

Bangladesh
Suppliers' Credit as External Finance
Challenges for Fiscal and External Debt
Management

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This report was prepared by a team led by Zaidi Sattar and comprising Zahid Hussain, Syed Nizamuddin, Bhaskar Naidu, and Cashfya Cazi (SASPR); Malvina Pollock and Golam Azarbayejani (DECPRG); Malcolm Stephens and Abdul Bayes (consultants). The work was carried out under the general direction of Roberto Zaghera and Fred Temple. Throughout the preparation of this report Sadiq Ahmed, Shekhar Shah and Kapil Kapoor provided strategic guidance and advice. Valuable contributions came from John Williamson and Arvind Gupta. Comments, suggestions and valuable inputs from the following are gratefully acknowledged: Mohsin Alikhan, Shamsuddin Ahmad, Khurshid Alam, Marc Heitner, Subramaniam Iyer, Reazul Islam, M. Iqbal, Naoko Kojo, Ahmad Jamshidi, Ron Hicks, M. H. Ansari, Wajid Shah, and Tanjina Rahman. The report was processed by Mehar Akhter Khan. Md. Faijul Islam did the cover design. The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors and do not necessarily represent the views of the World Bank, its Executive Directors, or the countries they represent.

Abbreviations

ADB	Asian Development Bank
BPDB	Bangladesh Power Development Board
BTTB	Bangladesh Telegraph and Telephone Board
CAD	Current Account Deficit
CMEC	China National Machinery and Equipment Import and Export Corporation
COFACE	French Export Credit Agency
DFID	Department for International Development
ECA	Export Credit Agencies
ECGD	Export Credit Guarantee Department, U.K.
EDC	Export Development Corporation
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GFS	Goods and Factor Services
GOB	Government of Bangladesh
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFI	International Financial Institutions
IMF	International Monetary Fund
IPP	Independent Power Producers
MFA	Multi-Fiber Arrangement
NCB	Nationalized Commercial Bank
OCR	Ordinary Capital Resource
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation and Development
PICC	People's Insurance Company of China
SOE	State-Owned Enterprise
XGS	Exports of Goods and Services

Foreword

Bangladesh has managed its external debt liabilities prudently, thanks mainly to the predominance of concessional debt in its external obligations. Its low debt service ratio places it in the group of moderately-indebted low-income countries, according to the World Bank's criteria. This scenario could change rapidly in the future if current trends in the use of suppliers' credit by several government agencies continue. Suppliers' credit is a quasi-commercial loan, which implies a significant hardening of credit terms for a country like Bangladesh that has traditionally relied on concessional debt. Provided the projects financed by such credit are viable and the credit terms are competitive, this need not be a problem. But this report indicates that this is not always the case.

While this study was being prepared, there were indications of many proposals under consideration by different ministries and parastatals. Although this might be a reaction to the slowdown of concessional aid – a situation arising primarily from the slow pace of sector reforms -- it is nevertheless important to highlight the potential dangers of moving away from the traditional reliance on concessional debt into the area of non-concessional external finance. This is what the report does. It argues that Bangladesh could still mobilize substantial concessional external finance – probably through the end of the current decade -- if needed sector reforms were put in place. And it warns that the easy option of increasing reliance on suppliers' credit could potentially lead to an unsustainable fiscal and external debt situation.

The need for the study emerged out of the many discussions between the Ministry of Finance and representatives of IMF and the World Bank in the area of fiscal and debt management. A draft of the final report and its key findings were discussed with the Minister of Finance and key officials of the relevant ministries.

Frederick T. Temple
Country Director
World Bank Dhaka Office
Bangladesh

Executive Summary

Although Bangladesh can count on substantial flows of concessional external finance – its traditional source of such funding – through the current decade, a number of its government agencies are already looking for alternatives. Some are turning to Suppliers' Credit as a principal avenue of non-concessional, public-sector finance for infrastructure projects. The trend, a response to some slackening in the flow of concessional external finance due to the slow pace of sector reforms, is significant. The total outlays involved in projects recently approved and those being currently negotiated are well over a billion dollars. This surge in suppliers' credit brings with it significant payments liabilities for the medium to long-term and raises questions of debt sustainability.

Although suppliers' credit, when compared to commercial loans, have some element of concessionality, this type of financing clearly represents a significant hardening of terms for a country like Bangladesh that has traditionally relied on concessional sources of funds. Such change is not necessarily harmful, provided that the projects being financed are viable, that they generate foreign exchange earnings either directly or indirectly and that financing terms are competitive enough to yield good value for money.

Unfortunately, this does not seem to be the case for most projects in Bangladesh that use this financing option. First, serious questions arise about the transparency of negotiated single-source contracts; second, the potential divergence between apparent and real credit terms seems to be ignored; and, finally, projects are often of poor quality and lack cost-recovery mechanisms for debt servicing, and the recipient state agencies or parastatals are often insolvent. While the low debt service ratio of the economy might create an incentive to accommodate larger amounts of suppliers' credit for public sector projects, the associated fiscal burdens on the parastatals, if not the government, need to be kept in view. Since most suppliers' credit so far have been underwritten by the government, debt service payments are, in effect, its contingent liabilities and require adequate budgetary provisions in the event the concerned agencies are unable to service the debt – a highly likely scenario.

Suppliers' credit in the private sector needs to be viewed in a somewhat different light. In order to minimize risks, private borrowers are expected to exercise due diligence so that (a) returns from investment cover the cost of debt service, and (b) procurement costs are minimized. Moreover, it must be assumed that lending agencies scrutinize project quality and financial viability before the contract is entered into with a private borrower. This study suggests that suppliers' credit are better suited for financing private investments especially those that generate foreign exchange because they act as a hedge against currency risks while minimizing debt repayment risks.

This study of suppliers' credit as a source of external finance for Bangladesh is intended to serve as a guide to government Ministries (as well as to the private sector) and policy makers on the potentials and pitfalls of using suppliers' credit for project finance in the public sector. The study establishes the critical importance of proper project selection on the basis of economic

viability and cost recovery, demonstrating that to do otherwise would land the economy into unsustainable debt servicing problems on the one hand and an unviable domestic debt situation on the other. The study argues the proposition that it does not make economic sense to contract credit on expensive terms when the present “window” of cheaper credit through ODA is available for Bangladesh at least for the next five to ten years, after which availability could become limited. While not discouraging suppliers’ credit outright as a source of project finance, the analysis makes a strong case for continuing the traditional reliance on concessional finance for the next decade and, in all cases, for giving high priority to prudent management and monitoring of external debt.

Bangladesh Suppliers' Credit as External Finance Challenges for Fiscal and External Debt Management

1. Introduction

1.1 Although Bangladesh can count on substantial flows of concessional external finance – its traditional source of such funding – through the current decade, a number of its government agencies are already looking for alternative providers. Some are turning to Suppliers' Credit as a principal avenue of non-concessional, public-sector finance for public infrastructure projects. The trend, a response to some slackening in the flow of concessional external finance due to the slow pace of sector reforms, is significant.

1.2 For a country like Bangladesh that has traditionally relied on concessional sources of funds, this type of financing clearly represents a significant hardening of terms. The change is not necessarily harmful, provided that the projects being financed are viable and either directly or indirectly generate foreign exchange earnings and that financing terms are competitive enough to yield good value for money. Unfortunately, most projects in Bangladesh that are using this financing option do not meet these criteria, a practice that gives rise to questions both of prudent debt management and transparency and effective use of suppliers' credit. Examining these

questions, the present study strongly discourages the use of suppliers' credit for infrastructure projects in the public sector except as a last resort. In such circumstances, it lays down strict guidelines for effective utilization. The study was the outcome of several discussions recently held between the Ministry of Finance and representatives of the World Bank and IMF in the area of fiscal and debt management.

2. Macroeconomic Context

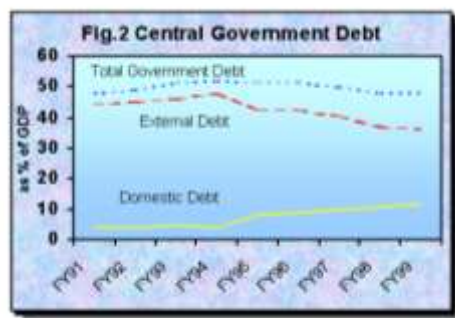
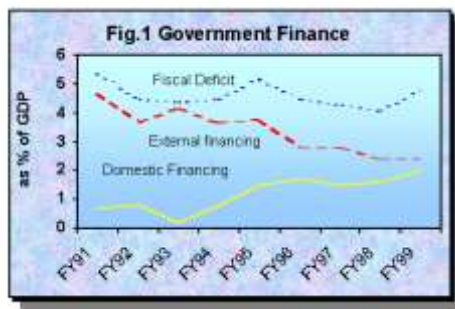
2.1 Thus far, Bangladesh has been the recipient of substantial amounts of concessional aid to finance its massive needs for infrastructure. Recently, however, several government agencies have been seeking out foreign suppliers' who would offer capital goods on credit for projects involving power generation/distribution systems, bridges, road and rail links, dredgers and water supply equipment, telephone systems and

Table 1: Summary of Public Sector Suppliers' Credit 1997-2003

(summarized from Appendix-A)	Principal	Interest Payable	Total
1/ Ministry of Energy and Mineral Resources	854.15	150.21	1004.36
2/ Ministry of Communication	82.01	11.58	93.59
3/ Ministry of Shipping	78.63	17.79	96.42
4/ Ministry of Industries	73.50	3.68	77.18
5/ Ministry of Posts and Telecommunications	319.70	70.34	390.04
6/ Ministry of Defense	115.00	9.00	124.00
Total (in million US\$)	1523.00	262.60	1785.60

2 Suppliers' Credit as External Finance

the like – on a relatively fast track basis. The total outlays involved in projects recently approved and those in the pipeline are well over a billion dollars [Table 1 and Appendix-A¹]. This surge in suppliers' credit over past practice gives rise to significant payments liabilities for the medium to long-term. With sector reforms stalled and, in consequence, concessional flows on the decline, parastatal and state agencies appear to have gone for the easy option of resorting to off-budget non-concessional finance, such as suppliers' credit, that does not require sector reforms as a precursor to inflows. This unfortunately comes at a time when macroeconomic stability was the hallmark of the 1990s decade.



2.2 Overall macroeconomic outcomes improved throughout the 1990s with annual real GDP growth averaging 5 percent in comparison to 4 percent in the 1980s.

Macroeconomic fundamentals also appear to be sound. With fiscal deficits averaging 4-5 percent of GDP and current account deficits in the 2-3 percent range, both internal and external balances have remained within sustainable limits. Inflation has been contained and the exchange rate has remained fairly stable under a

moderately flexible exchange rate regime. Given this framework of macroeconomic stability, the external debt situation has also remained manageable.

2.3 Between 1972 and 1999, Bangladesh received a total amount of \$34.8 billion in foreign aid, of which \$16.8 billion came in the form of grants and the remaining \$18 billion in loans – mostly under concessional IDA terms. Annual debt service in fiscal 1999 amounted to \$773 million on an outstanding stock of \$14.8 billion in external debt as of June 30, 1999. Although dependent on substantial inflows of external resources for its development, Bangladesh has thus far managed its external debt portfolio quite prudently, meeting all debt service obligations without the need for any re-scheduling². With a current debt service ratio³ of under 10 percent, the country is described as moderately indebted by the Bank's criteria of indebtedness.

2.4 Nevertheless, some disconcerting trends mark the profile of government finance and debt accumulation. Although overall fiscal deficits have remained within sustainable limits, they are being increasingly financed from domestic resources, often by resorting to government borrowing from the banking system while revenue efforts continue to lag behind [Figure 1]. While total central government debt appears steady at around 50 percent of GDP, its external and domestic components have moved in opposite directions. Peaking at 48 percent in FY94, the former declined from 45 percent in FY91 to 36 percent in FY99 [Figure 2]. Domestic debt, on the other hand, quadrupled in the same period, rising from about 4 percent of GDP in FY91 to 12 percent in FY99. Once recapitalization of NCBs and the financing of loss-making SOEs are fully reflected, total central government debt is projected to rise to 60 percent of GDP by 2005⁴.

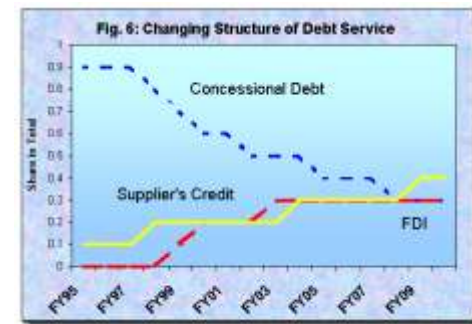
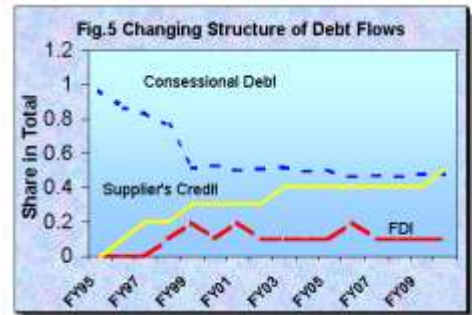
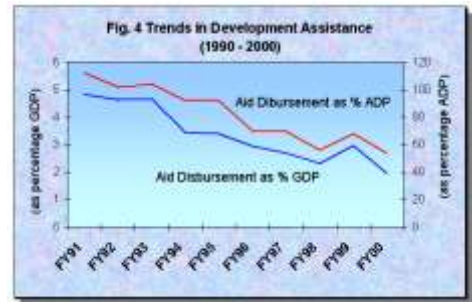
2.5 In this light the emergence of non-concessional finance, such as suppliers'

credit and publicly guaranteed FDI, in the external debt portfolio of Bangladesh assumes a less benign aspect. If current trends persist, the present, comfortably low debt-service ratio [Figure 3} is likely to disappear rapidly, to be replaced by mounting medium- to longer-term debt servicing liabilities. This need not occur. Although private capital and debt flows are replacing ODA in many developing countries, Bangladesh is still in a position to avail itself of a concessional window of over \$2 billion a year at least to the end of the decade. Keeping that option open, however, requires putting stronger reform initiatives in place.

2.6 Considering that such a “window of opportunity” does exist, Bangladesh’s increasing reliance on non-concessional flows to finance industry and much needed infrastructure in the near future seems ill-advised. If current trends continue in FY2000 and beyond, the share of non-concessional debt flows – suppliers’ credit and publicly guaranteed FDI -- are projected to exceed concessional debt flows. The critical question is how the country will meet the challenge of handling the mounting payments liabilities, and whether it can achieve a measure of balance between a growing stock of such debt and the economy’s foreign exchange earnings capacity from exports and workers’ remittances. Just as critical is the need to keep a close watch on the debt-servicing capacity of parastatals and of the state agencies that receive non-concessional external funds in local currency. When projects such as public infrastructure are funded with non-concessional external finance such as export credits, suppliers’ credits and buyer credits, it is absolutely essential to focus on cost recovery issues.

2.7 Current trends in debt inflows into Bangladesh suggest a somewhat stationary level of concessional flows from such donors as IDA, ADB and several bilateral donors (consequently, falling shares in ADP and GDP – fig.4). The typical

repayment period for such loans ranges from 20 to 40 years, including grace periods of up to five years, and the loans carry interest rates or service charges of about one percent. Since Bangladesh generally cannot tap international capital markets or commercial banks for project loans, the only non-concessional borrowing it has done has taken the form of suppliers’ credit to state agencies or parastatals from state export credit agencies such as those in China, India or Russia. Although the terms for suppliers’ credit are softer than those for a typical commercial loan, for Bangladesh they still amount to a significant hardening of terms⁵ over traditional concessional loans and implying some acceleration in debt-servicing liabilities. Combined with the public guarantees underlying production sharing contracts in the gas sector and IPPs in the power sector, the medium- to long-term debt portfolio becomes somewhat costlier (2% in 2000 compared to 0.96% in 1995)⁶ as the share of non-concessional finance grows [Figure 5-6].



3. Potential Sources of External Finance for Bangladesh

3.1 By conservative estimates, the country would need external resources of over \$60 billion for the next twenty years, to bridge the gap between its investment requirements and domestic savings⁷. **Mobilizing this massive amount of external resources -- in the public or private sector -- is a challenge intensified by the limits on official development assistance for the foreseeable future though not, if reforms are adopted, for the next five-to-ten years.** Although ODA has been declining for developing economies, Bangladesh, given its poverty levels and the desire of development partners to help, could prove an exception. If Bangladesh is unable or unwilling to embrace sector or governance reforms in the medium-term, however, the volume of ODA is likely to shrink further.

3.2 If ODA declined as the level of required investment remained high, Bangladesh would have no option but to tap alternative modes of project finance available in the international market consistent with its present level and pattern of debt exposure. Table 2 below lists the various options available and likely to emerge in the medium to longer term.

3.3 *Official grants and concessional loans.* Coming from international financial institutions (IFI) such as the World Bank or Asian Development Bank, this soft-term finance is not tied. But soft bilateral aid is most often tied to the source country.

Non-concessional finance. ADB has recently offered Ordinary Capital Resource (OCR) facility to Bangladesh – limited exposure on near commercial terms. Bangladesh could become eligible for IBRD loans in the next five years.

Suppliers' Credit/Export Credit. What is popularly known as suppliers' credit in Bangladesh is basically a form of export credit in the international financial market. [See Appendix B for a typology of Export Credits.]⁸ Export Credit finance is normally tied to goods and services acquired from the country that provides the credit, although most such arrangements permit financing for the acquisition of up to 15% of the exported goods and services either from third countries or local (i.e., Bangladeshi) sources. The normal maximum length of credit under either supplier or buyer credits is ten years, beginning from the appropriate Starting Point of Credit, normally acceptance of the goods or services or completion of the project. The rate of interest would normally be fixed and subject to the Commercial Interest Reference Rates (CIRR)⁹.

Export Credit arrangements normally require a 10-15% down payment that the buyer or borrower has to fund in full by the time a project is completed and before the credit period begins either from his own resources or by means of a separate borrowing. Export Credit Finance, which no longer provides access to finance where interest rates are subsidized, does offer the possible advantage of fixed interest rates, quite long credit periods and often medium- and long-term credit that cannot be obtained from other sources. Repayment terms, however, are characterized by only limited flexibility. Normally, equal half-yearly repayments of principal are required throughout the credit period, meaning that the first repayment of principal would be due six months after the completion of the project/starting point of credit.

Key considerations about Export/Suppliers' Credits include the following:

- ① They are, of course, mainly tied finance – although an Export Credit

from Germany that must be used primarily for the purchase of German goods and services, normally makes up to 15% or 20% of the credits available for purchase of British or French or US components or parts of the project/contract. Nonetheless, competitive bidding and transparency – even where finance is tied – should be elements within the credit

arrangements.

- Export/Suppliers' Credits can provide long-term credit, i.e. not only grace periods lasting until a project is completed or goods have been accepted by the buyer but including a possible 10 years or more for repayment of the credit, stretching the total time from 4 years, for example, to as many as 14.

Table 2: Potential Sources of External Finance

<i>Type of Finance</i>	<i>Source</i>	<i>Recipient</i>	<i>Observations</i>
1. Official grants	Bilateral/multilateral agencies or govts.	Govt/ NGO	Limited “window” in future
2. Concessional loans	Bilateral/multilateral agencies or govts.	Govt/ NGO	Potentially large amounts still available; but disbursement subject to absorptive capacity and sector reforms
3. Non-concessional loans -- IBRD -- OCR of ADB	World Bank, ADB	Public	ADB has offered limited OCR facility; Bangladesh could graduate into blend IDA-IBRD in the next 5 yrs.
4. Supplier Credit/ Export Credit	State agencies or private corporations	Public/priv/ NGO	Typically has some concessionality element; require sovereign guarantees in the case of Bangladesh; tied finance, but competitive bidding and transparency possible and recommended.
5. Cofinancing	>\$50 million projects cofinanced by IFI and Export Credit Agencies	Public/priv	A possibility. Blending IFI and Supplier Credit; competitive bidding.
6. FDI	Multinational corporations	Public/priv	Require supporting legal and policy environment, high ROR to cover costs and risks; comes with or without sovereign guarantees; growing source of project finance; no public liability in absence of guarantees.
7. Capital market (Bonds)	International capital market	Public	Various types and maturities; relatively high cost; only accessed by high return, high profile projects, e.g Jamuna bridge.
8. Commercial loans	Commercial banks	Public/priv	High cost, market rates of interest; not yet accessed, but possibility exists in future for financing foreign exchange earning projects.

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- ① Leading experts on Export Credits stipulate that at present, there is a "market window" for Export Credits which Bangladesh could exploit, a potential source of up to \$1 billion per year and, assuming satisfactory policies and performance, a continuing source of such credits.

Co-financing. Export Credits are flexible and can be mixed or blended or co-financed with such other sources as Multilateral Institutions, Bilateral Aid, Commercial Bank loans and, in due course, Capital Market funds from bonds, particularly for projects of over \$50 million that might well require drawing finance from a number of the sources above and blending them. The Asian Development Bank in particular is looking for ways to develop co-financing on particular projects with Export Credit Agencies.

Foreign Direct Investment (FDI). This is increasingly becoming a vital source of project finance for Bangladesh, both in the private and public sector. It holds two great advantages: there are normally no scheduled or fixed repayment dates and outflow normally depends on profits being generated. In Bangladesh, however, where the biggest chunk of FDI has come in the energy sector, government guarantees of periodic repayment to the foreign investors ensure periodic payment of negotiated amounts, meaning that Bangladesh has essentially assumed any commercial or political risks.

International Capital Market (Bonds). Bangladesh has not yet accessed international capital markets where the still limited appetite for emerging-market paper makes the availability rather than the cost of this kind of finance for projects or capital goods the likely key consideration. Where or when capital markets are open, any funding from them would almost certainly have to involve borrowing by the Government of Bangladesh (e.g. floating bonds for Jamuna Bridge). It is not clear

that such borrowing, either at fixed or floating rates of interest, would currently be possible. Offering the possibility of a flexible repayment profile, capital market finance would not be tied to procurement in any particular country, and at current international interest rates, a fixed interest rate arrangement for such borrowing could be attractive.

Commercial Loans. Commercial Bank Finance can – in theory – be raised for a particular project and structured according to the security that such a project may offer -- either a guarantee of repayment from the Host Government or a lien on the export earnings etc. of particular projects. Such finance will often be at floating rates of interest with repayment periods normally shorter than those provided under Suppliers' Credit. Commercial Bank Finance would not normally be tied to supplies from any particular exporting country, however, and may provide some flexibility on grace periods and the profile of repayment. Commercial Bank Finance can sometimes be a useful source of funding for down payments. The problem is often not so much the terms of this kind of finance as its availability. Most commercial banks are currently rather cautious about medium- and long-term lending into emerging markets. Nevertheless, the future holds the possibility of financing projects that directly earn foreign exchange.

3.4 To sum up, policymakers in Bangladesh, **need to keep in mind that concessional finance is indeed the least-cost debt instrument still available in substantial quantities for at least the next five to ten years. Since, beyond this period, this "window" could become highly restricted, prudent long-term debt management would dictate making the most of this concessional window now.** Beyond concessional finance, the various options open to Bangladesh consist of increasing FDI flows and export/suppliers' credit in the medium term and, in the long term,

absorbing modest amounts of non-concessional finance, comprising IBRD loans and the ADB's OCR facility, floating international bonds and seeking commercial bank loans.

4. Suppliers' Credit in the Public Sector— Critical Issues

4.1. The Annual Development Program usually lists a number of approved infrastructure projects without specifying a financing source. Typically, these and some other projects outside the ADP represent a shopping list of concepts in search of external resources¹⁰. Their inclusion in ADP without funding availability indicates the high priority assigned to them by the Ministries on apparent grounds of economic and social necessity. On close examination, however, the economic and commercial viability of many of these "wish list" projects remains untested if not doubtful - the reason for the absence of concessional funds. Having little or no access to commercial capital, banking and international money markets, Ministries and parastatal agencies are being driven to court foreign states and state agencies to provide capital goods for projects under suppliers' credit financing. Suppliers' credit made available in this fashion is essentially state-supported export credit.

4.2 Often, however, export credit agencies facilitating suppliers' credit do a poor job in the critical area of project evaluation. Although they are not necessarily incompetent in project analysis, they tend to rely mainly on sovereign or bank guarantee, conducting risk analysis not of the project cash flow but of the guarantor. Records of many suppliers' credit projects in Bangladesh (e.g. Rehabilitation of Railway lines, purchase of sea trucks by Ministry of Shipping), indicate that cost recovery mechanisms or debt servicing ability of the recipient state agency was mostly ignored, quite possibly in light of sovereign guarantees.

4.3. For Bangladesh – hitherto dependent entirely on concessional funding – suppliers' credit is a hard-term loan, -- so far a negligible element in Bangladesh's total stock of public debt that posed little or no debt servicing problem. As of June 30, 1998, outstanding hard-term loans -- mainly on account of suppliers' credit – totaled about \$240 million: \$200 million from China, and the rest from India, Romania, the Netherlands, Italy and USA, requiring still modest annual repayments of less than \$25 million. Repayments of these loans in hard currency are the direct (not contingent) liabilities of GOB – as they all come with sovereign guarantees.

4.4 This situation could be changing. Consolidated figures obtained from the Planning Commission and from several line Ministries reveal that the value of public-sector projects being financed, committed or proposed to be financed under Suppliers' Credit since FY1996-97 comes to more than \$1 billion (Appendix A). The bulk are projects for infrastructure development under the Ministry of Telecommunications, Roads and Railways Division of the Ministry of Communications, and Ministry of Energy and Mineral Resources (Bangladesh Power Development Board and Petrobangla).

4.5 All suppliers' credit received in the public sector so far constitutes hard-term loans as defined under one criterion or another by the Hard Term Loan Committee of the Ministry of Finance. Government policy on suppliers' credit financing is to require that the Ministry/Agency advancing such a proposal determine through international tender or otherwise that the projected suppliers' credit is the most competitive in terms of price, maturity and rate of interest that could be obtained. Recent practices by several Ministries/Agencies, however, clearly suggest that the guidelines on transparency and competitive procedures have been ignored. Moreover, no guidelines appear to spell out prudent

limits on amounts of suppliers' credit consistent with the economy's debt-servicing capacity. (Section 6 below offers some guideposts to safe volume limits on non-concessional debt in general and suppliers' credit in particular.)

4.6 **Some case studies.** A closer look at the contracting and implementation of five suppliers' credit projects reveals that except for one parastatal (BTTB), others have extremely limited to non-existent debt-servicing capacity. -Appendix E examines the five:

1. BTTB (Ministry of Posts and Telecommunications): Establishment and Extension of Digital System in District Towns
2. BPDB (Ministry of Energy): 210 MW Chittagong Thermal Power Station (2nd Unit)
3. BPDB (Ministry of Energy): 210 MW Ghorasal Thermal Power Station (6th

Unit)

4. Bangladesh Railway (Ministry of Communications): Rehabilitation of Main Line

5. Bangladesh Railway (Ministry of Communications): Rehabilitation of Main Line (Slippers)

Historically, BPDB, with system losses of 30 percent or more, has not been able to service more than 30 percent of its foreign debt. Bangladesh Railway, which typically loses over \$20 million annually, services even less. Fiscal adjustments to keep government (and overall domestic) debt within sustainable limits in the long run would require radical reforms to improve the earnings of Railways, BPDB and other parastatals contemplating project financing with suppliers' credit. A specific reform will be required to insure that competitive bidding is part of any deal for raising suppliers' credit finance for public sector projects. Atypically, the two Railway

Box 1: Islamabad-Peshawar Motorway in Pakistan **High-Cost Debt for Infrastructure**

Construction of the Islamabad-Peshawar Motorway by a Turkish firm, M/s Byndir Inc., is nearing completion. This 154-km motorway will have six lanes, 17 fly-overs, 42 underpasses, 4 river bridges, 6 overhead bridges over railway tracks and 8 inter-changes. Project costs are estimated at Rs. 26.9 billion, 50% of which (approximately \$250 million) has been financed through a government guaranteed supplier credit from the contractors, M/s Byndir Inc. The interest cost of the loan is *libor* (6.4%) plus 4.5 percent with a repayment period of six years and a grace period of three years. This is a major infrastructure project of the National Highway Authority in Pakistan. Because of the autonomous character of NHA, projects such as this do not require to be processed through the Planning Commission, unless resources are being requested from the Public Sector Development Program (PSDP). In this case, substantial allocation had to come out of the PSDP and therefore budgetary accommodations had to be made. However, the project itself does not appear economically viable as calculations of IRR and NPV show negative values. As for the debt servicing implications, it was clear that the toll collection and other income from the project would only yield annual revenues of \$4.5 million whereas annual debt servicing costs were \$49 million. Debt liabilities on account of the project are therefore contingent liabilities of the central government which will eventually have to bear the burden of the debt almost entirely. Even if it were constructed on a BOO/BOT basis by the private sector, poor financial viability indicates that, if it was associated with a government guarantee (which is often the case), the ultimate liability would have devolved on the government. In contrast, the choice of a concessional debt instrument such as an IDA loan for the same amount would have required annual payments of under \$15 million.

Source: Infrastructure Unit, South Asia Region, World Bank

projects noted above were built on contracts awarded through competitive bidding. Clear cost savings resulted, even though the projects themselves were not necessarily self-sustaining. In contrast, it has been argued, as in the case of the BTTB project, that much time is lost in arranging international competitive bids – an invalid excuse when large amounts of public funds in foreign exchange are involved. This report makes the point repeatedly that competitive bidding and suppliers' credit finance are not mutually exclusive. Moreover, evidence suggests that non-reforming sectors tend to opt for suppliers' credit with alacrity when concessional resources appear to dry up¹¹. It seems that only one Ministry – namely, Communications – has, as a matter of policy, used suppliers' credit as an option of last resort.

4.7 **Lessons for Policy.** The five case studies reveal that even when financing comes as suppliers' credit, competitive bidding is possible and, as with the Railway project for purchase of slippers, money-saving. Nor, when public funds and huge amounts of foreign exchange are involved, can such bidding be considered too time-consuming. Of the three agencies studied, BTTB, BPDB and Bangladesh Railways, only the first is a solvent public monopoly that is expected to be able to service its foreign debt liabilities from the revenue generated, either from the project itself (given the pent up demand in district towns) or from its conventional revenue surplus. BPDB has only made partial payment on past debt and is likely to continue that practice. The Chinese project (210 MW Chittagong Thermal Power Station) has been found to be neither inefficient nor cost-effective. Moreover, BPDB has to deal with the immediate payments on a number of IPPs. Bangladesh Railway's Rehabilitation projects are unlikely to turn its conventional losses into surplus right away. Railway authorities argue – perhaps rightly so -- that rail services are likely to become profitable once the rail link over the

Jamuna Bridge actually connects the country's northern regions to the southeastern region. Until then, cost recovery from these projects is unlikely.

4.8 While the economy's low debt service ratio could appear to justify larger amounts of suppliers' credit for public sector projects, the associated fiscal burdens on the parastatals, if not on the government, alter that appearance. Since government has underwritten most suppliers' credits to date, they effectively represent contingent liabilities of the government for which adequate budgetary provisions need to be made in the highly likely event that the concerned agencies are unable to service the debt.

4.9 Cross country evidence has shown that unless cost recovery is made an essential ingredient of project feasibility for large, public-sector, infrastructure projects such as highways, bridges, and power stations, suppliers' credit financing can burden the national budget and public exchequer with excessive liabilities and runaway domestic debt. In Pakistan, due to inadequate user charges (tolls and service charges), a number of large infrastructure projects (e.g. highways, airports) financed under suppliers' credit are unable to cover O & M costs, let alone service foreign debt. Part of the problem lay in grandiose schemes for opulent investments that were inconsistent with projected revenue earnings. In Indonesia, where public-sector suppliers'-credit projects were being serviced at enormous cost to the exchequer (due to sharp depreciation of the Rupiah following the East Asian crisis), poor cost recovery also generated debt service problems for several private-sector BOO and BOT infrastructure projects.

4.10 Since the mid-1980s, internal communications of the Ministry of Finance suggest that suppliers' credit was generally discouraged because of the relatively hard terms involved and because such credits, almost by definition, were further characterized by:

- a) Negotiated contracts (i.e. absence of competition and consequent poor value for money);
- b) Local Agents (lobbying and generally undesirable activities)
- c) Lack of Transparency (actual credit terms etc. not corresponding to their appearance.)

The five case studies that confirm these shortcomings also indicate that transparency and competitive bidding are quite possible and beneficial. [see Background papers for details].

4.11 In view of these findings and generally adverse cross-country evidence on the performance of suppliers' credit projects in the public sector, it is legitimate to ask whether it makes economic sense to contract credit on expensive terms when cheaper credit could be available through ODA. The answer is negative. This study strongly discourages Bangladesh from using suppliers' credit as external finance for public sector projects, particularly as a "window" of concessional finance remains open during the current decade at least. Suppliers' credit should be only an option of last resort when all efforts to attract concessional finance have failed -- and even then under guidelines that would ensure transparency, competitive pricing, cost recovery and debt-servicing capacity.

4.12 ***Guidelines for use of Suppliers' Credit.*** Even as a last resort, the use of suppliers' credit requires that a judgment on the utility of expanding its role be made by the Government of Bangladesh and, in particular, the policy makers and government agencies most responsible for managing external resources and monitoring external debt. Recognizing that Suppliers' Credit in the public sector should not be used as a substitute for concessional aid, a decision that such credit could be useful needs to incorporate careful attention on the following aspects:

- it is very desirable that there be a clear understanding of **the normal terms and conditions** for such credit. Hopefully, this Report will be helpful in providing this information and giving officials and others a better understanding of Suppliers' Credits.
- it is very desirable that the key institutions both inside and outside Bangladesh have a clear understanding of what the **policy and practices and decision making processes** are in respect to approving Suppliers' Credits.
- it is very important that a clear system be in place ensuring that the **Government monitors and manages the external debt** arising from Suppliers' Credits and other borrowing or investment flows.

4.13 In Bangladesh's particular circumstances, moreover, a strong preference should be given to viable projects that will, for example, generate the foreign currency with which to repay external borrowing. This condition is particularly true where buyers or borrowers are public sector bodies which are running at a loss and without foreign currency resources of their own. Obviously, a project that is not viable is not an attractive underwriting proposition for lenders or insurers or investors. In such circumstances a Sovereign Guarantee would be a necessary -- though not a sufficient -- condition of any financial package. Such a Sovereign Guarantee then becomes a contingent liability of the government, a burden that raises the legitimate question: does it make economic sense for the government to contract expensive credit when, with sector reforms, cheaper credit is still available through ODA.

4.14 ***Tendering.*** If credit is required for the imported component of goods and services, it is perfectly possible when seeking Tenders to stipulate that the credit

terms which are required be set out in the Tender. In other words, those submitting Tenders can be required either to meet the terms of the credit which have been stipulated (e.g. downpayment required, the appropriate pre-credit or manufacturing period before the goods and services are delivered or before the project is completed, the length of the credit period and the rate of interest which will apply) or offer something better. And since the required credit terms have been set out in the calls for Tender, only Tenders that include these or better terms could be regarded as compliant. If, as is usually true, more than one supplying country is willing to provide some medium- and long-term project finance under Suppliers' Credit, then open, competitive bidding and transparency in bidding and contract award become easily attainable factors on which to place primary emphasis. Procurement officers can focus on

- a) the price and quality of the goods and services themselves;
- b) whether the terms of the credit and the associated finance meet those set out in the call for Tender.

4.15 *Credit Terms and Availability.*

Careful decisions will, of course, be needed on the credit terms to be stipulated. In this regard, the OECD Arrangements (OECD 1998) or Berne Union Agreements could be used as benchmarks¹² in setting, first, the **cost** and **terms** of credit and, secondly, the **availability** of credit. In commercial markets, some tradeoff is normal between these two factors so that where the availability of credit is more limited, the cost is higher. However, this is not necessarily the case in the area of Export Credits. The terms of Export Credit set by the OECD Arrangement and Berne Union Understanding could be used as reference points. For short-term credit, Berne Union requirements usually stipulate a maximum of 180 days credit. For medium- and long-term credits, the OECD provisions cover both the length of credit and profile of repayment as well as the minimum interest

rates. Again, competition could generate offers of credit terms better than the reference terms above.

4.16 *“Apparent” Credit Terms.* One of the many problems with negotiated contracts is the potential for disguising real prices and credit terms. Consider the following examples:

- ❶ a low – apparent – rate of interest, say, 2% could mean that the real rate of interest and financing costs have simply been transferred into the price of goods supplied (the so-called technique of “cosmetic interest rates”);
or
- ❷ an – apparent – grant of, say, 30% could be offset by a basic price 50% or so higher than competitive prices available from other countries/suppliers for the same goods and services.

These are real problems that can only be solved by open tendering, competition and transparency. This study stresses the more effective use of Export Credits as a stimulus to competition and transparency.

4.17 *“Apparent” Rates of Interest.* It is, in any case, very dangerous to set practices or guidelines or policies by reference to interest rates alone. A policy that places an “apparent” interest rate of 4% or less, for example, in one category and higher interest rates in another in isolation from other considerations is very dangerous and undesirable. . Such policies invite suppliers or financing institutions in other countries to show or offer unreal rates of interest, making up the difference by adding the sum involved to the contract price.

4.18 Should the Government of Bangladesh decide, despite these pitfalls, to seek suppliers' credit as a useful financing option, implementation of that decision requires cautious and well-managed steps.

Since parastatals and state agencies are the public-sector recipients of suppliers' credit and the generators of the consequent underlying sovereign guarantees, their projects must pass stringent tests of economic viability, and debt servicing in local currency must be ensured by adequate provision of user charges and other cost recovery mechanisms¹³. Since these projects are essentially contingent liabilities of the government, their full integration in the budgetary process is also essential.

4.19 Bangladesh does seem able to seek to blend suppliers' credits with Bilateral Aid under Mixed Credit Arrangements that could offer the possibility of longer repayment/credit periods and also lower rates of interest. one example is the Communications Ministry's £70 million Bhairab Bridge project financed with DFID grant mixed with ECGD export credit. Such arrangements would normally have to be in line with the provisions of the OECD Arrangement; but Bangladesh,

a favorable position in terms of the repayment period (up to 10 years.)

5. Suppliers' Credit in the Private Sector

5.1 Suppliers' credit in the private sector presents somewhat different considerations and could be a potentially useful source of external finance for many private firms unable to raise sufficient foreign exchange resources from domestic financial institutions. In order to minimize risks, private borrowers are expected to exercise due diligence so that (a) returns from investment cover the cost of debt service and (b) procurement costs are minimized. Suppliers' credit could be a preferred option for financing private investments, particularly those that generate the foreign exchange that both reduces debt service risks and provides a natural hedge against currency risks. Use of suppliers' credits in such activities could reduce the repayment problems that, for example, some of the power projects in Indonesia face after the massive depreciation of the Rupiah. In sanctioning such private-sector borrowing, however, the GOB must not under any circumstances guarantee commercial and repayment risks (including guarantees by NCBs.) Although export-oriented firms will have a distinct advantage, it might be possible -- with the approval of the high-powered approval committee of the Board of Investment (BOI) -- for some non-exporting firms to get the supporting commercial bank guarantees that would give them access to suppliers' credit.

5.2 Given Bangladesh's current, low, debt-service ratio and low private debt exposure, there is scope for raising investment finance through the mechanism of export credit. Lending to the private sector implies an examination by lenders of the financial viability of the projects concerned -- much

Table 3: Export Credit Exposure of Berne Union member countries in Emerging Markets, 1999

<i>Country</i>	<i>Exposure (US\$ mil)</i>	<i>Percentage of total</i>
Bangladesh	209	0.1
China	34,305	11.1
Egypt	8,066	2.6
India	6,984	2.3
Indonesia	16,690	5.4
Malaysia	2,576	0.8
Pakistan	3,691	1.2
Philippines	6,003	1.9
Thailand	6,143	2.0
Vietnam	1,801	0.6
Total Exposure of all Berne Union members in 65 Emerging Market Countries	309,667	

Source: International Union of Credit and Investment Insurers (Berne Union)

being a category 2 country,¹⁴ is currently in

more than when the lending is carried out under a sovereign guarantee-- and a careful weighing of the commercial, foreign exchange and political risks. More available information on the economy's private capital flows and payment liabilities (often difficult to obtain at present) could provide the incentive to foreign suppliers to expand their credit line. In consequence, the private sector in Bangladesh could increase its share of external finance out of the growing pool of export credit available worldwide -- \$500 billion and growing. Keen to tap Export/Suppliers' Credit lines for independent projects or joint ventures, the private sector in Bangladesh was able to draw about \$30-40 million of suppliers' credit annually during the past few years (Appendix A). Reports obtained from the Bangladesh Bank also indicate a substantial increase in private sector credit from abroad in the current fiscal year (1999-00).

5.3 As a new entrants in the world's financial markets, Bangladesh and its policymakers need to understand that export credit is first and foremost a mechanism for export promotion of products from the source country, and is not to be regarded as foreign aid. Given Bangladesh's relatively low debt service ratio [Appendix-C] and fairly stable exchange rate, its relatively low exposure to export/suppliers' credit from the Berne Union member countries can be attributed to several factors, the most important of which are:

- dearth of sound project proposals,
- lack of information on private debt flows,
- absence of credit rating by Moody or Standard and Poor,
- lack of knowledge by domestic enterprises about international financial architecture and available financing options, and
- uncertain political risk.

5.4 As for the private sector, the key body involved with clearance of export credits/suppliers' credits is the Board of Investment (BOI). With the exception of "Trade credits of less than 360 days," all credits need prior BOI approval that obviates the need to obtain Central Bank or Foreign Exchange approvals to purchase foreign currency to make payments. There is no requirement for international tender or confirmation that the import prices are internationally competitive. Once such credits are "registered" with BOI, however, the mechanism for following up on actual transactions/investments is weak or non-existent. The latest Bangladesh Bank figures show that as of March 1999, total outstanding private sector debt amounted to \$421 million, including \$54.5 million in suppliers' credits. For the fiscal year 2000, it was indicated that private sector credit was running at nearly \$500 million. Although private sector debt is not a public liability, it must be repaid in foreign exchange, making close monitoring of the level and composition of private debt important. The Bangladesh private sector has not yet been able to draw any significant amount of project resources out of the Berne Union¹⁵ member countries whose total Export Credit exposure in 65 emerging market countries (including those of South Asia) as of September 1999 was over \$300 billion (Table 2). Of this, only \$200 million was the exposure to Bangladesh.

5.5 *A Potential "Window" for Bangladesh?*

Given the present minimal exposure of Bangladesh to high-quality Berne Union Export Credit markets, it is reasonable to believe that many Export Credit Agencies (ECA's) would be willing to provide and support new credits for Bangladesh. This assumption defines the scope for new and extra exposure/commitments and a "window" for Bangladesh.

The reason for optimism stems from the following facts:

- (a) the current external debt service ratio is relatively low;
 - (b) the present exposure of ECA's is low for a country of Bangladesh's size and potential;
 - (c) its repayment record is good;
 - (d) Bangladesh needs capital goods etc. of the kind that a number of countries can supply and that attract medium- and long-term credit;
 - (e) the OECD Arrangement permits the longest terms for Bangladesh and also some flexibility in blending of Export Credit with Bilateral Aid.
- (d) All actual and potential creditors – both private and public – must be confident that the Government has an **effective policy and practice/arrangements for monitoring and managing external debt**;
 - (e) The overall **debt-service ratio must remain within pre-determined targets** consistent with the economy's capacity to earn foreign exchange.

5.6 Given the sizable stock of export credit internationally and assuming the availability of a market window for Bangladesh, the GOB needs to do and not do certain things if it wishes the private sector to take the best advantage of this opening. Leading experts on export credit suggest that Bangladesh could access medium- and long-term credits of some \$500 million per year, provided it maintains the confidence of those providing and supporting such credits. Such confidence will not be easy to sustain unless the following conditions are met:

- (a) Projects under consideration must be economically sound and cost recovery must be ensured; projects that directly generate foreign exchange would be preferred;
- (b) The GOB **must maintain reliable, accurate and readily available records of all external debts**, the profile of repayments and the category of debtor (private, public, bank) and the main category of creditor (e.g. IFI/Multilateral, bilateral, Government, export credit agencies, commercial banks etc);
- (c) **Clear and known procedures** seen to be strictly applied must govern the approval of credits and establish, for example, which credits need the

- (f) Current **macroeconomic stability** must be sustained with an open investment regime and sound and effective economic policies.

6. Prudent Limits to Suppliers' Credit: Challenges to Fiscal and External Debt Management

6.1 ***Economic considerations.*** Any form of foreign borrowing has the potential to benefit a country if, and only if, it finances additional productive investment with a rate of return greater than the borrowing cost. But things can go wrong in three ways:

- (a) If the extra output does not generate additional foreign exchange receipts and the country builds up an excessive burden of debt service liabilities in consequence;
- (b) If the borrowed credit is used to finance dubious or mistaken investment projects that do not generate enough extra output to cover the cost of debt service;
- (c) If investment projects are financed without proper scrutiny and therefore end up costing more than they should have done (e.g. with higher capital costs more than offsetting the nominal interest saving. See section 8.6-8.7.)

6.2 Four major components now make up Bangladesh's external debt portfolio:

- (a) concessional debt, publicly guaranteed, comprising multilateral and bilateral ODA;
- (b) publicly guaranteed liabilities on account of FDI in the energy sector;
- (c) publicly guaranteed suppliers' credits contracted by state agencies and parastatals; and
- (d) private flows, comprising FDI, export/suppliers' credits and other commercial debt.

6.3 Bucking historical trends, non-concessional debt inflows (including PGFDI) in FY00 equaled the traditional flow of concessional debt to the public sector. Projections based on recent trends suggest that, by 2010, annual flows could reach over \$700 million [Appendix-A.] If current trends persist, debt service liabilities will also rise substantially to reflect the increasing cost of debt and hardening of terms. Available information indicates that from FY00 a third of all external debt is likely to be made up of suppliers' credit –on the face of it, a softer brand of commercial debt. The question is how much of such debt can the economy absorb without derailing the internal and external balances achieved in the past decade. What might be the prudent limits to such debt? The question can be approached in two ways:

- Given the current profile of suppliers'

credit inflows in the medium to long term, what will be the implications for debt servicing?

- Alternatively, given a target debt-service ratio for the medium- to long term, how much suppliers' credit per year can the economy absorb?

6.4 The Bank's RMSM-X model is used to make macroeconomic projections and assess the sustainability of alternate debt profiles in terms of fiscal and current account balances and the resultant debt service ratios. The macroeconomic effects of suppliers' credit are incorporated into the RMSM-X through a number of relationships. Public investment in

Table 4: Summary Macroeconomic Indicators

<i>Policy Scenario</i>	<i>Macro Indicator (% GDP)*</i>	<i>2002-06</i>	<i>2007-10</i>
High Case Reform Scenario	<u>\$300 million SC</u>		
High level of concessional finance, minimum non-concessional debt; high case FDI	GDP growth	6.6	7.0
	Govt deficit	-3.6	-3.2
	Domestic debt	16.8	15.8
	CAD	-3.4	-2.9
	Debt service ratio	9.8	11.0
	<u>\$500 million SC</u>		
	GDP growth	6.6	7.0
	Govt deficit	-3.7	-3.3
	Domestic debt	16.9	16.3
	CAD	-3.8	-3.3
	Debt service ratio	12.1	12.9
Business as Usual Scenario	<u>\$300 million SC</u>		
Concessional finance stagnant; low quality supplier credits; modest FDI and commercial loans meet external gap	GDP growth	5.2	4.9
	Govt deficit	-5.0	-5.3
	Domestic debt	20.5	26.1
	CAD	-3.7	-4.5
	Debt service ratio	11.7	16.0
	<u>\$500 million SC</u>		
	GDP growth	5.2	4.9
	Govt deficit	-5.4	-6.2
	Domestic debt	21.3	29.4
	CAD	-4.1	-4.9
	Debt service ratio	13.0	18.0

(*) Debt service ratio is stated as percentage of exports plus remittances.

infrastructure and energy financed by

suppliers' credit is assumed to affect GDP growth with a one-year lag through the standard ICOR relation.¹⁶ In the balance of payments, the current account is affected contemporaneously because of capital goods imports with an equivalent inflow in the capital account. The current and capital accounts are also affected in later years as the interest and amortization payments, estimated directly, become due. The fiscal accounts are affected by public development expenditures and interest expenses. Income growth, additionally, produces indirect effects on both balance of payments and the fiscal accounts.

Assuming that the external environment remains unchanged in so far as prospective flows of worker remittances¹⁷ and international prices of goods and services are concerned, debt servicing capacity is estimated for annual flows of \$300 million and \$500 million in suppliers' credit. Two scenarios test fiscal and external debt sustainability for the period up to 2010. The *high-case reform scenario* stipulates a maximum amount of concessional debt in a policy environment that secures needed reforms in banking, power, telecommunications, ports, the judiciary, public administration and the SOEs. A *business-as-usual scenario* projects stagnant aid flows and growing amounts of

6.5 Results Table 4 and Appendix D.

Box 2: Financial Sustainability of Macroeconomic Projections

A. External Sustainability

To ensure creditworthiness (and solvency) of an economy over the long run, the ratio of external debt to GDP must not increase continuously. To keep the external debt to GDP ratio from rising, the current account deficit must satisfy the following sustainability condition:

$$\text{Primcad} \leq - (r^* - g) * b^*$$

where

Primcad	=	non-interest (primary) current account deficit (as % of GDP)
r*	=	real foreign interest rate
g	=	rate of growth of real GDP
b*	=	external debt to GDP ratio

B. Internal Sustainability

The solvency of the public sector in the long-term requires the ratio of public debt to GDP to be stable or declining over time. To ensure sustainability, the following relationship must hold:

$$\text{Primdef} \leq g*b + g*b^* + (\pi + g) * h - r * b - (r^* + d) * b^*$$

where

Primdef	=	primary deficit to GDP ratio
g	=	real GDP growth
b	=	domestic public debt to GDP ratio
b*	=	external debt to GDP ratio
π	=	domestic inflation rate
h	=	monetary base to GDP ratio
r	=	domestic real interest rate
r*	=	foreign real interest rate
d	=	rate of real exchange rate depreciation

Sources: The above approach to sustainability is credited to S. van Wijnbergen and W. Buiter and is drawn from the following publications by them: van Wijnbergen, S., "External Debt, Inflation and the Public Sector: Towards Fiscal Policy for Sustainable Growth", *World Bank Economic Review*, 3 (3:1989), 297-320; Buiter, Willem H., "A Guide to Public Sector Debt and Deficits", *Economic Policy* (November 1985), 13-79.

suppliers' credit and non-concessional finance. Prudence dictates that the structure and composition of debt should be such that the debt-service ratio remains within a critical limit which should be determined primarily by a country's foreign exchange reserve position. Given the current low and stagnant reserve position of Bangladesh – below the IMF threshold of three months' import cover – debt service ratios of 15 to 20 percent spell danger; anything above these numbers ought to be avoided¹⁸.

6.6 Fiscal and external debt sustainability in the two scenarios could be examined under different criteria of sustainability [see Box 2]. A secular rise in the domestic debt-GDP ratio or external debt service to export ratio usually signals an unsustainable macroeconomic situation. In this context, a useful indicator for sustainability postulates a declining or stable present value of debt over time

6.7 **High Case Reform Scenario:** This is the ideal case where government is serious about sector reforms resulting in improvement in governance and revitalization of the financial sector, and in the functioning of ports, power supply and telecommunications; all of which improve the government's fiscal balance and reduce the cost of doing business for the private sector. The critical GDP growth rate of 6-7 percent can be achieved under this scenario which also clears the way for the maximum amount of concessional finance on an annual basis: IDA's maximum of \$1 billion, ADB and IMF's \$400-500 million each, and some \$1 billion from other bilateral donors. Thus bulk of the external gap can be met under this scenario with concessional flows, the balance being covered by private FDI flows and other private debt, including suppliers' credits. No further suppliers' credits are visualized for the public sector except those contracted up to 2001. Export performance of 1990s is repeated in 2001-10 with high growth of 10-11 percent on the assumption that the export sector

adjusts to the post MFA trade environment. These assumptions yield a highly sustainable domestic debt profile and current account deficits with debt service ratio remaining at current levels. ***This scenario indicates what is possible, not what is probable, given current policy trends.*** Under this scenario, the public sector's resource gap could be met entirely from concessional finance, and the private sector could absorb as much as \$500 million or more of suppliers' credits.

Conclusion. *With improved policy performance, Bangladesh can expect to make more use of suppliers' credit. However, part of the policy reform ought to be careful selection of public projects, improved fiscal sustainability and cost recovery, and transparency in the selection of supplier credit options (competitive bidding etc.).*

6.8 **Business as Usual Scenario.** This situation holds when reforms are incomplete, improperly executed, or half done. In this case, the economy is unlikely to move beyond the low-moderate GDP growth of 5 percent on a sustained basis. Concessional finance is likely to stagnate at current levels, at best, and if external gap is met by increasing flows of suppliers' credits -- as current trends indicate -- the debt service ratio will rise rapidly reaching unsustainable levels averaging 16-18 percent in 2007-10 period with \$300-500 million of suppliers' credits. Such a rise would be a reversal of the favorable trends in external debt witnessed throughout the past decade – the debt service ratio declined from 21 percent in FY91 to under 10 percent in FY00. The present value of total debt also shows secular increase upto and beyond 2010 [Appendix-D]. If current trends continue, and suppliers' credits keep pouring into generally loss-making state agencies or parastatals, with ill-conceived or non-viable projects, the entire debt servicing liability will have to be borne by the government resulting in extra interest obligations and off-budget expenditures leading eventually to an unsustainable domestic debt burden as well. With the

external debt service ratio exceeding prudent limits, it is also unlikely that the remaining financing gap can be met from non-concessional sources and FDI would be difficult to attract. The implication is that the projection -- based on current trends -- of \$500-700 million suppliers' credit intake during 2001-10 is clearly unsustainable and, if materialized, would land the economy into deep problems on both counts: external debt and fiscal balance. Fiscal unsustainability would remain as long as state agencies are loss-making or projects are not viable on the basis of cost recovery. Thus in a non-reform policy environment, fiscal imbalances alone could provide convincing case for staying clear of non-concessional external finance.

Conclusion. *If Bangladesh were to contract large volumes of suppliers' credit without commensurate improvements in policy performance, the country is bound to land into a messy situation!*

6.9 The two preceding scenarios could vary if the private sector were the recipient of export/suppliers' credits. In the "high case", even if \$3 billion of concessional finance were not forthcoming, the economy would retain ample scope to absorb \$500 million or more of suppliers' credit to private firms without tipping the external debt balance. In the "business as usual" scenario, if government were to reduce its intake of suppliers' credit substantially, the private sector would have the leeway to pick up some suppliers' credit without exceeding the prudent limits of debt servicing. Although the need for the credit would be real in this case, however, its "availability" would be extremely limited, if not non-existent, due to the unsustainable fiscal and external debt assessed by export credit agencies. It is important to note that in all cases the debt-service ratio is sensitive to credit terms and export performance. Higher concessionality in external finance reduces the debt burden just as better export performance raises debt servicing capacities.

6.10 **Fiscal considerations.** The preceding discussion has focused clearly on the external debt scenario and the implications arising from a changing volume and structure of Bangladesh's debt portfolio for the medium- to long term. However, sustainability of external balances does not guarantee sustainability of domestic debt unless the fiscal stance of the government is prudent as well. Typically, suppliers' credits in the public sector, although guaranteed by the central government, are contracted by state agencies and parastatals (e.g. BPDB, Railways) whose financial balance sheets are seldom in positive territory. Moreover, in terms of interest cost for the parastatals, concessional debt from multilateral or bilateral donors is hardly different from suppliers' credit as the government on-lends these funds at 6-7 percent interest. Therefore, even though foreign exchange liabilities can be met from future export earnings, system losses, cost recovery problems in major infrastructure projects and other non-profitable activities of state agencies more often than not preclude their capacity to service foreign debt. As a result, such debt eventually becomes contingent liabilities of the government requiring budgetary provision in the long run.

7. CONCLUSION AND POLICY RECOMMENDATIONS

7.1 There is compelling evidence that suppliers' credits are being contracted by government agencies that fail to give due regard to project feasibility or the debt-servicing capacity of the parastatals in question. Projects are often being undertaken as off-budget expenditures, and debt servicing requirements over time are not fully reflected in the revenue or development budget. Consequently, strong misgivings have arisen about suppliers' credits as a source of external finance both within and outside government circles in Bangladesh. Indeed, the motivation behind

this study was the concern that various Ministries/Agencies were contracting such credits without appropriate examination of the real costs and returns of projects; transactions were not entirely transparent; and budgetary control over resource allocation and utilization was being undermined.

7.2 Suppliers' credits seem to have become inextricably associated with some of the less desirable aspects not only of the work of "Agents" but also of negotiated contracts and inadequate value for money. Most export credit business around the world, however, is not conducted on the basis of negotiated contracts. Used effectively, export credits open avenues to access and develop flexible sources of international credit, finance and investment on attractive and competitive credit terms that would not otherwise be currently available to Bangladesh. The opportunity to exploit such credit sources is potentially important to both the public sector and the private sector in Bangladesh.

7.3 *The Fundamental Issue(s)* For public agencies, the key test is one of economic sense: whether to contract costlier suppliers' credit when cheaper ODA resources on offer have not been fully exploited. Since future debt liability is sensitive to the credit terms of current and future debt flows, prudent debt management calls for restraint. Taking on too much non-concessional debt in the nation's debt portfolio is sure to aggravate the economy's debt-servicing liability. Where recourse to suppliers' credit is a last resort, it is imperative that stringent criteria be applied to public-sector project selection with strict enforcement of competitive bidding. This – and effective external debt monitoring and management – is of vital importance.

7.4 Attempting to make an objective assessment of the scope and potential -- as well as the dangers -- of using suppliers' credit as a source of external finance for

projects in the private and public sectors, this study underscores the importance of several key issues related to the use and medium-and long-term flows of suppliers' or export credit in Bangladesh. They are as follows:

- ❶ The goal of achieving 6-7 percent annual GDP growth for rapid poverty alleviation in the medium and long term presupposes a growing financing gap to be met from external sources;
- ❷ Given the limited prospects of ODA, export or suppliers' credits could appear the next best thing to concessional finance in the international market. Indiscriminate reliance on this mode of external finance by the public sector is, however, so dangerous that this study strongly argues that suppliers' credits be used *only as a last resort for public-sector projects*;
- ❸ By some estimates, Bangladesh public and private sectors could potentially tap as much as \$500 million - \$1billion a year of export credit finance over the next ten years, but sums of that magnitude are not guaranteed and actual flows will depend on effective use of resources for high quality and sound projects that ensure adequate returns for debt servicing and on the confidence of creditors in Bangladesh's ability to service overall external debt;
- ❹ Inflows of quality suppliers' credit will also be a function of how well Bangladesh manages its changing external debt portfolio in future as the share of non-concessional finance increases;
- ❺ If state agencies and parastatals are the ultimate recipient of suppliers' credits, and projects lack adequate cost recovery mechanisms, such credits could simply end up becoming contingent liabilities of the government – a situation that must be

avoided in the interest of fiscal prudence;

- ❶ Where the private sector is the borrower, export/suppliers' credit would represent access to external financing capacity with some degree of concessionality in comparison to funds from capital markets or commercial loans.

7.5 When the private sector contracts non-concessional debt, such as suppliers' credit, questions of project viability and transparency of process diminish as concerns for public policy since these are matters for lenders to examine before reaching a credit agreement. The growing need for external finance by the private sector can be met only if the policy environment continues to be supportive, the financial system and service infrastructure are efficient and cost effective, and the economy's overall debt liabilities are commensurate with its foreign exchange earnings capacity. But when the public sector is the recipient of suppliers' credit, issues of project selection and economic viability, transparency in loan processing, as well as fiscal considerations, become critical. Bangladesh's low current debt service ratio creates the scope for taking on some more non-concessional debt to finance, say, viable high priority infrastructure projects. However, cross-country evidence has shown the importance of ensuring the cost-effectiveness and cost-recovery aspects of such projects with due regard to the debt-servicing capacities of concerned public agencies. In this context, due consideration needs to be given to the provision of adequate user charges and to ensuring that price-setting mechanisms cover all costs in the long run. In the interest of transparency and accountability, project outlays and debt-servicing expenditures on account of suppliers' credit need to be fully reflected in the budget.

7.6 Although this study recognizes export and suppliers' credit as a viable option for project finance in Bangladesh, -- in view of the country's growing future needs for external resources and in light of dwindling ODA -- it conditions that conclusion with a number of provisos and a strong note of caution. First, is the recognition that Bangladesh does not have and will not have access to international finance on commercial terms from the capital markets or commercial banks for some time to come. Second, although credit terms for suppliers' credit tend to be harder than traditional concessional loans for Bangladesh, such credits still offer more concessionality than commercial debt. Thus Bangladesh has a limited semi-concessional "window" for external finance to meet its needs for the medium and longer term. This "window of opportunity," however, could just as quickly turn into a "black hole" of debt with disastrous macroeconomic consequences. To avert such an outcome, sufficient caution and adequate scrutiny must be exercised in the matter of project selection and cost recovery, particularly by policymakers in the public sector. Taking advantage of the current high comfort level in the external debt burden of the country, any government that pursues politically mandated, costly and non-viable, infrastructure projects only to gain short-term political advantage would invite catastrophe. At all times, external debt management and regular monitoring is of paramount importance to keep the economy's debt burden under strict scrutiny.

7.7 Recommendations

This report finds that, in general, suppliers' credit received by public-sector agencies and parastatals, have not yielded good value for money due mainly to lack of transparency of process and to general reliance on single-source contracts instead of competitive bidding. Consequently, suppliers' credit might have been costlier than what the interest rate and other credit

terms would imply. If current trends persist, the economy's debt burden could rise to unsustainable levels with the debt service ratio tripling in a decade. Therefore, the utmost restraint is called for in the intake of suppliers' credit, particularly by the public sector.

a) Public Sector

1. Indeed, as long as concessional ODA resources are available, recourse to suppliers' credit for project finance should be discouraged. If, in fact, Bangladesh were to undertake some critical sector reforms, much higher levels of ODA would become available. And even treating suppliers' credit finance as a last resort option, officials in the public sector should come to a better understanding of the nature and usual terms of suppliers' credit.

2. They must also recognize that suppliers' and export credit can and generally are used in most other countries in conjunction with open tendering and competitive bidding. Officials also need a better understanding of the terms of the OECD Arrangement (as a reference point) so that they can more effectively analyze and assess the credit terms in particular contracts. Credit terms in OECD Arrangements could serve as benchmarks in Calls for Tender.

b) Private Sector

The possibilities for accessing credit from suppliers in other countries could be explained in a viable way (through the Chambers of Commerce) to both Bangladesh companies needing to import goods and services and also to the commercial banks involved in financing and trade.

c) Overall Policy

In order to make the best possible use of this source of international finance and not run into debt servicing problems, it is important that the government adopt

certain thresholds in terms of foreign exchange reserves or debt service ratios and strictly monitor inflows:

❶ **First**, a safe limit for foreign exchange reserves needs to be followed. **A three month import cover** is IMF's standard for most developing countries. **Non-concessional debt such as suppliers' credit should be allowed only when reserves exceed this threshold.**

❷ **Second**, if suppliers' credit is to be taken as a last resort, when concessional aid is unavailable, set a realistic ceiling on total suppliers' credit to be taken in any one year. The limits could cover three categories:

- ❶ **Short-term Trade Finance** – maximum credit terms of 1 or 2 years;
- ❷ **Private-Sector Credit** of 2 years or more;
- ❸ **Public-Sector Credit** of 2 years or more.

It is important that these **ceilings** be built into the stipulated resource envelope of ADP and the revenue Budget and that they channel the bulk of the inflows to the private sector. Model simulations in Section 6 indicate that, given a target debt-service ratio of 20 percent, in the Business-as-Usual scenario, the current pace of suppliers' credit will be in the range of \$500-700 million a year during 2001-10 and will result in an unsustainable external debt burden by 2007. Without sector reforms, fiscal sustainability is not ensured, since, with most credit-receiving parastatals being non-viable, their intake will eventually become contingent liabilities of the government.

❸ **Third**, systems to administer and monitor annual ceilings and sub-

Ceilings could, without difficulty or undue bureaucracy, be built onto existing procedures involving ERD, the Board of Investment and Bangladesh Bank, implemented through the Hard-Term Loan Committee.

- ① Fourth, the Hard-Term Loan Committee should examine the economic viability and debt servicing capacity of concerned agencies – public or private. In the case of public agencies, fiscal operations arising out of the suppliers' credit must be made transparent and kept from becoming off-budget financing items. Debt-servicing costs must be fully reflected in the development or revenue budget of the parastatals concerned and in the ADP, so that they make the extra effort for cost recovery.
- ① Fifth, to prevent suppliers' credit from becoming contingent liabilities, the practice of offering sovereign guarantees to each and every loan should be avoided.
- ① More generally, public debt obligations should be made fully transparent and effective mechanisms for monitoring and managing External Debt need to be developed. This would require making available timely and reliable figures on such debt – including, especially, the profile of repayments. Creditors and potential creditors are now increasingly interested in knowing the ratio of short-term external debt (including private debt) to foreign

exchange reserves. Just as important, external debt-servicing figures should include servicing of concessional as well as non-concessional debt, payments on FDI and repayments on account of export credits

Key message

Sustainability of 6-7 percent GDP growth for rapid poverty reduction requires finding adequate resources to finance investment in industry and infrastructure services, and the external resources to bridge the associated external deficit. Only deep and meaningful sector reforms can ensure sufficient flows of concessional funds – the least-cost debt for Bangladesh which needs to improve its absorptive capacity to take advantage of credit availability.. A standard instrument of project and trade financing, suppliers' credit is an instrument to be used as long as its use supports activities that benefit the economy and it flows in amounts consistent with debt-service sustainability. Suppliers' credit could be used in the public sector as an option of last resort, under stringent criteria of project viability. If sector reforms are not implemented, concessional aid flows are likely to dry up. The widespread resort to non-concessional finance such as suppliers' credit -- without regard to sound project fundamentals – could, however, land the economy in an unsustainable fiscal and external debt situation that could eventually constrain growth as well as poverty alleviation.

End Notes

- ¹ It is relevant to note that supplier credit finance of defense purchases need not be compared with the argument for continuation of reliance on concessional finance since such finance is not available for these purchases anyway.
- ² Arrears to the tune of \$15 million that appear in official debt figures are due to UN sanctions on Iraq, Bosnia and some dispute over suppliers' credit contract with China.
- ³ Debt service payments as a ratio of export earnings is 8.9 percent in FY99 and only 7.8 percent when workers' remittances are included.
- ⁴ The Maastricht limit for a prudent debt level for EU countries is 60%.
- ⁵ The Government's high-powered Hard-Term Loan Committee defines a hard-term loan as any foreign borrowing with interest rate of 4% or above, a repayment period of 7 years or less, that requires a down payment. By this definition, all supplier credit received can be described as hard-term loans.
- ⁶ Cost of debt is calculated by taking interest and profit repatriation as a percentage of total debt stock. Given the current profile of non-concessional debt, cost per unit of debt is expected to rise to 5.5% by 2010.
- ⁷ See Chapter VIII, *Bangladesh 2020 A Long-run Perspective Study*, The World Bank 1998.
- ⁸ Supplier credit is but one form of export credit. If the credit and terms of payment are set out in a contract between the supplier and buyer with no separate loan agreement, then the technique is supplier credit. However, if the credit terms are set out in a separate loan agreement, typically through a commercial bank, it is a buyer credit. Export credit and supplier credit will be used interchangeably in this report.
- ⁹ Officially Supported Interest Rates under OECD Arrangement (OECD 1998). The Arrangement provides a system of minimum fixed interest rates: the Commercial Interest Reference Rate (CIRR). This represents the minimum interest rates that Governments of exporting countries can support, based either on the 5-year Government bond yield for that currency or 3-, 5- and 7-year Government bond yields according to the length of credit. Countries select the option for the CIRR in their own currency. Sterling and most currencies are based on the 5-year bond yields; the US and Canadian Dollar and Dutch Guilder follow the "three-tier" system. These rates are adjusted monthly. There is still some potential for subsidy because the interest rate is supported throughout the life of the loan but the expectation is that there will be little, if any, net subsidy over time.
- ¹⁰ Portfolio of Aid Worthy Projects. Annual publication of the Planning Commission, Ministry of Planning.
- ¹¹ BTTB cited compulsions – in the absence of concessional resources - to meet public demand for telephones, not admitting that pending sector reforms would have obviated the need for such financing.
- ¹² Certain standard terms of credit are provided for under the Berne Union Agreements or the OECD Arrangement (OECD 1998), and it is these which could be stipulated (as a benchmark but not necessarily a limit) in the Call for Tender, i.e. stating the appropriate OECD or Berne Union credit terms applying to medium- and long-term business for Bangladesh. If there is any doubt about what is or is not regarded as appropriate, the relevant government agency can check with the OECD Secretariat in Paris.
- ¹³ A test of economic viability would be if a state agency can get access to supplier credit without needing a sovereign guarantee.
- ¹⁴ To determine maximum repayment periods, importing countries are classified under two categories, based on World Bank thresholds. Category 1 countries are those that have graduated out of IBRD facilities (a GNP per capita above \$5280 based on 1998 data). Category 2 consists of all other countries, including Bangladesh.
- ¹⁵ International Union of Credit and Investment Insurers currently has 46 members, 31 from OECD and 15 from non-OECD countries. The Union not only works for international acceptance of sound principles of export-credit and foreign-investment insurance; it also provides a vital forum for the exchange of information, experience and expertise among Members. Export credit offered by members of the Berne Union must be in accordance with guidelines set forth in the 1998 OECD Arrangement on Guidelines for Officially Supported Export Credits, which sets the maximum credit terms that will be supported/insured for particular kinds of goods and services.
- ¹⁶ The ICOR is assumed to remain constant at 4.5 throughout the projection years, except in the high-case reform scenario, where it gradually falls to 3.8 by 2010.
- ¹⁷ Remittance growth during 2001-10 is projected at 3-5 percent annually.
- ¹⁸ The Ministry of Finance set a critical limit of 18 percent for the debt service ratio in 1986. Analysts get increasingly concerned as the debt-service ratio rises, especially if it goes above 20%, almost triple the ratio in FY99.