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Paris Club Gives Serious Thought to Philippine Debt Proposal

The Paris Club of sovereign creditors has reportedly formed a special committee to evaluate the Philippines' debt-for-equity proposal, BusinessWorld reported on October 13.

The proposal, presented at the United Nations World Summit last month, is assured of the support of Italy and Germany, two stalwart members of the Club, according to Philippine ambassador to the U.N. Lauro L. Baja, Jr.

He said Italian Prime Minister Silvio Berlusconi and outgoing German Chancellor Gerhard Schroder have both promised to "give favorable consideration to the Philippine proposal once [it] is submitted to the Paris Club."

Paris Club President Jean-Pierre Jouyet has created a technical committee of experts to evaluate the proposal for presentation to the Club's 21 member states. A brainchild of Philippine House Speaker Jose de Venecia, the scheme does not seek debt forgiveness or new money. Instead, it asks creditors to plough back 50% of debt repayments to development projects like reforestation, mass housing, safe water systems, hospitals, infrastructure, or micro-financing. Ambassador Baja said participation by creditors is voluntary.

At the World Summit, U.N. Secretary-General Kofi Annan endorsed the radical proposal, calling it "a creative way of approaching the issue of external debt." Sen. Sergio Paez Verdugo, president of the International Parliamentary Union, promised to include the debt proposal in the agenda of the IPU executive council meeting in October in Geneva, Switzerland.

Back in the Philippines, Speaker de Venecia's proposal does not enjoy solid support, especially from the country's economic managers. Central Bank Governor Amando Tetangco Jr.
distanced himself from the proposal, fearing it might send a wrong signal to foreign creditors.

"The best approach is to grow out of debt which is what we're trying to do now," Mr. Tetangco told Manila Times in a recent interview. "We need foreign funding because domestic funding is not enough to finance the requirements of the domestic economy. So we need to borrow."

Finance Secretary Margarito B. Teves also told the Times his department won't endorse the debt-relief proposal. Instead of debt relief, the Philippines should refinance debt to multilateral creditors if the interest rates are lowered, he said.

Another way to lower debt is to reduce the country's budget deficit, according to Budget Undersecretary Laura B. Pascua, who said the country is currently paying a high premium because of its fiscal woes.

"We're paying a high premium of 400 basis points, higher than the other Asian countries that have the same case [as] RP," The Manila Times quoted her as saying.

The Philippines owes foreign creditors about US$44 billion and, for this year alone, will make US$4.5 billion in debt amortization.

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G-20 Backs New Strategies to Fight Poverty
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The Group of 20 is open to the idea of taxing air tickets and selling bonds to increase aid to Africa in the next five years, Bloomberg News reported on Oct. 17.

Financial leaders of the group of industrial and developing nations acknowledged the need to adopt new strategies to fight poverty and promote global stability, but they stressed participation should be voluntary.

Germany, France and other European Union (EU) countries had
proposed a compulsory levy on air tickets, but EU finance ministers failed to agree on the tax in May. Spain, in particular, opposed the plan because it would damage their tourism industries.

In July, the G8 leaders, in their meeting at Gleneagles, Scotland, pledged to double aid to Africa to US$50 billion a year by 2010, erase debts of the poorest nations and work toward dropping trade barriers that limit the flow of goods into rich countries.

Gordon Brown, the British Chancellor of the Exchequer, had suggested selling bonds backed by existing aid budgets to boost funding. Called the International Financing Facility, it makes it difficult for donors to renege on aid pledges because nonpayment will be treated as sovereign debt default, Bloomberg said. The U.S., however, prefers to funnel money through its Millennium Challenge Account, which ties aid to specific goals.

The G-20 said: "Innovative mechanisms for development financing, pursued on a voluntary basis, will generate additional resources." It urged members to "take concrete actions" towards increasing aid budgets to 0.7% of gross national income, called for fewer "unfair" trade barriers and urged support for nascent export industries in poor countries, Bloomberg said.

The full text of the G-20 Communique is available at http://bankrupt.com/misc/G-20Communique.doc

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The Role of the IMF in Safeguarding Global Financial Stability
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[Remarks of IMF Managing Director Rodrigo de Rato at the l'Institut International d'Etudes Bancaires (IIEB) Barcelona, Spain, on October 21, 2005.]

Thank you for inviting me to this distinguished gathering of top executives from banks across Europe. I welcome the opportunity -- only a few weeks after the Annual Meetings of the IMF and World Bank -- to share with you the Fund's assessment of the outlook for the global economy and potential risks for the international financial system. I will also describe some cornerstones of the Fund's recently issued Medium-term Strategy. Finally, in view of the importance of the interaction between the IMF and the private sector, I would like to offer some thoughts on how we can make the most of this dialogue in the future.

Assessment of Economic and Financial Risks

How do we at the IMF see the risks in the global financial system? In a nutshell: We believe the momentum of the global
expansion will be maintained and that inflation will stay under control. But the outlook is subject to great uncertainty, and the balance of risks is toward the downside.

The destruction caused by hurricanes Katrina and Rita is expected to slow U.S. economic growth somewhat in the last four months of 2005, but the economy retains considerable momentum, which reconstruction will reinforce in the first half of 2006. The Chinese economy, the other major pillar of the expansion, continues as strongly as ever, and the growth of emerging and developing economies as a group is still quite robust. Elsewhere, in particular in Europe, the growth outlook is less favorable than it was six months ago. While the Japanese economy appears to gain momentum, the pace of recovery in the Euro Area remains disappointing, underlining the need for policies to boost confidence and growth.

The principal risks in our current outlook are: first, the rising trend and volatility of energy prices and their potential impact on output and inflation; second, protectionism in the event that the Doha Round of negotiations were not to conclude successfully; third, a disorderly adjustment of the global imbalances; and fourth, the possibility of an sharp correction of the still rather favorable financial market environment. Let me comment briefly on the latter two risks.

The persistence of global imbalances has become an increasingly worrisome source of vulnerability in the medium-term. The question is not whether they will be reduced, but whether their reduction will happen in an orderly or a disorderly way. During the past year some progress has been made. Fiscal revenues in the United States have rebounded. The prospects for structural reform in Japan are brighter than for many years. And we have begun to see greater exchange rate flexibility in Asia. However, there is a need to move forward more decisively. The world needs to move away from a pattern of growth where investment in most of Asia is too low, high consumption in the United States is financed by rapidly increasing debt, and growth of domestic demand in Europe and Japan is too weak.

Many countries need to share the work of reducing global imbalances and sustaining growth.

(a) In Europe, there is a need to strengthen confidence. Governments need to articulate comprehensive, growth-oriented strategies that address both unemployment and aging, mainly through reducing the rigidities prevailing in labor, product and service markets. They should also extend the Single Market to the provision of services, including financial services.

(b) In emerging Asia, there is scope for greater exchange rate flexibility and increased domestic demand. The recent moves in China and Malaysia are welcome, and I hope that the authorities will use the flexibility afforded by their
new arrangements. I also hope that other countries in Asia which have been managing their exchange rates more flexibly will continue to do so. In addition, faster domestic demand growth in Asia through a continuation of structural reforms, to encourage investment, has to be part of an orderly adjustment process.

(c) As so often in the recent past, the U.S. economy has been one of the main engines driving global growth. But as the net external liabilities of the United States continue to increase, so do its external vulnerabilities. Therefore, the U.S. part of the equation on global imbalances—reducing the fiscal and current account deficits—is particularly urgent. The administration's plan to reduce the fiscal deficit is welcome, but the unprecedented cuts in non-defense discretionary spending that it requires would have been difficult to achieve even before the devastation wrought by Hurricane Katrina. I believe that actions on the revenue side, preferably through reforms to broaden and simplify the tax base, will also be needed.

In global financial markets, the risks are superimposed on a cyclical situation that has already lasted longer than expected. Credit conditions remain unusually favorable, including for sub-prime borrowers, and we expect the currently tight credit spreads to widen as the credit cycle peaks. The key question at this juncture is the speed and extent of the likely market corrections. Much uncertainty surrounds this question, especially since credit derivatives and collateralized debt obligations have played an important role in distributing and pricing risk. As these markets are not yet fully understood by all investors or supervisors, they need to be closely monitored. Nevertheless, over the last four years, the resilience of the global financial system has clearly strengthened. There are important buffers in the system that can serve as shock absorbers even when risks materialize:

(1) first, the much strengthened balance sheets of the financial and corporate sectors in many countries;

(2) second, the increased diversity of investors and their investment behavior;

(3) third, improved risk management, and the enhanced transparency and disclosure in financial markets;

(4) fourth, the wide dispersal of financial risk from banking to non-banking sectors; and

(5) last but not least, the inability of investors "to sit on the fence" for long; the bottom line for asset managers is: "no risk, no return"—therefore, to shun all risk is only a short-term or temporary option for them.

Turning to emerging market countries, it is encouraging to observe a reduction of crisis vulnerability and contagion over
the past year or two. This group of countries is benefiting from a substantial increase in private capital inflows. In aggregate this year, these should be almost comparable in magnitude to flows into the United States, but with a much higher proportion in form of foreign direct investment (FDI). These inflows are supporting the widespread build-up of reserves in many emerging market countries. This development is only partly due to favorable cyclical factors. It also owes a lot to improvements in the fundamentals of many emerging market economies. Their more sophisticated debt management and the greater development of local capital markets as well their recent ability to sell local currency debt to international investors have also played important roles. The diversification of the investor base for emerging market debt is facilitating those trends and contributing to the growing maturity of this asset class.

Nevertheless, in a situation in which the state of the global economy is generally good and when financial market conditions are very supportive, one of the biggest risks to beware of is complacency. Emerging market economies need to stay the course of prudent macroeconomic policies and structural reform. Strengthened fundamentals, in particular sustained fiscal efforts to bring down the debt burdens, are a key to reducing their vulnerability to external shocks. I also encourage policy makers in these countries to continue their pro-active debt management and to take further steps to develop local capital markets. If these endeavors prove successful, there may be less reason to fear that a slowdown in global growth or a correction in the global imbalances will actually lead to a sharp reduction in private capital inflows to emerging market economies.

The Fund's Medium-Term Strategy as it Relates to the Financial Sector

The Fund's Medium-Term Strategy, which I have developed over the past year, is based on one central tenet: helping the Fund's members meet the challenges of globalization. Nowhere have globalization and the changes it has brought about become more visible than in global financial markets. Financial globalization has pulled the world economy in a hugely beneficial direction, helping to allocate world savings to more productive and diversified investments. But it also has created new challenges, as the integration of capital markets has increased the size, speed, and reach of potential shocks across mature and emerging market economies. This has altered the context of the Fund's mission. Safeguarding the stability of the international monetary system is now a qualitatively and quantitatively different task than it was 15 years ago. The Fund must remain in step with a rapidly changing world. And our main activity -- surveillance -- has to adapt to capture more effectively the potential risks to systemic stability in a global marketplace.

The Fund's toolbox has already changed over the past several years. We have developed the Financial Sector Assessment
Program -- a systematic and comprehensive "health check" of our members' financial sectors. We have been promoting international best practice through Standards and Codes; this initiative serves as an important tool to help enhance the quality of economic institutions and improve the quality and transparency of data. We have developed better tools for assessing debt sustainability and fragilities in national balance sheets. And we created an International Capital Markets department, which regularly monitors and analyzes financial market developments and risks, in particular, through the Global Financial Stability Report (GFSR).

But much remains to be done: We will have to continue improving our "risk-reporting systems." Not the least with this in mind, the GFSR has recently begun to focus on the global asset allocation process. If we develop a better understanding of the forces and factors that drive the decisions to allocate or re-allocate assets by banks and institutional investors, we will be better able to anticipate shifts in capital flows across sectors and borders. In this respect, our surveillance is becoming ever more global, or "multilateral" as we say. In our surveillance work we therefore intend to better integrate global issues and country risk assessments. In other words, we need to optimize the matrix between "client coverage" -- in our case country work -- and product expertise, which, by definition, is global. The Managing Director of the IMF struggles in many ways with the same matrix organization issues that many of you around the table struggle with.

Dialogue Between the IMF and Private Sector

International capital flows are now overwhelmingly private flows of funds. Hence, learning from you and understanding the investment decisions of both financial and non-financial firms is critical for a comprehensive assessment and management of risk. Let me be clear: I do not envision the IMF as a global super-bureaucracy for regulating and supervising financial markets, but rather as a global forum in which those in charge of monitoring risk at the national level can meet and share their assessments. I see it as an institution that provides a "radar screen" which gathers all relevant information -- from public as well as from private sources -- to gain a fuller global view of risks in the system. And, on this basis, we should be better able to advise members on appropriate risk management strategies.

Risk and risk-taking are not something suspicious, but essential ingredients in an efficient vibrant market economy which should not be stifled. In fact, the system should include enough participants willing to assume and hold risk, not least to have enough players who provide market liquidity at times when it is most needed. And we need to ensure that there are adequate cushions to absorb risks. This is also one of the reasons why we have begun to weigh in on the international accounting debate.
Just as the Fund benefits from its dialogue with private financial institutions, the private sector can also benefit in many ways from the Fund:

(a) It is the only international institution that is capable of providing truly global systemic surveillance.

(b) Its activities are crucial for crisis prevention, in particular: by promoting best practice among its members on macroeconomic and financial policy; by fostering transparency; by helping to strengthen core economic institutions; and by setting broad incentives for improving the investment climate.

(c) Its lending facilities are available to help countries in crisis get their feet back on the ground when almost all other external financing has dried up.

As a general rule, we do not shout our judgments in the market place -- we see our role as that of a trusted advisor, helping our members become less vulnerable to external shocks or changes in market sentiment. One example is the increasingly successful effort to help countries develop their local capital markets. Local currency borrowing shifts foreign exchange risk to those who can better absorb it. As such, this is another chapter in the "risk transfer saga" that is being written as we speak.

The Fund's crisis lending and conditionality has been subject to much critical debate. But the fact is that the IMF is the only international body that can effectively help anchor crisis resolution strategies; this includes giving advice to members on complex debt operations. Our work has also given impetus to market initiatives, including the adoption of collective action clauses in sovereign bond contracts. Even so, recovery from financial crisis is a complicated endeavor, and among the priorities in the near future, we need to review the effectiveness of the Fund's instruments to facilitate crisis resolution, including the Lending Into Arrears Policy.

Integrated financial institutions like those assembled here today can also make major contributions to global financial stability:

(1) By continuing to make every effort to improve risk management in your key markets. I applaud the work undertaken recently (in the Counterparty Risk Management Policy Group II) under the chairmanship of Gerald Corrigan and encourage you to follow up speedily in the implementation of the report’s recommendations.

(2) By transferring know-how and strengthening corporate governance in the financial sector while operating in emerging market and developing countries; and

(3) By contributing to effective crisis resolution efforts, such as the development of the "Principles for Stable
Capital Flows and Fair Debt Restructuring in Emerging Markets." This initiative between private sector representatives and emerging market officials holds promise, especially, if it continues to gain broad support among all concerned parties.

Conclusion

The last two decades have witnessed tremendous change in the global financial system. Work on financial stability issues has moved to center stage across the IMF membership, in national and multilateral institutions alike, and rightly so. An efficient IMF is critical in this context, because it is the only truly universal institution that can monitor and assess the system as a whole and provide a platform for joint efforts by all participants in the system to strengthen its resilience. In 1944, the Fund was given the mandate to safeguard the stability of the international monetary system. This mandate is more relevant than ever today when the internationalization of finance has become a reality. Sustained success in performing this key task relies not only on the good interaction between the Fund and the policy makers in member countries; it also requires permanent efforts by the private sector to bolster market discipline.

Thank you for your attention!

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G-20 Calls for IMF, World Bank Revamp
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[Copy of G-20 Communique issued on October 16, 2005.]

We, the Finance Ministers and Central Bank Governors of the G-20, highlight the vital role the Bretton Woods Institutions (BWIs) should play in promoting macroeconomic and financial stability, economic growth, and poverty reduction. We recognize the need for the BWIs to be effective in delivering these objectives and believe that high standards of governance and internal management are critical. We welcome the IMF Managing Director's Strategic Review. More work is needed to develop a 'roadmap' for the future strategic reform of the BWIs, and we look forward to the work underway at the IMF to develop further details of the Strategic Review.
It is our shared view that more innovative approaches and renewed commitments are needed to cope with dynamic issues, such as growing international interdependence and interactions through trade and financial integration, uneven progress toward alleviating poverty and achieving the development goals of UN Millennium Declaration, prevention and resolution of international financial crises, and external shocks. Within this context, we agree upon the strategic importance for the BWIs to reinvigorate their fundamental missions and roles in meeting new challenges in a globalized world economy.

Mission of BWIs

We reaffirm the complementary roles that the BWIs are called to play, and recognize that promoting macroeconomic and financial stability and development continue to be of critical importance. Likewise, we believe there is a need to ensure effective pursuit of, and tangible progress towards, these objectives to further strengthen efficient cooperation between the two institutions. The IMF should primarily focus on national and international macroeconomic and financial stability, exercising enhanced surveillance of the global economy, international capital markets and strengthening crisis prevention and resolution. The World Bank should keep its focus on development, sharpening its financial and technical assistance roles for both least-developed countries and emerging markets. We welcome the review of the division of responsibilities launched by the two managements, taking into account external expertise, as part of the strategic review and look forward to their report to the International Monetary and Financial Committee (IMFC) and the Development Committee (DC) at the Spring Meetings in 2006.

Governance of the BWIs

The world economy has evolved considerably since the founding of the BWIs, with fast growth in many emerging markets and deepened integration in industrialized countries. We reaffirm the principle that the governance structure of the BWIs - both quotas and representation - should reflect such changes in economic weight. The G-20 underscores the critical importance of achieving concrete progress on quota reform by the next International Monetary Fund (IMF) and World Bank Annual Meetings in Singapore. The G-20 will seek to identify principles for quota reform, which could be an important input into the IMF's Thirteenth General Review of Quotas, scheduled to be completed by January 2008.

Management and Operational Strategies of the BWIs

We believe the IMF and the World Bank should work to enhance their institutional effectiveness, and that the strategic review needs to consider how to improve internal governance. The selection of senior management should be based on merit and ensure broad representation of all member countries.
We believe the BWIs should adjust their operations in a timely manner so as to meet the changing needs of their members, while maintaining their high quality standards and results-orientation. The BWIs should continue improving their lending frameworks, and consider ways to best meet their members' needs for financial assistance, while ensuring continued financial strength and minimizing moral hazard.

All G-20 members are committed to ensuring the continued role of the BWIs and will focus their efforts on strategic reform measures in the coming years. We will revisit these issues at our next meeting in Australia in 2006.

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T R O U B L E D   C O U N T R I E S
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ARGENTINA: Caracas Promises to buy US$500 Mln More Bonds
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Venezuela will buy an additional US$500 million in Argentine bonds next year, Venezuela's The Daily Journal reported on October 18.

The plan was outlined in the proposed 2006 budget submitted by Finance Minister Nelson Merentes, who said US$150 million of the debt had already been purchased. The additional bonds will adopt the same conditions as the previous transactions.

In May, Venezuela purchased US$100 million of 2012 Argentine bonds bearing a yield of 9.5%. This was followed by US$200 million in July. By next year, the country's total Argentine bondholding would reach US$1 billion, according to the Journal.

This buying spree is part of President Hugo Chavez's good neighbor policy of helping out countries in the continent and vow to check the dominance of the United States in the region. Caracas has now acquired about US$15 billion in sovereign debt from other countries, most of them in Latin America, the paper said. Pres. Chavez has also forged close ties with left-leaning presidents like Argentina's Nestor Kirchner, Brazil's Lula Silva, Chile's Ricardo Lagos and Cuba's Fidel Castro.

Mr. Chavez, who has a long-running feud with the Bush administration, has withdrawn about 60% of its official reserves from the United States, and deposited most of the funds at the Bank for International Settlements (BIS) in Basle, Switzerland.

Mr. Merentes did not say how and when the planned Argentine bond acquisition would be completed. As with previous transactions, the government will use revenues from oil to
purchase the bonds.

ARGENTINA: September Tax Collection Up 24% Year-on-year
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A huge jump in income tax and VAT revenues raised Argentina's tax collection by 24% in September, Reuters reported on October 3.

Taxes collected for the month totaled ARS9.89 billion (US$3.41 billion), up from ARS7.98 billion last year, as income tax revenues rose 38.4% and VAT by 23.4%. The government has predicted a record high tax collection of ARS100 billion this year and economic growth of 7% for the third straight year. Following the economy's collapse in 2001-2002, it has grown robustly every year, and for the first seven months of 2005 alone, it grew 8.9%.

"Federal tax revenue, which totaled ARS7.98 billion in September 2004, is closely watched by investors as a gauge of Argentina's solvency and ability to pay back debt after emerging this year from a massive sovereign default in early 2002," says Reuters.

Buenos Aires faces debt payments amounting to US$3.87 billion in the remainder of the year, of which US$2 billion is owed to the International Monetary Fund.

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Argentina faces debt payments equivalent to US$4.95 billion in the last quarter, MercoPress reported on October 13.

In October, US$1.1 billion in principal and interest will mature, another US$1.2 billion next month, and US$2.2 billion in December. Including debt already paid, total debt due this year is US$9.5 billion, of which US$1.6 billion represents interest.

Following the successful debt swap in February, in which 76% of bondholders participated, the nation's debt is now US$126.4 billion, down from US$144.4 billion in December 2001. This represents 70% of GDP, still in the vulnerable zone, according to MercoPress, but a significant improvement from 130% before the debt swap.

As of June, 46% of the total sovereign debt are in US dollars; 36% in Argentine pesos and 11% in yen, euro, sterling, Swiss francs and other currencies. Debt to multilateral organizations total US$27.4 billion, with the IMF holding US$11.21 billion, followed by the Inter-American Development Bank, US$8.75 billion; and the World Bank, US$7.33 billion.

Argentina still owes US$23.4 billion to bondholders who refused to participate in the debt swap. It is now negotiating another loan program to roll over its outstanding debt to the IMF.


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BRAZIL: Upgraded Rating Reflects Reduced Credit Vulnerability
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Moody's Investors Service has upgraded Brazil's foreign currency country ceiling for bonds and notes to Ba3 from B1 and the foreign currency country ceiling for deposits from B2 to B1. The foreign currency rating for government bonds was also upgraded to Ba3 from B1, while the local currency rating
for government bonds was affirmed at Ba3. All ratings have a positive outlook. Brazil's local currency guideline remains A3.

The rating agency said the upgrade reflects the presence of steady progress on several fronts in recent years that have combined to significantly reduce the country's credit vulnerabilities.

Moody's said Brazil's improved credit profile is supported by the presence of an economic policy framework that has shown itself conducive to a stable macroeconomic environment, and evidence of fundamental changes in the export sector that have come to strengthen Brazil's overall export performance.

Importantly, changes observed in the government's debt structure have served to mitigate sources of credit risks associated with exchange rate fluctuations, a major factor present in previous episodes of financial stress. Moody's also noted that recent domestic political events have served to confirm the presence of a newly acquired resilience by Brazil to shocks of a different nature.

The commitment by Brazilian authorities to fiscal responsibility has been evidenced by the presence of primary surpluses of a magnitude that has been consistent with the objective to bring about a decline in the government's debt ratios, which has occurred, though gradually. Because government debt ratios remain high in relative terms, Moody's indicated that further adjustments in the fiscal accounts will be required in the future.

Strong export growth has been a central factor in support of the reduction reported in Brazil's external debt ratios. Structural changes in Brazil's productive sector have served to increase the international competitiveness of the export sector, which, in comparison to other countries, benefits from diversified products and markets, a condition that serves to mitigate external shocks related to changes in the international environment.

In spite of this, Moody's noted that, in absolute and relative terms, Brazil's external debt burden remains sizeable and will continue to operate as a major constraint on the country's credit rating.

Changes in the government debt structure, a direct result of proactive debt management on the part of the authorities, have led to a shift in the government's credit risk profile, virtually removing as a source of credit vulnerability the financial impact that fluctuation in the exchange rate used to have in the government's debt service. This has come at the expense of increased exposure to domestic financial conditions, which may be reduced over time if the government is able to increase both the average maturity and the share of fixed-rate local debt.
Fitch Ratings on Oct. 11 revised the Outlook on Brazil's 'BB-' sovereign ratings (long-term foreign currency and long-term local currency) to Positive from Stable. This reflected the country's favorable trends in the balance of payments and external debt dynamics, as well as substantial progress in moderating inflationary pressures, holding out the prospect of lower real interest rates and underpinning future growth prospects. In addition, the Outlook revision is supported by the fact that the recent turmoil in Brazilian politics has not compromised the country's commitment to sound macro policy settings.

On Oct. 17, Fitch issued a Special Report entitled "Brazil: Rating Outlook Positive," which details the rationale for this Outlook revision.

"The improvement in Brazil's external solvency indicators has been impressive and is expected to continue. And, in spite of a strong currency, Brazilian exports continue to expand at a nice pace," said Roger Scher, head of Latin American Sovereign Ratings at Fitch.

Exports were up 23.4% in the year to September to US$86.7 billion, compared with a 19.6% increase in imports to US$54 billion, for a US$32.7 billion nine-month trade surplus, or US$41 billion over the last 12 months. Fitch has raised its forecasted trade surplus for year-end 2005 to US$40 billion from US$33.3 billion in July 2005, when Fitch issued a report on the Brazilian sovereign. The current account surplus is forecast at US$11.5 billion (or 1.4% of GDP) this year.

Net external debt (NXD) to current external receipts (CXR), a key external solvency indicator monitored by Fitch, should fall below 100% this year from 128% last year and a high of 308% in 1999. Still, Brazil's ratio compares unfavorably to the 'BB' median of 56.1%, though Brazil's NXD relative to GDP compares favorably against peers.

Even so, Fitch warns that despite the government's adherence to its primary budget surplus targets, the public debt burden remains high and of short duration and remains a constraint on
Brazil's sovereign ratings. Central to reducing the public debt and firmly anchoring public finances on a sustainable path is a reduction in real interest rates, which remain very high by international standards and impose large fiscal costs. In Fitch's opinion, establishing a consistent track record on appropriate monetary policy actions to meet the central bank's stated inflation target, including in the run-up to the presidential elections, would further enhance the credibility of the macroeconomic policy framework. This would support a sustained reduction in inflation expectations and real interest rates that would be beneficial both for growth and public finances. Likewise, central bank autonomy reform would underpin monetary policy credibility and therefore lower real rates.

"GDP growth should be higher next year than originally expected, due to lower real interest rates," said Mr. Scher. Fitch revised its 2006 GDP growth forecast to 3.5% from 3.2%.

Finally, while the corruption scandals that have rocked Brazilian politics since June of this year are far from resolved, there have been signs of late that Brazil's political leaders are not willing to compromise sound macro policy settings and economic performance as a result of pre-election power struggles. The Lula administration passed the LDO multi-year budget guidelines law in August, albeit two months later than is customary, with the budgetary spending and tax ceilings intact. Moreover, President Lula vetoed amendments to the LDO that would constitute policy slippage. Congress will ultimately vote on whether to uphold or override his vetoes. While the president may have difficulty putting through a 2006 budget this year, signs of his ability to govern have emerged, in spite of the corruption allegations. Such signs include the recent victory of his allies in the election for the leadership of the Chamber of Deputies.

"Fitch will closely watch whether President Lula can uphold his vetoes and pass a sound budget, or whether there will be fiscal policy slippage as a result of the current political crisis," Mr. Scher said.

Factors that could trigger an upgrade of Brazil's sovereign ratings include: exports and the balance of payments continuing to weather a strong Real, slower global growth and the possibility of increased risk aversion in the international capital markets; a fall in real interest rates underpinning sustained GDP growth rates of at least 3.5% per year; governability maintained in spite of the corruption investigations and the 2006 elections (underscored in the near term by passage of the Lula LDO vetoes and the 2006 budget), as well as continued fiscal restraint; and finally, greater certainty about the continuity of macro policies in the incoming administration.

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COLOMBIA: Ratings Unaffected by Pending Court Ruling

Standard & Poor's Ratings Services has affirmed its 'BB/B' foreign currency and 'BBB/A-3' local currency sovereign credit ratings on the Republic of Colombia. The ratings agency also said that the outlook on Colombia remains stable.

This affirmation takes place on the eve of a Constitutional Court ruling on an amendment and on an election guarantees law that would allow presidents to stand for a second consecutive term. Neither outcome of the ruling would affect the ratings.

"Standard & Poor's expects the main lines of policy on economic and security matters to be maintained regardless of who stands and wins the next presidential election in May 2006," said Standard & Poor's credit analyst Richard Francis. "Improved domestic security has underpinned domestic confidence and improved the country's investment climate."

Partly as a result, GDP growth has risen to more than 4% this year, and the general government fiscal balance has improved, falling to close to 3% of GDP in both 2004 and 2005 from nearly 4% in 2003.

Notwithstanding the improved economic prospects, the government faces significant challenges because of its high interest burden (nearly 16% of revenue), the need to increase military expenditure, and the rising cash deficits in the state-run pension systems. Furthermore, despite significant security advances, domestic confidence and thereby investment could falter if guerrilla warfare intensifies.

"Improved economic prospects--coupled with stronger external indicators--will underpin the ratings on Colombia over the next two years," Mr. Francis added. "However, the government's underlying fiscal position is constrained by large, legally mandated transfers to local governments and public pension
systems in addition to the interest on its debt. Therefore, tax hikes, transfer reductions, and pension reform will be needed over the next three years to maintain fiscal discipline. If fiscal prospects improve and the debt and interest burdens decline, the ratings could improve. On the other hand, fiscal slippage or a deterioration in national security could result in renewed downward pressure on the government's creditworthiness."

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DOMINICA: IMF Approves US$1.7 Mln Disbursement Under PRGF
---------------------------------------------------------
The Executive Board of the International Monetary Fund (IMF) has completed the fifth review of Dominica's performance under its three-year Poverty Reduction and Growth Facility (PRGF) arrangement. The Board also completed Dominica's financial assurances review, which is required in accordance with the IMF Guidelines on Conditionality to ensure adequate safeguards of IMF resources, and approved a waiver for the non-observance of a continuous performance criterion on non-accumulation of external payments arrears.

Additionally, the Executive Board approved a one-year extension of Dominica's repayment expectations to the IMF in a total amount equivalent to SDR1.3 million (about US$1.8 million) arising from December 22, 2005 through December 22, 2006. The repayments will now fall due exactly one year after these dates.

As a result of the Executive Board's completion of the fifth review, Dominica can draw an amount equivalent to SDR1.2 million (about US$1.7 million) under the PRGF arrangement, which will bring total disbursements to SDR5.4 million (about

Following the Executive Board's discussion of Dominica on October 14, Agustin Carstens, Deputy Managing Director and Acting Chair, issued this statement: "The Dominican economy has achieved a remarkable turnaround since the low-point of 2001-02, and is now set to record the second straight year of above average growth. The recovery is to a large extent a reflection of the authorities' successful implementation of their economic program and the resulting restoration of confidence. Continued progress with the reform agenda is essential to sustain the current momentum and address remaining vulnerabilities in the economy.

"The clearest evidence of the success of Dominica's adjustment program has been the marked strengthening of public finances. As a result, the public debt burden has been set on a downward course. Recent legislative changes will boost the efficiency of tax collection and increase the transparency of public finances.

"Public debt is still high, however, and fiscal policy will need to remain geared towards further debt reduction. The 2005/06 budget targets a primary surplus that appropriately balances the need to reduce debt with the need to reinstate the 5 percent cut in public wages introduced in the 2003/04 budget. Looking ahead, it will be important to continue targeting fiscal surpluses consistent with the objective of reducing debt to a more manageable level, including by a focused effort on containing the government's wage bill. Ideally, the aim should be to reduce the debt-to-GDP ratio to at least 60 percent over the next decade, which would provide an anchor for public expectations and improve the credibility of fiscal policy.

"Finalizing the debt-restructuring process will also help provide clarity to the debt issue. Dominica has made commendable progress in reaching collaborative agreements with most creditors, and continues to demonstrate good faith by depositing payments to nonparticipating creditors into escrow accounts under the restructured terms. It is a concern that agreements with the remaining nonparticipating creditors have not yet materialized. Although there appears to be progress in most cases, the recent actions by one outstanding creditor is unfortunate. As a result, continued efforts will be needed to reach a collaborative agreement and hence to complete the debt restructuring process in a timely fashion.

"A fundamental challenge going forward is to underpin the current growth momentum with further progress on structural reforms. Addressing remaining risks to public finances will be critical, including those from the large unfunded liabilities of the social security system. Removing bottlenecks that are impeding private investment should also be a high priority. This calls for reforming the electricity market to allow new entrants, rationalizing the existing
investment promotion agencies, and modernizing the land registration process to ensure comprehensive coverage. Indeed, over time, such reforms to create a more enabling business environment are more likely to stimulate private sector led growth than the current reliance on tax incentives. Reducing financial sector vulnerabilities by strengthening regulatory oversight will also be important for maintaining macroeconomic stability.

"The Dominican authorities are seeking to bring all the different elements of the reform agenda together in their forthcoming Growth and Social Protection Strategy document. The premise is that progress in lowering unemployment and reducing poverty will depend critically on consolidating gains made in macroeconomic stabilization and on fostering a more conducive business environment. With the rebound in economic activity, the government is in a good position to carry out an ambitious reform agenda that will have a lasting impact on the economy. The international community, in turn, should actively support the authorities' efforts and objectives," Mr. Carstens said.

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DOMINICAN REPUBLIC: Draws US$139 Mln from IMF Stand-by Loan
-----------------------------------------------------------
The Executive Board of the International Monetary Fund (IMF) has completed the first and second reviews of a 28-month SDR437.8 million (about US$631.7 million) Stand-By Arrangement with the Dominican Republic approved on January 31, 2005 and granted waivers for the nonobservance of the continuous performance criterion on the non-accumulation of new external payments arrears and of seven structural performance criteria for the period end-February 2005 to end-July 2005. The Executive Board also granted a waiver of applicability for the end-September 2005 quantitative performance criterion on the balance of the non-financial public sector. In addition, the Board completed a review of the country's financing assurances Completion of the reviews will enable the Dominican Republic to draw immediately up to an amount equivalent to SDR96.32 million (about US$139.0 million).

Following the Board's discussion of the Dominican Republic on
October 17, Agustín Carstens, Deputy Managing Director and Acting Chair made the following statement:

"The Dominican Republic authorities' strong macroeconomic policies under the Fund-supported economic program have resulted in a significant improvement in economic conditions, including rapid economic growth, low inflation, and higher international reserves. The fiscal balance has improved, creating the basis for the achievement of the program's objectives for 2005. The authorities should continue monitoring expenditure closely in order to facilitate the transition to the more ambitious fiscal objectives for 2006.

"Looking ahead, several challenges need to be addressed to consolidate the progress made thus far. The timely passage of the tax reform legislation is essential to maintain the revenue base in light of the expected revenue losses following the implementation of Dominican Republic-Central American Free Trade Agreement and the elimination of the foreign-exchange commission and the financial transactions tax. The tax reform will also improve the equity and efficiency of the tax system. On the expenditure side, the authorities will need to maintain strong discipline by restraining public sector wages, limiting the earmarking of revenue, and prioritizing investment spending.

"Subsidies to the electricity sector will need to be substantially reduced. To address the weak performance of this sector, the authorities have appointed private managers for state-owned distributors, who will implement much-needed reforms to increase the cash recovery indices of distributors and rationalize staffing levels.

"The central bank has been successful in quickly bringing down inflation and restoring the credibility of monetary policy. The central bank needs to continue improving monetary policy management and communication.

"The authorities have made significant progress in restructuring the external debt with minimum disruption to market relationships. Their market-friendly approach in conducting the successful debt exchange and in discussing debt restructuring with private creditors will help promote renewed access to international capital markets.

"In the structural area, challenges for 2006 include the introduction of reforms to address a wide range of governance and transparency weaknesses in the fiscal, monetary and banking sectors. Approval of proposed legislation to overhaul public sector financial management procedures and centralize fiscal functions in one cabinet post will be key to address institutional weaknesses that presently hinder the planning and execution of fiscal policy. Plans to strengthen the central bank will improve its ability to conduct an independent monetary policy aimed at keeping inflation low. Progress already achieved in the banking regulatory framework will need to be complemented by further strengthening bank
supervision. Implementation of consolidated accounting and supervision will be key to ensure adequate capitalization levels in the banking sector," Mr. Carstens said.

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DOMINICAN REPUBLIC: Paris Club Resets Debt due this Year
--------------------------------------------------------
On 21 October 2005, the Paris Club concluded an agreement with the Government of the Dominican Republic. This agreement consolidates around US$137 million of maturities falling due in 2005. This rescheduling is expected to reduce debt service due to Paris Club from US$357 million to US$222 million.

Paris Club creditors welcomed the completion of the 1st and 2nd review under the IMF Stand-by arrangement approved on 31 January 2005; they also welcomed the success of the private debt restructuring completed by the authorities of the Dominican Republic, in conformity with the principle of comparability of treatment. This consolidation is expected to make an important positive contribution to the Dominican Republic's economic outlook and to strengthen its external position.

Paris Club creditors welcomed the measures of adjustment in the economic and financial programme undertaken by the Government of the Dominican Republic and stressed the importance they attach to the continued and full implementation of this programme. The rescheduling is conducted under the so-called "Classic terms": claims are to be repaid progressively over 12 years, including 5 years of grace. ODA loans will be rescheduled at a rate not higher than the interest rate of the original loans. Other loans will be rescheduled at a market interest rate (known as "appropriate market rate") defined on the basis of risk-free rates for the currency considered.
On a voluntary and bilateral basis, each creditor may also undertake debt for nature, debt for aid, debt for equity swaps or other debt swaps. Paris Club creditors will review the external financing needs of the Dominican Republic in December 2005 in connection with satisfying the conditions for the 3rd review under the IMF Stand-by Arrangement with a view to providing additional relief in 2006, if needed, to support the programme.

Background Notes

The members of the Paris Club, which participated in the reorganization of the Dominican Republic's debt, were representatives of the governments of France, Germany, Japan, Spain and the United States of America. Observers at the meeting were representatives of the governments of Belgium, Canada, Denmark, Italy, Norway, Switzerland, as well as the IMF, the International Bank for Reconstruction and Development, the Inter American Development Bank, the European Commission and the Secretariat of the UNCTAD. The delegation of the Dominican Republic was headed by Juan Temistocles Montas, Technical Secretary of the Presidency and Vicente Bengoa, Secretary of Finance. The meeting was chaired by Mr. Ramon Fernandez, Deputy Assistant Secretary at the Treasury and Economic Policy Department of the French Ministry of Economy, Finance and Industry, Vice President of the Paris Club.

Technical Notes

(1) A Stand-by Arrangement was approved by the International Monetary Fund on 31 January 2005.

(2) The stock of debt owed to Paris Club creditors as at 1 September 2005 was estimated to be US$2,047 million, out of which US$733 million of pre-cut off date debt, and US$1,314 million of post-cut off date debt. The cutoff date (30 June 1984 for the Dominican Republic) is used by Paris Club creditors for the sole internal purposes of the Paris Club agreement for official bilateral creditors. When a debtor country first meets with Paris Club creditors, the "cutoff date" is defined and is not changed in subsequent Paris Club treatments and credits granted after this cutoff date are not subject to rescheduling. Thus, the cutoff date helps restore access to credit for these debtor countries.

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ECUADOR: Selling US$500 Million New Bonds

Ecuador has revived its bond offering, which was abandoned in April amid a political crisis.

Quito will issue US$500 million worth of bonds, lower than the US$750 million originally planned, according to Finance Undersecretary Alexis Valencia. In a paid advertisement in the New York Times on October 4, the government gave banks until October 14 to present offers to manage the issue.

The bond sale will take place in the first week of December. Proceeds will be used to refinance existing debt, Mr. Valencia said. The new bonds will be issued in the U.S. and other markets, possibly including Europe. S&P has removed the country's long-term sovereign credit rating from CreditWatch, citing reduced risk of a shortfall in government financing.

"The conditions are right because levels are back to those of April," Mr. Valencia told Bloomberg in a telephone interview. "That's why we are doing this now."

Protesters forced President Lucio Gutierrez to resign on April 20 and elevated Vice President Alfredo Palacio to his place.

Demand

"It's an outrageous risk to take," Jaime Valdivia of Emerging Sovereign Group, who manages US$230 million of emerging market assets, told Bloomberg. Asked if there's demand for the bonds, he said, "There will be interest . . . because anything goes; there is no regard for fundamentals." He may buy a 10-year bond at 12 percent yield, he said.

One likely buyer is Venezuela, which has pledged to buy as much as US$500 million of Ecuador debt, according to Deutsche Asset Management's Edwin Gutierrez, who helps manage US$1.7 billion in emerging-market debt, including those of Ecuador.

"I guess everyone expects that the regional lender of last resort, Chavez, may be involved in a new issue, which of course provides a technical underpinning to any potential issue," he told Bloomberg in a separate interview.

This is the first bond offering of Ecuador since defaulting on US$6.5 billion of debt in 1999 and issuing global bonds due 2012 and 2030 as part of a restructuring in 2000. Yield on the benchmark 2012 bond rose to 11.994% on Oct. 4.
Ecuador looks good in the short term, an IMF assessment said late September.

The country, whose incumbent administration has vowed not to accept dictates from outsiders including the IMF, just needs to keep tight rein on spending to stir away from trouble. "The short-term view is broadly positive. But significant concerns remain about Ecuador's policy framework and medium-term outlook," the assessment letter from the IMF reads.

The same letter notes that "underlying fiscal performance has been weakening, reflecting rising primary spending, recently stimulated by expansionary expenditure policies." It cautioned against spending too much in the run up to the 2006 presidential elections.

Ecuador is not seeking an IMF loan, but needs the Fund to review its economic reform progress on a quarterly basis to receive loans from other organizations, including US$400 million from the Latin American Reserve Fund. A sovereign bond offering of US$500 million later this year should keep the company stable in the immediate future, says the IMF.

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Standard & Poor's Ratings Services affirmed on Oct. 4 its 'CCC+' long-term sovereign credit rating on the Republic of Ecuador and removed it from CreditWatch with negative implications, where it was placed on Aug. 23, 2005. Standard & Poor's also said that the outlook on Ecuador is stable.

The rating action reflects the approval of a US$400 million loan from Fondo Latinoamericano de Reservas (FLAR), which reduces the near-term risk of a shortfall in government financing.

"Access to financing from FLAR mitigates revenue losses associated with the shutdown of oil production in August," said Standard & Poor's credit analyst Lisa Schineller. "Eventual disbursement, pending approval of Ecuador having a Central Bank board of directors in place, eases near-term..."
financing pressures."

In October, a significant amount of locally issued government debt comes due, which is not expected to be fully rolled-over, and in November, interest is due on its global 2012s.

Although the political backdrop in Ecuador remains fragile given a highly divisive political environment and limited support for President Alfredo Palacio, social tensions have stabilized. In addition, an economic team is working to improve relations with multilateral creditors and secure adequate financing for the remainder of 2005 and 2006.

"Creditworthiness could improve with consistent policy signals backed by prudent fiscal performance that, in turn, restore confidence in government policy and improve the outlook for access to financing," noted Ms. Schineller. "Conversely, the ratings could come under downward pressure amid signs of fiscal slippage and increased financial stress for the sovereign."

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GRENADA: S&P to Raise Rating to 'B-' Upon Debt Swap Completion
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Standard & Poor's Ratings Services on Sept. 28 assigned its 'B-' rating to Grenada's proposed step-up U.S. dollar and Eastern Caribbean (EC) dollar bonds due Sept. 15, 2025. (The size of the issue will be determined by the participation rate in the proposed debt exchange, which has an Oct. 7, 2005, participation deadline.)

The rated bonds will be tendered in exchange for the following rated defaulted securities: US$100 million 9.375% bond due 2012, and US$41.5 million 7.15% bond due 2014; and for approximately US$47 million and EC$238 million (or US$88 million) of unrated securities.

Upon completion of the exchange offer, Standard & Poor's expects to raise its long-term foreign currency sovereign
credit rating on Grenada to 'B-' from 'SD', its long-term local currency sovereign credit rating to 'B-' from 'CCC', and its short-term foreign currency rating to 'C' from 'SD'. The new ratings will incorporate Standard & Poor's expectation that the successfully completed debt restructuring, combined with the ongoing strong donors' support and necessary fiscal adjustment, will alleviate fiscal pressure and the government's debt service.

According to Standard & Poor's credit analyst Olga Kalinina, all of Grenada's external bonds, domestic and external commercial loans, all but one domestic bond, and five of the sovereign's 17 guaranteed claims are included in the exchange offer. The offer excludes bilateral and multilateral debt and the government's Treasury bills.

"The principal amount of the new bonds will equal that of the exchanged obligations (US$277 million) plus the interest accrued but unpaid on them through Sept. 15, 2005," said Ms. Kalinina. "At the same time, the new bonds will have longer maturities and a lower average coupon than the sovereign's original debt obligations; specifically, the offered step-up schedule envisages an interest rate on new bonds of 0.85% payable during the first three years (2005-2008) and then rising to 8% by 2015."

The ratings on the new bonds are contingent upon the successful completion of Grenada's debt exchange, with the tender of at least 85% of the total principal amount of eligible claims required for the closure of the offer.

"Grenada's new bond rating is constrained by a high government debt burden and large fiscal deficits, as well as by the continuing challenge of restructuring the island's economy, which was devastated by Hurricane Ivan," Ms. Kalinina noted. "However, Grenada's economy is expected to enter a recovery phase in 2006, reflecting the rebound of tourism and agriculture. The rating is also supported by the government's expected commitment to prudent fiscal management."

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INDONESIA: Reopens 10-year Bond Issue to Raise US$750 Million

Jakarta has tapped Citigroup Inc., Credit Suisse First Boston and Merrill Lynch to manage a two-tranche bond offering worth
US$1.25 billion, Dow Jones Newswire said on October 5.

The country hopes to raise a minimum of US$750 million from the 10-year, January 2016 bonds with a yield of between 7.625% and 7.75%; and US$250 million from the October 2035 bonds with a yield of 8.625% to 8.75%. The final size of the offering will depend on the demand.

The 10-year issue is the second for the year. The first issue in April raised US$1 billion and was priced at 3.02 percentage points over comparable U.S. government debt. Indonesia will use the proceeds to finance the budget deficit, which has widened this year as higher oil prices increased government subsidies on fuel.

The purpose of the 30-year tranche is to extend Indonesia's yield curve, the same way it has other emerging-market economies like the Philippines, Venezuela and Brazil, DJ Newswire explains.

"It was a natural progression for Indonesia to tap the long-dated part of the curve," an unnamed banker told DJ Newswire, pointing to likely demand from pension funds and insurers for a credit that is still relatively rare on the international market.

The finance ministry opted to raise the money abroad because local investors are demanding unattractively high yields. Domestic 10-year bonds yield 15% above comparable U.S. Treasuries, according to the report.

Indonesia is the only net importer of oil among members of the Organization of Petroleum Exporting Countries. It subsidizes fuel to artificially lower local prices, a policy that's eating up the state budget now that oil prices are at historic highs. S&P has cut its outlook on the country's 'B+' sovereign rating to Stable from Positive, citing the government's failure to respond to a tumbling rupiah and the rising cost of maintaining hefty fuel subsidies.

President Susilo Bambang Yudhoyono has since raised interest rates and fuel prices. The central bank raised the key SBI rate by one percentage point to 11% on Oct. 4.

In related development, the IMF hailed Jakarta for cutting fuel subsidies, calling it a "wise and courageous" decision, Agence France-Presse says. The Fund said the move should shore up investor confidence in the country.

"This has been an extremely good step in the right direction," IMF Chief Economist Raghuram Rajan told the Singapore Press Club earlier this month. "The subsidies were weighing on the government's fiscal account and there were concerns being expressed by both international and domestic investors," he said, adding that Jakarta's move to raise interest rates should control inflation.
"I think the problem when governments absorb the price of fuel . . . the question is when do they stop? And with Indonesia it was amounting to 3.0 percent of GDP (gross domestic product) approximately," he said, adding, "We welcome this step and we think it is something that many countries in the region should adopt."

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INDONESIA: S&P Rates Proposed Global Bonds 'B+'
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Standard & Poor's Ratings Services on Oct. 4 assigned its 'B+' rating to Indonesia's (foreign currency B+/Stable/B; local currency BB/Stable/B) proposed US$1.25 billion global bonds. The bonds will be issued in two tranches -- one tranche of at least US$750 million maturing in January 2016, and a second tranche of at least US$250 million maturing in October 2035. The sovereign ratings on Indonesia are supported by the country's declining debt and debt-serving burden, its track record of conservative fiscal management, and adequate external liquidity.

The administration of President Susilo Bambang Yudhoyono has demonstrated its commitment to fiscal consolidation begun by previous governments.

Agost Benard, Credit Analyst, Standard & Poor's, said, "Although the government's belated response to the damaging effects of the fuel subsidy highlighted weaknesses in policy formulation and coordination, the average 126% fuel price rise on Oct. 1, sent a positive signal in its robustness. Notably, the measure also had strong parliamentary support."

The price rise should allow the government to cap its fuel subsidies for 2005 at Indonesian rupiah (Rp) 89.2 trillion (US$8.8 billion; 3.4% of GDP). This should enable the government to continue reducing its fiscal deficit to 0.9%-1.1% of GDP this year from 1.3% in 2004, and to register a primary surplus of about 1.2% of GDP.

Ongoing primary fiscal surpluses enabled a steady fall in public sector indebtedness over the past four years. Gross public sector debt is expected to fall to a projected 61.0% of GDP by the end of 2005, from 94.6% in 2001. By reducing consumption distortion and hence import demand, the lower subsidies will also ease pressure on the balance of payments, cutting the estimated monthly US$1 billion spent on oil
imports before the price rise. Nevertheless, Indonesia's retail fuel prices on average remain about 45% below world prices. The deficit target therefore remains vulnerable to further rises in oil prices and interest rates, although these are not expected to reverse Indonesia's medium-term progress toward an eventual balanced budget.

The ratings on Indonesia are also supported by adequate external liquidity, despite the fall in reserves this year after central bank intervention to support the rupiah, and debt repayments. Its foreign reserves were at US$30.2 billion as of September 2005, up from US$27 billion in 2001, and short-term debt was negligible. As a result, even with smaller current account surpluses, the ratio of gross financing requirement to reserves is forecast to remain a low 60% for 2005. This indicates its short-term liquidity position is strong compared with its peers.

Standard & Poor's expects Indonesia to maintain adequate external liquidity with ongoing current account surpluses, improved investment flows on the back of diminished political uncertainty, and reforms under the new administration. The ratings on Indonesia are constrained by its still-high external leverage. Public sector net external debt was about 60% of current account receipts in 2004. Although this is lower than the median level in similarly rated countries, it presents a heavy amortization profile and remains a source of ongoing external vulnerability for the medium term.

The ratings are also limited by the country's below-potential economic growth, which averaged a relatively modest 4.1% in the past five years. Although growth accelerated in the first half of 2005 to 5.9% year on year, elevating Indonesia's economy to a higher growth path needs a sustained rise in its low investment ratio, which remains below 20% of GDP. This, in turn, hinges on the government's success in improving the investment climate and competitiveness by implementing broad microeconomic reforms, particularly in the judicial, legal, and labor market areas.

Mr. Benard further said, "Without such reforms, Indonesia's economy will continue to underperform, posing a challenge to social and political stability. Nevertheless, progress in these areas -- the latest example being the timing and implementation of fuel price rises -- speaks to a pattern of incremental steps and slow implementation."

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IRAQ: Italy Cancels 80% of Debt
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The Government of Iraq signed on October 6 a bilateral agreement with Italy canceling the equivalent of US$2.4 billion of Iraqi debt, amounting to 80% of Italy's claims against Iraq. The bilateral agreement implements the Agreed Minute concluded in November 2004 between Iraq and eighteen Paris Club creditor countries.

This is the third bilateral agreement that Iraq has signed with Paris Club creditors. In December of last year, the United States of America cancelled the entirety of its claims and Canada cancelled 80% of its claims against Iraq in June.

Prior to this agreement, the claims of the Italian government against Iraq totaled approximately US$3 billion. When fully phased in, the agreement will reduce this debt stock to approximately US$600 million. The debt reduction will take effect in three installments. Approximately US$900 million will be cancelled immediately; a second installment of approximately US$900 million of debt cancellation will automatically become effective upon the signing by Iraq of a formal stand-by arrangement with the International Monetary Fund (expected by the end of the year); and a final installment, equal to approximately US$600 million, will automatically take effect upon completion of the stand-by arrangement. The residual debt stock will be repayable over a 23-year period with 6 years of grace on principal payments. No principal or interest will be payable during the first three years.

"The conclusion of a bilateral agreement with the Italian government is another positive development for Iraq's debt management," said Iraq's Minister of Finance Ali A. Allawi. "Iraq appreciates the constructive approach taken by Italy throughout the negotiations of this agreement."

The other countries comprising the Paris Club creditors of Iraq are Australia, Austria, Belgium, Denmark, Finland, France, Germany, Japan, the Republic of Korea, the Netherlands, Russia, Spain, Sweden, Switzerland and the United Kingdom. Bilateral agreements between Iraq and each of these countries are expected to be signed by the end of the year.

In related development, Russia's Finance Minister Alexey Kudrin says teams from both sides are still reconciling Baghdad's debt to Moscow. Initially, this debt had been estimated at US$10.5 billion, but the loss of key documents and a host of other reasons have made it difficult to arrive at a final figure. Moscow is willing to go beyond the Paris Club framework and forgive as much as 90% of Iraq's debt, Mr. Kudrin says.
IRAQ: Referendum on Constitution Draws Record Number
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The referendum on Iraq's new constitution drew 63% of the nation's 15.5 million registered voters, according to The Associated Press.

The turnout was slightly higher than in January's parliamentary elections in which only 58% participated. The results were still uncertain as of this writing, but election commission sources say there were more "yes" votes than "no".

For the constitution not to pass, the Sunni Arabs who oppose it must gain a two-thirds majority in three provinces, AP says. Insiders at the Independent Electoral Commission of Iraq say only two provinces -- Anbar and Salahuddin -- delivered for the Sunnis. Anbar, which stretches for hundreds of miles west and northwest of Baghdad, includes Ramadi, Qaim and Haditha, all hotbeds of the insurgency. Salahuddin, which delivered the highest turnout, about 88%, includes Saddam Hussein's hometown of Tikrit and the insurgency strongholds of Samarra, Balad and Beiji.

Initial figures leaked by election officials show 16 of 18 provinces voting "yes," with the northern Kurdish province of Irbil delivering the highest turnout at 90%. The result did not surprise anyone as the Shiite majority and the Kurdish minority, which stand to benefit from the constitution, make up 80% of the population.

Still, a team of Iraqi and international officials are looking into allegations by Sunnis that the election was fraught with irregularities. The Election Commission, which is conducting an audit of the results, would not say which results are being challenged by the Sunnis.

>From the outset, the Sunnis, who account for only 20% of Iraq's estimated 27 million people, have opposed the charter, arguing that the extent of federalism enshrined in the document could lead to the country's eventual breakup and that it fails to clearly state Iraq's Arab identity, AP says.

Regardless of the result, Iraqis will again vote in a general election on December 15 to elect a full-term parliament, if the charter passes, or an interim parliament that will again draft a new constitution.
KYRGYZSTAN: Passes First Review of PRGF Arrangement

The Executive Board of the International Monetary Fund (IMF) completed on Oct. 25 the first review of the Kyrgyz Republic's economic performance under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement. This enables the Kyrgyz Republic to draw an amount equivalent to SDR1.27 million (about US$1.8 million).

The Executive Board approved the three-year arrangement on February 23, 2005, which became effective on March 15, 2005, for a total amount of SDR8.88 million (about US$12.8 million) to support the government's economic program for 2005-2007.

Following the Executive Board's discussion of the Kyrgyz Republic, Mr. Agustin Carstens, Deputy Managing Director and Acting Chair made the following statement: "The authorities are to be commended for preserving macroeconomic stability and keeping the PRGF-supported program on track despite the difficult political environment. As economic growth has slowed recently, it will be important to maintain strong performance under the program in order to boost confidence and help turn around the recent weakening of business sentiment.

"The new government's commitment to combating corruption and promoting private sector development is particularly welcome. Concrete results are now needed to gain credibility in the fight against corruption. Progress in raising tax collections and in reducing the energy sector's financial imbalances will be important measures of the success of this effort.

"Successful implementation of the fiscal program continues to be an important challenge. The tax reforms envisaged in the program -- in particular the lower income and payroll tax rates -- should go a long way toward improving the investment climate. The new government's realistic approach in preparing the 2006 budget is encouraging, and prompt approval by parliament of the proposed budget would send a clear signal of the country's continued commitment to a prudent fiscal policy. The authorities should also adhere to their commitment to enhance transparency in the mining sector under the Extractive Industries Transparency Initiative.

"While the central bank has been successful in containing inflation and maintaining stability in the foreign exchange market, further progress is needed in deepening the securities market to enhance the potential of indirect monetary instruments. It will also be important to take concrete steps to strengthen the independence of the central bank, in line
with the authorities' pledge to improve governance in public institutions.

"The Paris Club debt restructuring agreement has improved the prospects for debt sustainability and offered welcome breathing space. It is essential that the authorities pursue strong stabilization policies and maintain a cautious external borrowing policy, given the still high debt levels," Mr. Carstens said.

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The PRGF is the IMF's concessional facility for low-income countries. PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners and articulated in a Poverty Reduction Strategy Paper (PRSP). This is intended to ensure that PRGF-supported programs are consistent with a comprehensive framework to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent and are repayable over 10 years with a 5-year grace period on principal payments.

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NIGERIA: IMF Approves Two-year Policy Support Instrument
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The Executive Board of the International Monetary Fund (IMF) approved on Oct. 17 a two-year Policy Support Instrument (PSI) [*] for Nigeria under the IMF's newly created PSI framework, and which is intended to support the nation's economic reform efforts.

Nigeria's PSI is based on the National Economic Empowerment and Development Strategy (NEEDS), Nigeria's Poverty Reduction Strategy, and focuses on rapid and sustainable non-oil growth and poverty reduction. The PSI will assist Nigeria to develop a well-articulated and sound policy framework, including prudent macroeconomic policies, a strengthening of institutions, and ensure a governance structure conducive to private sector activity. Approval of a PSI for Nigeria signifies IMF endorsement of the policies outlined in the program.

The IMF's framework for PSIs is designed for low-income countries that may not need, or want, IMF financial assistance, but still seek IMF advice, monitoring and endorsement of their policies. PSIs are voluntary and demand driven. PSI-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners and
articulated in a Poverty Reduction Strategy Paper (PRSP). This is intended to ensure that PSI-supported programs are consistent with a comprehensive framework for macroeconomic, structural and social policies to foster growth and reduce poverty. Members' performance under a PSI is normally reviewed semi-annually, irrespective of the status of the program.

In commenting on the Executive Board decision, Ms. Anne O. Krueger, First Deputy Managing Director and Acting Chair, stated:

"Over the past 18 months, Nigeria has made commendable progress in implementing its economic reform program, aimed at accelerating economic growth, reducing poverty, and meeting the Millennium Development Goals. More recently, the authorities requested a Policy Support Instrument in support of a comprehensive reform program based on their National Economic Empowerment and Development Strategy.

"The authorities' program is designed to sustain and strengthen macroeconomic performance and encourage economic growth and diversification with front-loaded structural reforms. The program emphasizes pro-growth and export-oriented reforms that—along with prudent fiscal, exchange rate, and monetary management—will boost external competitiveness over the medium term. It is formulated with quantitative and structural assessment criteria that reflect policies meeting the IMF's standard of upper credit tranche conditionality, the same policy standard that would warrant IMF financial support beyond the first credit tranche. The continuing close relationship with the Fund envisaged under the PSI should support Nigeria in developing a well-articulated and sound policy framework and implementing the next phase of reforms, and promote and facilitate private sector activity and debt relief.

"A key challenge going forward will be to maintain an appropriate stance and mix of fiscal and monetary policies, in view of the importance of reversing the upsurge in inflation that was associated with the expansionary monetary and fiscal policies in early 2005. While the government is committed to containing spending in 2005 below budget appropriations, the projected increase in spending is still large, and the resulting fiscal expansion will place more of the burden of controlling inflation on the central bank. Following the failure to sterilize the buildup of excess liquidity in the first half of the year, the Central Bank of Nigeria (CBN) has recently taken stronger measures to reduce money growth—including increased sales of foreign exchange, more aggressive open market operations, and a further increase in cash reserve requirements—which have put the year-end monetary targets within reach. In addition, the prospective adoption of a 2006 budget that reduces the primary non-oil deficit well below the projected outturn for 2005 will further improve the policy mix. At the same time, the government aims to strengthen expenditures on poverty-related programs, allocating an extra
US$1 billion to well-defined programs related to the Millennium Development Goals.

"The authorities have initiated a broad and ambitious structural reform program aimed at improving public service delivery and the business environment. The program includes measures to strengthen budget procedures, advance civil service reforms, restructure the banking system, unify foreign exchange markets, rationalize the external tariff system, and improve governance and transparency. The authorities' recent decision to allow oil marketers to increase gasoline prices by about 25 percent will help reduce allocation distortions and implicit subsidies.

"Implementation of the agreement in principle that Nigeria has reached with Paris Club creditor countries should improve investor confidence and free up resources for poverty reduction. Negotiations on a comprehensive debt treatment are expected to take place in the near future.

"The authorities' homegrown program supported by the PSI provides an important opportunity for Nigeria to consolidate the gains achieved so far and address the significant remaining challenges stemming from past economic mismanagement and resistance to reform from vested interests. Achievement of the program objectives hinges on timely and rigorous implementation of the envisaged polices. The authorities fully recognize these challenges and are firmly committed to strict adherence to the program. The broad domestic ownership and support at all levels of government bode well for the success of the program. The continued provision of technical assistance will be essential for bolstering implementation capacity. More generally, the support of the international community for Nigeria's economic reform program is crucial at this juncture," Ms. Krueger said.

The annex to this report is available free of charge at http://bankrupt.com/misc/NigeriaAnnex.pdf

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[*] See paper under "Research & Analyses" for explanation of PSI.

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The representatives of the Paris Club creditor countries met on 18, 19 and 20 October 2005 and agreed with the representatives of the Federal Republic of Nigeria on a comprehensive treatment of its debt. This agreement implements the debt treatment framework for Nigeria announced by the Paris Club on 29 June 2005.

The representatives of the Paris Club creditor countries welcomed the ambitious economic program implemented by the Nigerian authorities since 2003 and their desire to secure an exit treatment from the Paris Club. This agreement takes place after the approval by the Executive Board of the International Monetary Fund of the Policy Support Instrument (PSI) on 17 October 2005 and includes a debt reduction under Naples terms on eligible debts and a buy back at a market-related discount on the remaining eligible debts after reduction.

This agreement will be implemented in two phases in consonance with the implementation of the PSI: in the first phase, Nigeria undertakes to pay arrears due on all categories of debts and Paris Club creditors grant a 33% cancellation of eligible debts; in the second phase, after the approval of the first review of the PSI by the Executive Board of the IMF, planned for March 2006, the Nigerian Government will pay amounts due under post-cutoff date debt, Paris Club creditors will grant a further tranche of cancellation of 34% on eligible debts, and Nigeria will buy back the remaining eligible debts.

In total, this agreement allows Nigeria to obtain a debt cancellation estimated at US$18 billion (including moratorium interest) representing an overall cancellation of about 60% of its debt to the Paris Club of around US$30 billion. Paris Club creditors will be paid an amount of US$12.4 billion, representing regularization of arrears of US$6.3 billion, plus a balance of US$6.1 billion to complete the exit strategy.

This exceptional treatment of Nigeria's debt offers a fair, sustainable, and definitive solution to Nigeria and Paris Club creditors. With the large debt relief included in this agreement, Paris Club creditors extend their strong support to Nigeria's economic development policy and its fight against poverty.

Background Notes

The members of the Paris Club which participated in the reorganization of Nigeria's debt were representatives of the governments of Austria, Belgium, Brazil, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, the Russian Federation, Spain, Switzerland, the United Kingdom and the United States of America. Observers at the meeting were representatives of the governments of Australia, Canada and
Norway as well as the International Monetary Fund, the World Bank, the African Development Bank, the European Commission, the Organization for Economic Cooperation and Development and the Secretariat of the U.N.C.T.A.D. The delegation of the Federal Republic of Nigeria was headed by Dr. Ngozi Okonjo-Iweala, Minister of Finance. The meeting was chaired by Xavier Musca, Director General of the Treasury and Economic Policy Department of the Ministry of Economy, Finance and Industry, Chairman of the Paris Club.

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NIGERIA: Threat to Repudiate Forces Paris Club to Grant Relief
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Nineteen rich country creditors grouped in the Paris Club officially announced on October 20 an US$18 billion write-off of Nigeria's debt, whose total debt to these creditors is around US$30 billion. While Jubilee USA Network and other civil society groups welcome the Paris Club's move to write off a substantial portion of Nigeria's debt, groups expressed specific reservations on the deal, including the terms of the debt buyback and the involvement of the International Monetary Fund (IMF), which is not a Nigerian creditor. Some observers pointed to the role of an early 2005 process in the Nigerian parliament calling on the government to repudiate the impoverished country's debt as a key factor forcing the Paris Club to act.

Jubilee USA is concerned however about specific terms of the agreement reached that would require the Nigerian government to spend US$12 billion on debt service payments over the next six months as part of the buyback arrangement, while adhering to a newly-created IMF economic program. The new IMF program, the Policy Support Instrument, extends IMF power to those countries it is not lending to. Past impoverished country experiences with similar IMF programs have shown that such programs lead countries to privatize essential services and cut social sector spending. Despite the concerns, Jubilee USA Network shares the Nigerian government's hopes that debt cancellation will allow the country to channel resources away from debt servicing and towards health care, education, and other critical social needs.

Debayani Kar, Communications and Advocacy Coordinator of Jubilee USA Network said: "Nigeria's debt write-off at the Paris Club demonstrates the partial success of the Nigerian
parliament's threat to cancel its own debt through repudiation, which helped to force the hand of these creditors. While we are encouraged by the Paris Club's agreement to cancel some of Nigeria's debt, we don't think it makes sense to make an impoverished country like Nigeria pay US$12 billion when that money should be spent on AIDS, health, and education."

Rev. David Ugolor, President of African Network for Environment and Economic Justice (ANEEJ) in Benin City, Nigeria said: "The Paris Club cannot expect Nigeria, freed from over 30 years of military rule, to muster US$12 billion to pay off interest and penalties incurred by the military. Since the debt, by President Obasanjo's own admission, is of dubious origin, the issues of the responsibilities of the creditors must be put on the table at the Paris Club. As desirable as an exit from debt peonage is, it is scandalous for a poor debt distressed country, which cannot afford to pay US$2 billion in annual debt service payments, to part with US$6 billion up front or US$12 billion in three months or even one year."

Sony Kapoor, Senior Advisor at Christian Aid (UK) said: "The deal will provide much overdue relief and free Nigeria from much of its debilitating debt. However it took the threat of repudiation to get this cancellation, as if the obvious need of the people and the odious nature of much of the debt were not enough. What is worse is that creditor countries are extracting a pound of flesh in the form of US$12 billion worth of payments from Nigeria and have put in place a new IMF program despite Nigeria not owing anything to the Fund. On a more positive note, the deal has set the scene for a more assertive negotiating stance by other indebted developing countries."

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Jubilee USA Network published this article on October 20. Jubilee USA is a network of over 70 religious denominations, labor groups, environmental organizations, and community and advocacy groups working for freedom from debt for countries in Africa, Asia, and Latin America.

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Nigeria reached on October 20 an agreement with its largest creditor, the Paris Club. The agreement will lead to the cancellation of a large portion of Nigeria's massive US$35.9 billion debt, 85.8% of which is owed to the Paris Club. The debt had built up over many years, following loans given by France, Germany, Japan, the United Kingdom and others to a string of Nigerian despots.

The agreement cancels US$18 billion of Nigeria's eligible debt. But, to receive this deal, Nigeria had to commit to paying the Paris Club nations US$12.4 billion, mainly to France, the UK, and Germany. This figure comprises US$6.3 billion in arrears to be paid by the end of October, plus another US$6.1 billion for a debt buy-back operation next March.

"This agreement extracts US$12.4 billion from Africa and transfers it to a group of wealthy countries who do not really need the money," said Dr. Paul Zeitz, Director of the Global AIDS Alliance. "It is an outrage that creditors simply plan to use this payment to fill their treasuries. The annual budget of such creditors as Japan and the United Kingdom is over 100 times that of Nigeria. Surely we can do better than accepting taking billions from the world's poorest continent. We expect more from the G8 nations, who promised Africa so much in their Gleneagles declaration in July."

"Nigeria's government has made the best of a terrible situation," he noted. "In the long run, Nigeria could save a billion dollars a year in debt repayments and potentially double health spending. That is an impressive achievement. Nigeria has the third highest number of HIV positive people in the world, and with these resources it could scale up AIDS treatment."

"However, the creditors should be ashamed of themselves if they simply take this money," Mr. Zeitz stated. "These creditors often knew that the money would be siphoned off by dictators and deposited in western banks, and the resulting debt is morally illegitimate. They bear a moral obligation to think more creatively about how to use this money. Nigeria has already paid these creditors US$11.6 billion in debt service since 1985. We challenge the creditors to redirect this additional US$12.4 billion to Africa's development."

"A substantial portion of this sum should be given to the Global Fund to Fight AIDS, TB and malaria and specified for high-quality health projects in Africa," he said. "The Global Fund has stated that it urgently needs greater contributions to proceed with additional grant-making next year."

Even with the recent scale up in global AIDS programs, the needs of orphans and vulnerable children are far from being met, and millions of children face abandonment. Global AIDS Alliance released on Oct. 20 a report, "Remember the Children: Global Fund Round 6 in 2006," which shows that with greater resources the Fund could dramatically increase funding to help children.

The Fund could also use these resources to help Africa improve health systems. Better health systems are needed to not only to fight AIDS, tuberculosis and malaria, but also to prepare for a possible avian flu pandemic.

The report is available at http://www.globalaidsalliance.org/remember_the_children.cfm

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PHILIPPINES: Supreme Court Sides with Arroyo on EVAT
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The Supreme Court has affirmed with finality the constitutionality of the expanded-VAT law, paving the way for its implementation as early as next month.

The decision comes more than two months after the court issued a temporary injunction to hear five petitions attacking the law's validity. The petitions, filed mostly by opposition lawmakers, had questioned the alleged inclusion of provisions not in the original draft and the authority giving the President prerogative to increase the rate to 10% from 12% beginning January. These provisions accordingly violate the constitution, which vests in Congress the sole power to make laws.

The High Court dismissed these arguments and ruled with finality on October 18. This clears the way for the implementation of the law, which is a key measure on the fiscal reform agenda of President Gloria Arroyo. Executive Secretary Eduardo Ermita said Malacanang will immediately implement the EVAT, notwithstanding the daily protests in the capital lately.
"We are preparing for more rallies, especially with the implementation of the VAT. We're confident that with proper information dissemination, the public will come to understand the need to raise taxes," Sec. Ermita was quoted by the Philippine Daily Inquirer as saying.

The finance department wants the law, which also raises corporate tax to 35% from 32%, to take effect on November 1. The measure is estimated to bring down the government's net financing requirements to PHP150 billion in 2006, down 31% from PHP216 billion this year. About PHP102.4 billion of 2006 borrowings will be raised from foreign sources; the balance from the domestic market, Finance Undersecretary Gil Beltran, who spoke to The Philippine Star, said.

ING Bank, which came out recently with a study, said this is positive news for the country's fiscal outlook. "Even with possible slippage, we currently expect a [budget] deficit of PHP144 billion or 2.4 percent of GDP in 2006," it said.

The investment bank said the government's resolve to implement the tax and achieve its revenue goals is important. "Riding on such achievement would be ratings upgrade. S&P, Fitch and Moody's continue to look for evidence of not only of unwavering resolve to implement VAT especially the VAT rate hike to 12 percent from 10 percent but also to further cut fiscal deficits. In our view, government would implement the VAT in full," it said.

It added, "short of this would see some adjustments in fiscal deficit expectations but should not alter significantly the direction of fiscal improvement -- that of a balance budget by the end of this decade."

Nomura International, in a separate report, revised its investment recommendation on the country's bonds to neutral from underweight following the Supreme Court ruling. Credit analyst John Teng believes the selling pressure on Philippine bonds had eased after the court ruled the EVAT constitutional. He recommended investors to buy Philippine sovereign bonds maturing in 2011, 2013 and 2015.

"Despite the doubts and uncertainties, we believe there is scope for the rating agencies to remove the negative rating outlook on the Philippines' sovereign ratings," he told ABS-CBN on October 21.

All three major rating agencies rate the country below investment grade with negative outlook. JPMorgan also shifted its recommendation on Philippine debt to overweight, according to Dow Jones Newswire.

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PHILIPPINES: EVAT Key to Economic Recovery, Says IMF

On September 19, 2005, the Executive Board of the International Monetary Fund (IMF) concluded Post-Program Monitoring discussions with the Philippines based on the information available through that date.

Background

Following President Arroyo's election victory in May 2004, economic reforms advanced at a significant pace. In the power sector, average generation tariffs were raised by half, substantially cutting losses of the state-owned National Power Corporation. In the financial sector, the Special Purpose Vehicle framework set up to facilitate the sale of non-performing assets began to gain traction. In the fiscal area, several tax measures were taken, culminating in Congress passing a landmark expanded VAT (EVAT) law in May 2005 that has the potential to sharply reduce the fiscal deficit. Subsequent events, however, interrupted the economic reform momentum. Allegations against the President led to impeachment complaints being filed before Congress, key Cabinet members resigned, and the Supreme Court issued a temporary restraining order on July 1 that stopped implementation of the new VAT law. The authorities quickly took steps to calm financial markets, including the appointment of a new economic team. On September 1, the Supreme Court declared the EVAT law constitutional, but retained the temporary restraining order in place for 15 days to allow for any appeals. Meanwhile, the impeachment charges against President Arroyo were dismissed by the House of Representatives on September 6, and with the political uncertainty having receded somewhat, financial markets have stabilized.

GDP grew by 4.8 percent y/y in the second quarter, above staff and market expectations, and up from 4.6 percent y/y in the first quarter. Buoyant services continued to underpin growth. Private consumption showed resilience to high oil prices, partly reflecting strong inflows of remittances. Headline inflation rose to 7.2 percent in August (y/y), up from 7.1
percent in July, and inflation through August averaged 8.1 percent. With inflation running at well above the target range of 5-6 percent for 2005, the Bangko Sentral ng Pilipinas (BSP) raised policy rates by 25 basis points in April to avert a rise in inflation expectations. In addition, reserve requirements were lifted by 2 percentage points in July to prevent excess liquidity feeding into peso depreciation and creating inflationary pressure.

Aided by continued compression of capital spending, the National Government budget through August appears to be on course to achieving the 2005 deficit target of 3 1/2 percent of GDP (authorities' definition). In conjunction with reduced losses by the National Power Corporation, this would allow the non-financial public sector (NFPS) deficit to be reduced to 4 percent of GDP in 2005, compared to a little over 5 percent of GDP in 2004. An increase in tax revenues earlier this year coincided with a high profile campaign to pursue tax evaders that began in April and quickly showed up in monthly collections. After a deceleration in the growth of tax revenues in July, preliminary data indicate that tax collections recovered in August. The better fiscal performance in 2005, aided by strong portfolio inflows, has kept financial markets liquid; the 91-day treasury bill rate has declined about 200 basis points in 2005 to date.

The balance of payments recorded a surplus of US$2 billion in the first half of the year; this primarily reflected a rise of more than one-fifth in overseas worker remittances (y/y), and a jump in net portfolio inflows to US$1.9 billion, compared with US$0.1 billion in the same period in 2004. Events since June have led to a marked slowing in portfolio inflows. Exports grew by only 4 1/2 percent through July as a result of soft market conditions for Asian electronics, compounded by the lagged effects of relatively low investment in production capacity in recent years. Despite higher oil prices, imports remained virtually flat. Nonetheless, reserves (net of pledged assets) were US$17.5 billion at end-August, well above the end-2004 level of US$15.2 billion.

The primary risk to the near-term outlook for the Philippine economy is that the prevailing state of uncertainty proves to be protracted and sidelines economic reforms. If reforms were to stall, investment is likely to remain subdued, and GDP growth of 4 3/4 percent is projected for 2005 and 2006. The outlook would be much brighter were strong reforms to resume. Soaring oil prices are a threat to the outlook, particularly if they serve to soften demand for Philippine exports. Adverse developments in international capital markets are another potential risk.

Executive Board Assessment

Executive Directors commended the authorities for the significant progress with much needed economic reforms that was achieved in the first year of the new administration. Furthermore, recent political uncertainties have receded,
paving the way for improved market stability and resumed reform momentum. Directors cautioned, however, that the country's external debt and financing requirements are large and, despite its resilience, the economy remains vulnerable to external shocks, especially changes in market sentiment and increases in global interest rates and oil prices. In light of these concerns, Directors stressed the importance of the authorities pressing ahead with the implementation of their comprehensive reform package in the fiscal, power, and banking sectors, in order to reduce the vulnerabilities of the Philippine economy, achieve public debt sustainability over the medium term, and improve the investment and business climate for higher and sustainable growth. They emphasized that an accelerated pace of reforms would send a strong signal to markets and boost investor confidence.

Directors underscored the crucial importance of meaningful fiscal consolidation and debt reduction for enhancing stability and growth prospects. They considered the expanded Value Added Tax (EVAT) reform, including the envisaged VAT rate increase, as the best option to reduce the fiscal deficit. Directors therefore expressed concern that the EVAT implementation has been further delayed due to an appeal made to the Supreme Court, and urged the authorities to consider alternative revenue-raising measures in case the EVAT law cannot be implemented in full in the end. Directors also urged the authorities to continue their efforts to resist pressures to exempt energy products from the VAT increase. They recognized however, that adding taxes to already high energy prices will imply hardship for the poor, and accordingly supported the authorities' plans to consider well-targeted and affordable mitigating measures that would preserve the integrity of the EVAT law.

Directors noted that, even with the full and successful implementation of the EVAT law, the authorities will still have a gap to fill if they are to achieve their goal of balancing the budget by 2010. Directors therefore encouraged the authorities to plan additional measures, such as a sweeping rationalization of tax incentives. Expenditure reforms, including rationalizing and improving the targeting of rice subsidies, were also seen as essential. Directors commended the authorities' intention to continue to allow full pass through of high oil prices in domestic fuel prices, thereby avoiding provision of any subsidies, which would help prevent a reversal of fiscal consolidation.

Directors viewed the significant increases in generation tariffs awarded to the National Power Corporation as an important contribution to the fiscal consolidation effort. They encouraged the authorities to protect these gains by adjusting tariffs in the future in a timely manner. They supported the authorities' plans for developing medium-term deficit targets for Government-owned and Controlled Corporations, as this would be essential to support fiscal consolidation.
Directors noted that civil service and pension reforms are critical for achieving sustainable fiscal consolidation. They welcomed the efforts being made by the authorities to reform the civil service and offer an affordable severance package. Directors also looked forward to the results of the actuarial review of the social security system that should pave the way for placing public pensions on a sustainable footing.

Directors stressed that power sector privatization is essential to restore the financial viability of the sector and to facilitate the investments needed to ensure adequate power supply. In this regard, they expressed concern about the delays in the bidding process for the transmission assets, and urged the authorities to finalize the agreements holding up the privatization of the generation assets. Directors underscored that the privatization process should be embedded in a sound regulatory framework.

While noting that a series of supply shocks have been the root cause of the rise in inflation, Directors were concerned that interest rate differentials were narrowing at a time when the Philippines' risk premium may have risen due to political uncertainties, which could lead to a weakening of the exchange rate and further additional inflationary pressure. Directors were also concerned that the persistence of above-target inflation for a prolonged period -- even when caused by temporary factors -- might lead to an upward and permanent revision of inflationary expectations, especially if the effects of higher oil prices, a weaker exchange rate, and the planned VAT increases are taken into account. Notwithstanding the recent increase in reserve requirements, they considered that a case still does exist for tightening monetary policy to guide inflation expectations down. Directors therefore welcomed the authorities' readiness to monitor developments closely.

Directors welcomed progress in banking sector reform, including the continued decline in non-performing loan ratios. They were encouraged that banks have begun to use the special purpose vehicle (SPV) framework set up to facilitate the sale of non-performing assets. Directors supported the authorities' plans to extend the SPV framework, and encouraged them to closely monitor developments in the trust and pre-need sectors. They also welcomed the privatization of the Philippine National Bank and recent acquisition announcements that would pave the way for necessary banking consolidation. However, Directors expressed concern that the amendments to the central bank's charter, which are critical to strengthening bank supervision, are still pending in Congress, and stressed the need for early approval. They also looked forward to the adoption of the International Financial Reporting Standards by the end of the year, which should lead to much needed improvements in transparency of banking sector indicators. Directors welcomed the continued progress made by the authorities in strengthening the anti-money laundering/combating the financing of terrorism regime.
Directors welcomed the authorities' efforts to further strengthen financial and balance of payments statistics.

The annex to this report is available at no cost at http://bankrupt.com/misc/RPAnnex.pdf

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PHILIPPINES: Debt Swell to PHP3.93 Trillion in July
-----------------------------------------------
The country's foreign debt dropped slightly in July to PHP1.851 trillion from PHP1.856 trillion in June, the Bureau of Treasury revealed on October 20.

About 57% of this debt was raised through issuance of foreign-denominated securities; the rest came from multilateral and bilateral institutions, such as the World Bank, the Asian Development Bank, and the Japan Bank for International Cooperation.

Overall, the national debt rose 1.1% to PHP3.93 trillion in July. Domestic debt, raised mostly from the sale of Treasury bills and bonds, amounted to PHP2.081 trillion. Nearly 60% of the debt have long-term maturity, 24.9% will mature in the medium-term and 15.8 percent in the short-term.

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PHILIPPINES: Well Within Deficit Target for Year
-----------------------------------------------
The government overspent in September, but is still within the deficit target for the year, Reuters said on October 5.

According to the finance department, spending for the month exceeded the PHP3.4 billion target by about PHP9 billion, largely due to higher interest payments and settlement of obligations to suppliers.

Budget Secretary Romulo Neri said the government failed to pay
some contractors and suppliers on time due to delayed budget releases. The overspending, however, was offset by savings in the eight months to August, in which spending was PHP32 billion below target.

With higher tax collection -- PHP700 million ahead of target as of September -- the government is confident of hitting its PHP180 billion projected deficit for the year, Finance Secretary Margarito Teves said.

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PHILIPPINES: Japanese Rating Agency Mulls Outlook Revision
----------------------------------------------------------
The Philippines may get an upgrade from Japan Credit Rating Agency Ltd. (JCRA) if the crisis hounding the Arroyo administration tapers off, The Philippine Star said on Oct. 3.

In its third quarterly sovereign review, JCRA noted more positive developments are coming out of Manila lately, among them, the favorable ruling on the expanded-VAT by the Supreme Court, higher OFW remittances, improvement on the fiscal deficit, exports recovery, and rejection by Congress of the impeachment complaint against President Gloria Arroyo.

Only two negative factors offset these gains: inflation, which grew at a steady pace during the quarter (7.6% in June, 7.1% in July and 7.2 percent in August); and streets protests demanding for Mrs. Arroyo's resignation.

"If the political crisis comes to an end and the export recovery becomes clearer, leading to a more stable economic performance, it will become necessary for JCRA to consider
revising the country's rating outlook again," JCRA said.

The agency downgraded its BBB rating to BBB- for the Philippines' foreign and domestic currency debt papers and changed its rating outlook from stable to negative on July 15. A key factor that will hasten a ratings revision is the implementation of EVAT, according to JCRA.

The EVAT is estimated to bring in PHP80-100 billion in additional revenues next year, especially if the rate is raised to 12% from 10%. There are moves in Congress, however, to defer coverage of VAT on power and oil products until after world crude prices normalize.

"How these factors will affect the tax revenues remains to be seen," JCRA said.

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RUSSIA: Moody's Upgrade Seen in November
----------------------------------------
Moody's Investors Service is expected to upgrade Russia's sovereign rating next month in recognition of the country's economic stability, Moscow Times said on October 19.

Only seven years removed from its largest debt default, Russia has become the darling of investors in emerging markets, the paper says. Greater political stability combined with prudent economic policy and high commodities prices make Russia a safer credit, Moody's senior sovereign analyst Jonathan Schiffer told Moscow Times.

"If you look at the boundaries of political discourse within which economic policy decision-making is made, these boundaries are narrowing and this in a sense is a tribute to the maturity of political and economic policy in Russia," Mr. Schiffer told the paper.

Bumper oil prices has allowed Russia to accumulate US$34 billion in oil revenues as of October 1. Its gold and foreign reserves totaled US$159.6 billion on Sept. 30, the Times says. This liquidity has allowed Moscow to retire debt early and save on interest cost.

Mr. Schiffer said Moscow's fiscal prudence is a good sign.
"They have for quite some years had a lot of money that they could have misused, but they have not misused it," he said.

Still, he calls for clarity on how the stabilization fund, which gathers windfall from oil, would be spent and said the government should tighten rules on borrowing by state companies.

Russia, which defaulted on US$40 billion domestic debt in 1998, is rated Baa3 by Moody's. The agency placed the rating on review for possible upgrade on September 8.

* * *

Outstanding issues:

5 issue(s) outstanding worth US$29,522,501,096
63 issue(s) outstanding worth RUB757,849,567,000

Issuer's rating:

Standard & Poor's BBB-/Stable Int. Scale (foreign curr.) 07/19/2005
Standard & Poor's BBB/Stable Int. Scale (loc. curr.) 07/19/2005
Standard & Poor's ruAAA National Scale (Russia) 07/19/2005
Moody's Baa3/Positive Int. Scale (foreign curr.) 10/06/2004
Fitch BBB/Stable Int. Scale (foreign curr.)

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SERBIA: Paris Club Deal Hangs in the Balance
--------------------------------------------
Serbia's parliament worked overtime last month to pass the necessary legislations demanded by the IMF to save a crucial loan package.

According to Agence France-Presse on Oct. 20, the parliament worked on reforms suggested by the IMF to fix the insolvent pensions system. In August, the Fund threatened to withhold the last tranche of the country's US$944 billion loan facility, putting in serious danger a Paris Club debt deal. Without the loan program, Belgrade loses the opportunity to have 15% of its US$700 million Paris Club debt cancelled.
The IMF's exasperation stems from Serbia's dilly-dallying in selling state oil and gas company NIS. On the day of the IMF statement threatening to withhold funding, ministers promptly revealed privatization plans for two NIS oil refineries. They said a team of privatization advisers will be given until March 2006, at the earliest, to present a report proposing how to proceed with the privatization.

In addition to the sale of NIS, the IMF also wants power and water utilities; the national airline, JAT; railways; post and telecoms sold by 2007, the SDR said in August. A team from the IMF was expected in Belgrade on October 20 to review the progress of these efforts and recommend action on the final US$250 million tranche.

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UKRAINE: Notes Assigned 'BB-'; Outlook Stable
---------------------------------------------
Standard & Poor's Ratings Services on Oct. 3 assigned its 'BB-' credit rating to the Republic of Ukraine's upcoming EUR600 million notes to be issued later in October. Standard & Poor's also affirmed its 'BB-' long-term foreign and 'BB' long-term local currency and its 'B' short-term sovereign credit ratings on Ukraine; the 'uaAA' national scale rating on Ukraine was also affirmed. The outlook is stable.

According to Standard & Poor's credit analyst Helena Hessel, the rating balances relatively robust external liquidity, low government debt levels, and a better-than-expected fiscal performance thus far in 2005 against significant political risk, which continues to be a key constraint on the rating.

"The rating also reflects the Administration's agenda to implement political and structural reform with the difficulties it faces in Ukraine's challenging political calendar," said Mrs. Hessel. "However, Standard & Poor's expects that the gradual rehabilitation of state institutions after decades of corruption and mismanagement should increase private sector confidence, reduce tax evasion, and attract foreign direct investment. Ongoing efforts to reduce
inflation, sustain output growth, and improve Ukraine's fiscal performance are the key economic challenges that must be addressed to ensure that its credit standing will not be compromised," she concluded.

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URUGUAY: Receives First Tranche of US$1.11 Bln IMF Loan
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The Executive Board of the International Monetary Fund (IMF) completed on Sept. 28 the first review under the SDR766.3 million (US$1.11 billion) Stand-By Arrangement for Uruguay. Completion of this first review makes SDR30.7 million (about US$44.4 million) immediately available to Uruguay.

In completing the review, the Board also approved the modification of the structural performance criterion on the timeframe for submission of a comprehensive tax reform, of the net domestic assets of the central bank for end-September and end-December 2005, and of the adjustors for the net international reserves and non-financial public sector debt performance criteria. The Stand-by Arrangement was approved on June 8, 2005 for a three-year period, under the Fund's exceptional access policy.

In commenting on the Executive Board decision, Agustin Carstens, Deputy Managing Director and Acting Chair, said:

"Uruguay's economic program, supported by a new Stand-By Arrangement, is off to a good start. The authorities' strong macroeconomic policies, together with generally favorable external conditions, have resulted in rapid growth, low inflation, and renewed access to international capital markets. As a result, economic vulnerabilities have been reduced significantly, although important risks remain. In particular, the still high public debt, weaknesses in the banking system, and pressures to raise fiscal spending continue to pose important challenges to the government's reform program.

"The five-year budget submitted to Congress in August reaffirms the government's commitment to strong macroeconomic policies through its term in office. It is now important to implement the budget and associated fiscal reforms. In particular, the authorities' plans for comprehensive tax reform, improving revenue administration, and reforms of specialized pension funds are well placed."
"Uruguay's progressive return to international capital markets is an important achievement that, together with continued sound macroeconomic policies, underpins prospects for a lasting exit from Fund financial support. Uruguay has taken advantage of favorable external conditions to improve the structure of public debt. Debt management will be further improved through the establishment of a specialized unit at the Ministry of Finance.

"Monetary policy has been successful in bringing down inflation. However, potential inflationary pressures need to be monitored carefully, to make sure monetary policy can react if necessary to safeguard the inflation objective.

"The restructuring of the banking system has progressed well, but risks remain. The ongoing divestment of NBC, the bank created out of the good assets of the failed banks, is welcome, as is the progress made in strengthening the largest state bank and its asset resolution efforts. Key remaining challenges include stepping up reforms at the state mortgage bank and reducing high financial dollarization, which remains a major vulnerability. The authorities' plans for strengthening the central bank, the supervisory authority of banks, and the deposit insurance framework are important milestones ahead.

"Continued success of the program depends on sustaining rapid growth and social progress. The authorities' strategy for achieving these goals rightly focuses on raising private sector investment, while supporting vulnerable groups through well-targeted social assistance. Developing a clear action plan to improve the investment climate and effective implementation of the two-year Social Emergency Program are important planks of this strategy, complementing the authorities' commitment to sustained fiscal consolidation and financial stability. The good start made in implementing the government's program harbors favorable prospects for achieving the overarching goals of sustained growth, debt sustainability, and social progress," Mr. Cartsens said.

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VIETNAM: Tests Market with Benchmark 10-year Bond
After a seven-year wait, Vietnam is finally going ahead with its first ever bond issue, Reuters says.

Representatives from the finance ministry and Credit Suisse First Boston, the sole bookrunner, went on an international road show that took them to Hong Kong on October 20, then to Singapore, London, New York and finally Boston on October 26.

The US$500 million bonds, which mature on January 2016, represent Hanoi's first foray into the capital markets, after issuing US$453 million in Brady bonds as part of a debt restructuring in 1998. About a third of these bonds had been bought back by the government as of September 2002. Analysts and fund managers expect strong demand, partly caused by what they call scarcity factor.

"There's scarcity value and investors like the macro-economic story," Desmond Soon, who spoke to Bloomberg News on Oct. 17 said. He plans to add Vietnam's bonds to the US$200 million of debt he manages at Pacific Asset Management in Singapore, provided the securities offer a yield of about 7 percent.

"China and India are the hottest countries in terms of economic growth in the medium to long-term. Vietnam is the third country with strong potential growth," Ben Yuen, head of Asian fixed income at First State Investments, told Reuters.

Since restructuring its US$553 million loans from international banks in 1998, Vietnam's economy has been expanding, with this year's growth estimated at 8%. With its accession to the WTO next year, analysts expect foreign investments and export to grow.

Credit rating agencies agree. Moody's rates Vietnam Ba3, three notches below investment grade, but higher than those of Indonesia and the Philippines, the only other Southeast Asian nations with speculative grades.

Moody's believes the country can handle "moderate" current-account deficits because of its solid exports growth, foreign direct investment and low-interest loans from the Asian Development Bank, World Bank and other countries. Its position as a net exporter of crude oil does not hurt either.

"Vietnam is potentially the most exciting emerging market in the world," said Angus Tulloch, joint managing partner of First State Investments in Edinburgh, which oversees about US$9 billion in the Asia-Pacific region and emerging markets. "The country is coming of age," he told Bloomberg.

Citigroup Inc., Nomura Holdings Inc., Deutsche Bank AG, HSBC Holdings Plc, JPMorgan Chase & Co., Merrill Lynch & Co. and Morgan Stanley will help sell the bonds, according to Bloomberg. Proceeds will be invested in a large shipyard belonging to state-run shipbuilder Vinashin.
VIETNAM: Proposed US$500 Million Global Bond Rated 'BB-'

Standard & Poor's Ratings Services on Oct. 18 assigned its 'BB-' credit rating to Vietnam's (foreign currency BB- /Positive/B; local currency BB/Positive/B) proposed US$500 million maiden global bond issue, maturing 2016.

This follows Standard & Poor's revision of its outlook on the long-term sovereign ratings on Vietnam to positive from stable. At the same time, the sovereign ratings were affirmed.

"The bond issue represents Vietnam's first foray into the international debt capital markets since the restructuring of its defaulted bank loans in 1998," said Standard & Poor's credit analyst Agost Benard. "It therefore marks an important step in the country's long transition toward a market economy, one that is increasingly seeking to leverage on greater international integration."

The sovereign ratings on Vietnam are supported by its moderate overall and external debt levels, strong export-led growth prospects, and conservative economic management underpinned by supportive external creditor relations. The ratings, however, are constrained by weak public finances, numerous structural and institutional deficiencies, including the lack of transparency in policy making and data provision, and limited monetary flexibility.

Vietnam's export-led growth strategy, and its fast-expanding private sector has boosted the economy, with real GDP rising by an average 7.1% annually over the past 10 years, without significant fluctuation. The country's resource rich and open economy, with exports at over 60% of GDP, has been able to attract significant FDI inflows averaging 5.5% of GDP in the past ten years. This, together with a steady flow of remittances and concessional foreign borrowing, ensures ongoing balance of payments surpluses and a moderate external debt level.

Vietnam, however, faces challenges in a number of key areas, including public finances, monetary policy, and the state-
owned financial and non-financial sector, where further reform is needed before the country's credit rating can improve.

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RESEARCH & ANALYSES
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Business as Usual: The WB, IMF and Liberalization Agenda
-----------------------------------------------------------------
At the G8 summit in July, world leaders said developing countries should have the right to set their own economic policies. Put into effect, this would mean an end to more than 20 years of rich countries using their power as donors and creditors to force trade liberalization on poor countries.

But Christian Aid's new report 'Business as Usual, the World Bank, the IMF and the Liberalization Agenda' warns against a complacent acceptance of the G8's statement. It shows that despite previous commitments from the International Monetary Fund (IMF) and World Bank to give poor countries more freedom to choose their own trade policies, little of substance has changed.

The report finds that:

- Alongside conditions attached to loans and debt cancellation, 'new conditionality' is now used to influence policy decisions. This includes an IMF scorecard for countries' policies. Countries with liberalized economies receive the highest score and are more likely to receive aid from other donors.

- There is still pressure to liberalize poor countries' tariffs and quotas; but there is now also a greater focus on
privatizing basic services and liberalizing local markets and investment.

The impact of these policies on poor people's livelihoods has been well documented.

This report shows how the IMF and World Bank's activities are also undermining democracy both nationally and internationally. Strings attached to loans can make governments more accountable to their financiers than to their local populations. Sometimes government decrees that bypass parliaments have been made an explicit condition for receiving IMF loans.

World Bank and IMF conditions that force poor countries to liberalize unilaterally are also undermining their position at the World Trade Organisation. It makes a mockery of the principle of negotiated agreements and undermines the flexibility that poor countries are supposed to receive under WTO agreements.

Christian Aid is calling for the IMF and World Bank to:

(1) ensure their activities support rather than undermine democratic processes;

(2) stop all economic policy conditionality; and

(3) give loans to countries based on an assessment of the specific circumstances in each country rather than an ideological commitment to liberalization.

*   *   *

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Deficits and Debt in the Short and Long Run
-------------------------------------------
[Authored by Benjamin M. Friedman, this paper was featured in the NBER Working Paper Series, October issue.]

ABSTRACT

This paper begins by examining the persistence of movements in the U.S. Government's budget posture. Deficits display
considerable persistence, and debt levels (relative to GDP) even more so. Further, the degree of persistence depends on what gives rise to budget deficits in the first place. Deficits resulting from shocks to defense spending exhibit the greatest persistence and those from shocks to non-defense spending the least; deficits resulting from shocks to revenues fall in the middle. The paper next reviews recent evidence on the impact of changes in government debt levels (again, relative to GDP) on interest rates. The recent literature, focusing on expected future debt levels and expected real interest rates, indicates impacts that are large in the context of actual movements in debt levels: for example, an increase of 94 basis points due to the rise in the debt-to-GDP ratio during 1981-93, and a decline of 65 basis point due to the decline in the debt-to-GDP ratio during 1993-2001. The paper next asks why deficits would exhibit the observed negative correlation with key elements of investment. One answer, following the analysis presented earlier, is that deficits are persistent and therefore lead to changes in expected future debt levels, which in turn affect real interest rates. A different reason, however, revolves around the need for markets to absorb the increased issuance of Government securities in a setting of costly portfolio adjustment. The paper concludes with some reflections on "the Perverse Corollary of Stein's Law": that is, the view that in the presence of large government deficits nothing need be done because something will be done.

The full text of this paper is available at http://papers.nber.org/papers/W11630

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Is it or is it Ain't my Obligation? Regional Debt in a Fiscal Federation
---------------------------------------------------------------------------------
[Authored by Russell Cooper, this paper was featured in the NBER Working Paper Series, October issue.]

ABSTRACT

This paper studies the repayment of regional debt in a multi-region economy with a central authority: who pays the obligation issued by a region? With commitment, a central
government will use its taxation power to smooth distortionary taxes across regions. Absent commitment, the central government may be induced to bail out the regional government in order to smooth consumption and distortionary taxes across the regions. We characterize the conditions under which bailouts occur and their welfare implications. The gains to creating a federation are higher when the (government spending) shocks across regions are negatively correlated and volatile. We use these insights to comment on actual fiscal relations in three quite different federations: the U.S., the European Union and Argentina.

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Policy Support and Signaling in Low-Income Countries
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[Prepared by the IMF's Policy Development and Review Department, this paper explains in detail the latest Policy Support Instrument of the Fund.]

EXECUTIVE SUMMARY

Fund activities relating to low-income members are centered on supporting their efforts to secure and maintain macroeconomic stability, growth, and poverty reduction -- consistent with their efforts to achieve the Millennium Development Goals. To ensure that Fund support for low-income members remains as effective as possible, it must adapt as members' needs evolve. This paper explores how the Fund's instruments and practices might be adapted to support sound policies in low-income members, in particular those that do not have a need or want to use Fund resources.

Staff undertook a survey of PRGF-eligible members and of donors seeking their views on how the mechanisms of Fund support for low-income countries could be made more helpful. Overall, the survey identified a need for: (i) the development of a new instrument designed for members that do not need, or want, Fund financial assistance; and (ii) filling information gaps, especially in program cases, through more frequent and regular detailed assessment letters.

A number of low-income countries may not need Fund financial support but still want the Fund to support their program and
endorse the quality of their policies. This paper proposes the creation of a Policy Support Instrument (PSI) for this purpose. The new instrument would: (i) be based on a member's poverty reduction strategy, ensuring ownership; (ii) consist of a policy framework normally focused on consolidating macroeconomic stability and debt sustainability, while deepening structural reforms in key areas that constrain growth; and (iii) provide the basis for rapid access to concessional Fund resources in the event of shocks. Use of the new instrument would be approved by the Board, and hence provide a visible signal of Fund endorsement of a member's policies.

For low-income members with a PRGF arrangement or a PSI, delays in completing reviews create a "gray period" during which information on performance is not readily available. Assessment letters should be used more frequently to fill this information gap, reducing the risk of an unwarranted interruption of donor support. The content of these assessment letters should be more detailed than is current practice.

While the precise staff resource cost will vary from country to country, the recommendations in this paper are likely to imply some additional resource costs in the near future, stemming primarily from the increased use of assessment letters, rather than the creation of the PSI. However, the PSI may require additional staff resources in the medium term.

The full text of this paper is available at http://bankrupt.com/misc/IMF-PSI.pdf

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Review of PRGF-HIPC Financing, Adequacy of Reserve Account of PRGF Trust, and Subsidization of Emergency Assistance

[The IMF published this update on the PRGF-HIPC program on September 8.]

INTRODUCTION

This paper provides the basis for the semi-annual decision on the adequacy of the Reserve Account of the PRGF Trust. It also updates the status of resources for financing PRGF operations and the HIPC Initiative and bilateral contributions to the subsidization of emergency assistance. The previous update was issued in March 2005 (EBS/05/48, 3/23/05). Detailed information on bilateral contributions to the PRGF and HIPC Initiative, as well as the balance in the PRGF Reserve Account, is provided in appendix tables. A draft decision on the adequacy of the PRGF Reserve Account is proposed in Section V for adoption by the Executive Board.[1]
This paper does not discuss PRGF and HIPC financing issues. Rather, the projections of the demand for, and supply of, resources for financing PRGF operations over the medium term are being considered separately in the context of the Executive Board's consideration of the G-8 debt relief proposal.

The full text is available at http://bankrupt.com/misc/PRGF Adequacy.pdf

[1] The Executive Board is required to review the adequacy of the Reserve Account of the PRGF Trust every six months as long as PRGF loans related to the financing of "rights" under rights accumulation programs following arrears clearance remain outstanding (Decision No. 10286-(93/23), adopted February 22, 1993, as amended). One such loan remains outstanding to Zambia through December 2005.

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SUBSCRIPTION INFORMATION

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Recommended Reading: Thomas H. Jackson's newest title, "The