funds which come from capital markets governed primarily by financial and economic considerations. Thus some special considerations influence use of these funds:

- (a) Poverty cut off point - funds are to be used only for relatively poor countries - present cut off point approximately \$200 per capita income - through a few countries in the \$300 range have also been assisted - most assistance to countries below \$100 income.
- (b) Per capita maximum cut off point
- (c) Creditworthiness - passage of a lack of Bank creditworthiness test is essential for any extension of IDA credit i.e. the country has equally to be one which cannot carry additional debt on conventional terms. There would be cases where a country still has some unused capacity to carry debt on conventional terms but needs a greater inflow of capital than this amount. One way out is a blend loan. While the Bank would prefer a country which is Bank worthy to fully use its credit - still we are flexible in the final judgement. There is a special variant in the IDA worthiness judgement which is used. Because of their short history, lack of experience in servicing external debt there are good grounds for easing them gradually into carrying conventional debt by blending the debt. Sometimes even if a country can carry additional debt we give them an IDA credit.
- (d) Economic performance criterion has not been previously defined. On the one hand certain countries have been judged ineligible as they have been following unsound economic or financial policies.

In other cases a record of sound policies has resulted in credit being given. The general interpretation is also accepted that there should be some evidence that the borrowing government is making a real effort to mobilize its own resources and gear its policies to development. It has been left to Bank economic missions to judge this. There is no simultaneous assessment of relative performance - but the Staff Economic Committee which judges the issue tries to maintain a common standard. Judgements are not always based on statistical indicators alone and the view of missions on the institutional framework and other qualitative factors in countries are used to supplement the statistical data. We ask ourselves: Is the country doing as much as it can be expected? Despite its policies, is the country growing? Ultimately what is important is, are they growing or aren't they growing?

19. There is one other element in a creditworthiness analysis which deserves mention i.e. the evaluation of enclave projects where a foreign group exploits a mineral resource. Normally the project itself does not determine whether finance is to be given. But in the case of enclave projects - even if the country is otherwise uncreditworthy such a project could be the subject of a Bank loan. In such a case the creditworthiness of the country is reinforced by that of the foreign shareholders. The receipts of the project could also be in part earmarked to repay the Bank loan.

20. What I have tried to indicate to you briefly is that so many factors affect an appreciation of creditworthiness - political, psychological, economic and financial involving predictions of what will happen in the future and how people will react in hypothetical circumstances - that ultimately much of the final appreciation is bound to be one of judgement. What is important is to keep in mind what judgements of creditworthiness are supposed to do.

In brief these judgements will permit the Bank to perform its lending function in a manner that protects the credit standing of the Bank, helps to create an

atmosphere favourable to international lending and at the same time promote the development of poor countries.

21. Because of the element of judgement involved complete risk of lending cannot be eliminated. The loan agreements, the technical appraisals, the survey missions help to reduce the risk. A forecast of creditworthiness can only be made for a reasonably safe period and must be revised constantly. We never set a ceiling limit to external debt, we generally estimate what additional debt a country can bear at any given time and frequently revise our estimates. This is why credit worthiness is not expressed in one fixed figure.

22. Many times the conclusions arrived at by the Bank can be challenged. However, the experience is that there has not yet been a single default despite nearly eighteen years of operations. If it is said that this is the result of overcaution by the Bank the only answer is that the Bank's policies are continuously changing, and it is improving understanding of development problems. The criteria for lending are being broadened and its activities are expanding.

23. In looking at this whole question from the Bank's point of view, the borrowing country's point of view has not been ignored. If our judgement is correct it must be identical with that of the borrower. The interest of the borrower is just as much at stake as the security of the credit the Bank group grants. Instead of looking at the question in terms of the criteria for credit worthiness we could also have looked at it in terms of the country's capacity to service external debt. The Bank mainly lends to countrys which cannot borrow in the financial markets on its own credit. Thus it is in the interest of the borrower to establish his credit step by step and in such a manner that the borrowing country will be strengthened rather than weakened. Thus a default never did anyone any good.

P. Wignaraja:se
June 15, 1964