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SecM90-1040

FROM: The Acting Secretary

August 3, 1990

NOTICE OF SEMINAR

Issues in Evaluating Debt and Debt Service Reduction Operations

A Seminar of the Executive Directors of the Bank on the above subject will be held on Wednesday, August 8, 1990, at 2:30 p.m. under the chairmanship of Mr. Qureshi, Senior Vice President, Operations.

Attached is the background material for the seminar. The material consists of an Introduction and Main Components of Presentation, as well as two previously issued papers, "Analytic Issues in Debt Reduction" (SecM89-520) and "Illustrative Effects of World Bank Support for Voluntary Debt and Debt Service Reduction Operations" (SecM89-1087).

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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

Issues in Evaluating Debt and Debt Service Reduction Operations

A Board Seminar

August 1990

Introduction and Main Components of Presentation

This volume is prepared as background material for the Seminar on "Issues in Evaluating Debt and Debt Service Reduction Operations". The seminar is based on the two documents in the volume: "Analytic Issues in Debt Reduction" (SecM89-520, April 28, 1989) and "Illustrative Effects of World Bank Support for Voluntary Debt and Debt Service Reduction Operations" (SecM89-1087, August 14, 1989). These two documents deal with technical issues important in evaluating debt and debt service reduction (DDSR) operations. The presentation also reflects further work done by staff in conjunction with the analysis of DDSR operations in Mexico, Philippines, Costa Rica and Venezuela[1]. In addition, the presentation takes into account the analysis embodied in a series of Board discussions that have taken place since April 1989.[2]

Outline of Seminar Presentation:

The presentation will consist of two parts. Part 1 is an overview of the factors and tools that need to be taken into account in comprehensive assessment of DDSR operations. Part 2 focuses on some practical issues in the evaluation of the financial effects of different DDSR operations, with specific examples.

Part 1 Evaluation of DDSR operations has proven to be a complex task. Each country's external debt situation is different. The links between external debt and the rest the economy are difficult to quantify. The financial evaluation of the resulting change in the form of debt is subject to considerable uncertainty. It involves the analysis of transactions across time and requires assumptions concerning the appropriate counter-factual situation in the absence of DDSR. Our objective in the first part of the seminar is to provide a checklist of the important considerations and the available tools rather than a

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[1] See "Briefing Note on Recent Debt Restructuring Agreement between Costa Rica and its Commercial Bank Coordinating Committee" (SecM89-1499, November 27,1989), Philippines: Debt Management Program" (R89-228, November 30,1989), "Mexico: Interest Support Loan" (P-5235-228, January 18, 1990), and "Briefing Note on the Proposed Program for Debt and Debt Service Reduction for Venezuela" SecM90-709, May 31, 1990).

[2] As reflected in "Implications of Debt Reduction Proposals" (SecM89-521, April 28, 1989), "Operational Guidelines and Procedures for Use of IBRD Resources to Support Debt and Debt Service Reductions" (R89-104, May 22, 1989) and more recently "Review of Progress Under the Program to Support Debt and Debt Service Reduction" (R90-48, March 21, 1990).

specific formula for the evaluation of a given DDSR operation. The weights given to individual items in the checklist and even the most useful tools will vary across countries.

One important factor to keep in mind is that the effects of DDSR will be perceived differently by the three major participants: (1) the debtor country; (2) commercial bank creditors; and (3) the IFIs and others financing the operations. SECM89-520, "Analytical Issues in Debt Reduction," provides a matrix illustrating potential qualitative effects of alternative instruments on these three groups. It is generally agreed that all parties should gain from a successful DDSR operation.

The major concern of the Bank in DDSR operations is the balance of costs and benefits to the debtor country. The major financial costs and benefits are outlined in SECM89-1087, "Illustrative Effects of Debt and Debt Service Reduction Operations." Benefits through macroeconomic channels may be as important or more important in some operations. Some of these interrelated channels include the impact on domestic interest rates, an improvement in the fiscal situation, a reduction in disincentives to investment, and potential capital reflows. A serious examination of these effects requires detailed country-specific modeling and analysis.

Another key consideration in analyzing DDSR operations is the comprehensiveness of the agreements. Small deals are, in many ways, simpler to analyze. Large deals bring in issues such as potential free riding, or extensive changes in the nature of external obligations. There are also analytical differences between arrangements where new money and debt reduction are the only options relative to deals in which other choices, including non-participation, are possible.

Part 2 The second part of the presentation focuses on some practical issues in the evaluation of different DDSR operations. Specifically, it deals with three main topics:

1. Factors that may affect the differences in valuation between the old and the new liabilities of debtor countries. DDSR operations consist of an exchange of assets, existing loans for either cash, bonds or new loans. In order to assess the impact of the operation, it is necessary to evaluate the different assets from the point of view of both the creditor and the debtor. Beside the interest rate and maturity terms,

three main factors are identified that may affect the way in which debtors and creditors value the instruments:

- Perceptions on the degree of seniority of different instruments.
- Degree of enforceability of different contracts.
- Collateral or other forms of credit enhancement on the new instruments.

2. Indicators to assess the effects of DDSR operations: These are three basic methods to use in obtaining quantitative evaluation of DDSR operations:
   - Internal Rate of Return
   - Present Value of Debt Service Reduction
   - Cash Flow Effects

   The methodology applied to estimate these indicators is explained, as well as their use and limitations.

3. Three types of DDSR operations are discussed:
   - Buybacks
   - Debt Exchanges
   - Concessional Loan Restructurings

   The differences and similarities between these operations are analyzed. The discussion is related to recent experiences of Bolivia, Chile, Costa Rica, Mexico and the Philippines.

International Bank for Reconstruction and Development

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SecM89-520

FROM: Vice President and Secretary

April 28, 1989

ANALYTIC ISSUES IN DEBT REDUCTION

Attached is a memorandum from the President entitled "Analytic Issues in Debt Reduction" for discussion together with the President's memorandum "Implications of Debt Reduction Proposals" (SecM89-521) in a meeting of the Committee of the Whole on May 9, 1989.

Questions on this document should be referred to Mr. Ishrat Husain (X33801).

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THE WORLD BANK
Washington, D.C. 20433
U.S.A.

BARBER B. CONABLE
President

April 28, 1989

MEMORANDUM TO THE EXECUTIVE DIRECTORS

ANALYTIC ISSUES IN DEBT REDUCTION

I. Introduction

1. A preliminary question that must be answered with respect to recent initiatives in support of debt reduction is: "Why is debt and debt service reduction needed?" The aim of debt and debt service reduction (DSR) is to make adjustment programs more effective in terms of higher levels of investment and a resumption of growth. DSR operations supported by the Bank and the Fund should be set in a framework in which the debtor countries would pursue strong short- and medium term adjustment policies, with a greater likelihood that their debt servicing burden would be reduced to the point that it becomes compatible with their capacity to service debt.

2. The general argument in support of DSR is that many debtor countries have been unable to return to growth in the presence of their very large debts. Although it has been possible to write down optimistic scenarios in which, with favorable external circumstances, new money, and rigorous internal policies, countries' debt indicators would eventually improve to the point where they would return to creditworthiness, such scenarios did not eventuate even for countries that had undertaken major adjustment efforts.

3. One reason for the persistence of slow growth is that the debt overhang acts as a tax on increases in current and future income: to the extent that the country improves its economic performance, a large share of the benefits accrues to the creditors rather than domestic residents. This inhibits investment and, therefore, slows growth. Put another way, creditors, both domestic and foreign, appear to be increasingly skeptical of the sustainability of adjustment in the face of the external debt burden, contributing to a vicious circle in which negative expectations feed on themselves. By reducing the creditors' share of the benefits from the adoption of adjustment policies and by reducing the uncertainty surrounding the sustainability of adjustment, DSR encourages investment. To be successful, the amount of debt reduction or cash flow relief provided to the debtor would have to be adequate in relation to overall financing needs.

4. The benefits to a country of using for DSR resources that would otherwise be available for investment depend on the country's economic situation. It is possible that DSR may not represent the most efficient use of resources in a number of countries where alternative investment opportunities may yield higher returns. This is one of the arguments for a case-by-case approach to DSR.

5. The remainder of this paper examines a set of issues that arise in considering the benefits of DSR from the debtor country point of view. It evaluates the impact of the instruments that are available to achieve DSR

under the various recent initiatives. It takes for granted that DSR will be undertaken on a country-by-country basis in the context of credible adjustment programs supported by the Bank and the Fund. The extent of the benefits to the debtor countries of DSR initiatives can be substantially affected by tax regulations and accounting rules in place in the creditor countries and the stance of official agencies in support of well formulated DSR offers from debtor countries. But given the differing tax, regulatory and accounting rules now in place in the creditor countries it is not possible to specify, a priori, a single set of instruments or techniques that would be generally preferred over others in all debtor countries or for all of the debt of a given debtor country. The choice of DSR techniques for a debtor country will vary according to the creditor country, the weight of the debtor country in the creditor's portfolio, and balance sheet considerations. From a debtor's point of view, the maximum cash flow relief that can be generated over time with a given pool of investible resources is the preferred result. Interest payment reductions in the early years may be preferable to debt reduction for some debtor countries.

II. Benefits to a Developing Country

Issue 1: When is debt and debt service reduction (DSR) beneficial to a debtor country?

6. Debt and debt service reduction (DSR) is not necessarily beneficial to all debtors. DSR financed by external borrowing should be considered, like any other use of foreign financing, in the light of the alternative potential uses of the funds. Borrowing at market terms for DSR is not sensible in those countries that have maintained normal market access and whose debt is not selling at a discount. The countries likely to be eligible for DSR generally do not have access to voluntary credit, except in very limited amounts, and their debt is selling at a discount because marginal creditors do not expect the current high levels of debt to be serviced in full. Therefore, the alternative for comparison must be a realistic assessment of debt servicing prospects in the absence of DSR.

7. If DSR is to make both debtors and creditors better off than they were before the introduction of the scheme, it must provide a bigger pie for the debtor and its creditors to share. The larger pie could come from the following sources:

(i) By increasing the incentives for the debtor country to adjust, and for investment, DSR can lead to more rapid growth. As noted in the introductory paragraphs, the debt overhang inhibits growth both by accentuating the uncertainty surrounding economic reform in the debtor countries and by acting as a tax on current and future incomes. DSR would reduce both the uncertainty and the implicit tax, and thereby encourage economic growth and future debt servicing capacity.

(ii) The availability of additional funds from International Financial Institutions (IFIs) for DSR allows both creditors and debtors to gain, but at some risk to the IFIs.

(iii) Tax and regulatory changes could enhance the value of the new claims to the creditors, with some of the gain shared with the debtors, but at a potential cost to creditor governments.

(iv) In conjunction with DSR, risk sharing features can be built into new claims that reduce the risk to the debtor country without adversely affecting the creditors. Benefits of such improved risk sharing, in the context of DSR, can be split between debtors and creditors. Examples of risk sharing features include recapture clauses that allow banks to share in exogenous windfalls to the debtor country, commodity price linked bonds, bonds that capitalize interest in periods of high interest rates, and contingent new money.

8. Because DSR is envisioned to proceed on a voluntary basis, the terms of the operations must leave the participating creditors at least indifferent to the alternative of staying out of the debt reduction scheme. It follows that DSR will be less costly to achieve, in terms of official financial support, when the alternative of nonparticipation is perceived by creditors to be less valuable. Accordingly, the effectiveness of any given level of official financial support for DSR would be enhanced by measures that reduced the benefits of creditor nonparticipation relative to participation.

9. DSR cannot be examined in isolation. Its effect will depend on its contribution to the medium term viability of a country's adjustment program, including the overall external financial support available to it. The assessment of that contribution will need to take account of various indicators of the country's ability to service its debt in the longer run, including the ratios of debt and interest service to both GDP and exports, as well as the impact of reduced debt service payments on the country's fiscal position. Issues relating to external resource requirements are addressed in Section VI.

Issue 2: What are the incentive effects of DSR on country policies and performance?

10. Consensual debt and debt service reduction (DSR) offers incentives to heavily indebted countries to pursue policies that will make them eligible for DSR. The prospect of higher growth and investment accompanied by lower debt service payments is certainly one that debtor governments will welcome. Provided that it is available only for countries pursuing serious adjustment programs, DSR will encourage debtor countries to pursue such adjustment programs, and thereby provides incentives to improve economic performance.

11. Would the prospect of DSR persuade countries that have so far managed to service their debts and have otherwise pursued prudent economic policies to pursue imprudent policies now in the hope of becoming eligible for DSR? Such

countries have generally maintained market access and have grown at reasonable rates. They have avoided the need for the wrenching adjustment undergone by heavily indebted countries with debt servicing difficulties. In many cases, they have also continued to receive large amounts of official financing, sometimes on partly concessional terms. If their economic performance or debt servicing record were to deteriorate sharply now, DSR could at best intervene only after a delay, and after the painful disruptions attendant upon debt crises and their aftermath that other countries have experienced. No realistic expectation of ultimate debt service reduction is likely to justify such a cost.

12. The issue might perhaps arise for countries that have lost regular market access because of geographic contagion, despite good economic policies and a good debt servicing record. This possibility should encourage commercial lenders to restore reasonable market access to those countries in a voluntary or concerted fashion.

13. In summary, the incentive effects of DSR are, on balance, likely to be favorable. The prospect of DSR should encourage (as well as facilitate) improved performance by governments; it should also encourage lenders to restore reasonable market access to debtors that have lost it despite their continued respect of contractual obligations and otherwise good economic policies; it should not encourage worsened performance simply in the hope of thereby obtaining debt reduction.

III. Forms of Debt and Debt Service Reduction

Issue 3: From the country's point of view, which forms of DSR are most beneficial, bearing in mind the potential benefits outlined above?

14. Some forms of DSR may be more beneficial than others to debtor countries. The following types of exchanges will be considered:

(a) Buybacks.
(b) Partially collateralized or guaranteed exchanges of old debt for new bonds with new terms:
- o Lower face value.
- o Lower interest rate, possibly for a limited period of time.
- o Payments contingent on commodity prices, interest rates or other exogenous events with an impact on the debtor country.

(c) Debt-equity swaps.

15. To a first approximation the financial markets will evaluate alternative DSR instruments as a combination of the old debt and the amount of new resources provided. (As an example, consider $1 million borrowed and used either for a cash buyback or to purchase a zero coupon bond to collateralize payments on a new instrument, traded for old debt. Assuming an interest rate of 10 percent and a secondary market price of 40 cents on the dollar, both these operations reduce the country's debt service payments by $150 thousand per year. They are equivalent because they involve an exchange of old debt for a new instrument that combines the features of 1) old debt, with no change in its value, and 2) an assured asset with a present value of $1 million.)

The relative efficiency of alternative types of DSR operations thus depends on the detailed characteristics of the new instruments and operations being undertaken.

16. In actual practice the costs and benefits of alternative forms of DSR will be affected by a number of factors, including:

(i) Subordination of old claims: if the old debt is junior to the new claims, the price at which old claims can be purchased will not rise as much. The benefit for the debtor in this case comes through a shrinking of the pie for the old creditors. They would stand behind other creditors and would face the largest risk of less than full debt service payments. There is a question as to whether creditors would voluntarily agree to a scheme that effectively subordinated their claims.

(ii) Entanglement (a special case of seniority): To the extent that the new claims are viewed as closely tied to Bank and Fund claims, they may have an enhanced value to creditors. To the extent that it is true, entanglement comes at a cost to the IFIs.

(iii) Tax, regulatory, and accounting treatment: For banks seeking tax advantages, current rules favor buybacks or exchanges at a discount in the United States and Japan; par exchanges with reduced interest rates would be favored by U.S. banks seeking accounting advantages.[1/] Banks in most European countries have little incentive to sell their claims, because they have already received the tax benefits from provisioning against their debts. Rules that maximized both the tax advantage and the accounting advantage would combine tax relief up front for DSR operations with accounting losses amortized over the life of the loan, together with rules that differentiated between new claims and claims not offered for exchange.

(iv) Liquidity effect: a significant impact on a country's short-run cash flows can be achieved by sharply reducing interest payments for a specified period, such as five years. The interest rate could then be stepped up to a higher level. The reduction in interest payments in the first five years could be forgiven, or might be capitalized, perhaps on a contingent basis as part of a recapture clause. The reduction would be more likely to be forgiven if the lower interest payments were credit enhanced. Interest capitalization can be thought of as the automatic provision of new money. While reducing interest for only a few years rather than the full life of a bond in the provision of liquidity increases the leverage afforded by credit enhancement, it does increase the possibility that the debtor would face a significant debt service bulge that could lead to renewed debt difficulties.

17. The benefits and costs of each instrument will vary across creditors and debtors (the debtor can offer a range of instruments designed to appeal to creditors in different countries, based on tax and regulatory rules, for

example). The debtor countries and creditors will need to do a case by case analysis. A matrix that identifies the attributes of alternative instruments is attached.

18. A general point that emerges from the staff's economic analysis is that debt exchange offers can be so designed to have, in most cases, all the advantages of buybacks, while providing the potential for added gains. The most important gain is that the amount of debt relief can be linked directly to economic performance and policy conditionality, which is more difficult with buybacks. Other gains would come through the potential subordination of old claims and through the possibility of incorporating features that improve the cash flow to the debtor. A partial recapture clause in case of windfall gains to the debtor country also can be built into an exchange offer. Recapture clauses may persuade creditors to accept lower payments now in return for the possibility of higher payments later when the liquidity situation improves. However, relative to debt exchanges, buybacks have the important benefit of unambiguously reducing the outstanding debt stock.

IV. Official Coordination and the Pricing of Debt Buybacks

Issue 4: Should the Bank relate its support of DSR to the pricing of debt buybacks and exchanges?

19. Secondary market prices will tend to rise as new resources are devoted to buybacks and debt exchanges and as banks less willing to part with their claims must be induced to sell or exchange; and commercial banks may tend to benefit disproportionately. Secondary market prices of the debt of likely beneficiary countries have risen as much as 20 percent since early March, indicating that commercial banks expect to benefit from official support for DSR.

20. It is not clear that recent price rises in secondary markets will be ratified by events. If negotiated DSR settlements result in the subordination of old claims, the secondary market price of these junior claims may not be appreciably higher than prices before indications of official support for DSR were publicized.

21. There may be a moral hazard problem in using current secondary market prices. Debtor countries may have the incentive to drive down these prices in order to facilitate the repurchase of debt.

22. Because World Bank support will be limited to transactions in which DSR produces a significant gain to the country, the Bank will have to take into account the terms of DSR operations. The significance should be judged not simply by the percentage reduction in the stock of debt or the level of interest payable, but rather by the improvement over time in the key debt

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1/ U.S. financial accounting rule FASB 15 allows banks, under certain circumstances, to hold reduced interest assets on their books at face value. Brazil's exit bonds appear to qualify for FASB 15 treatment.

indicators discussed in paragraph 10 and in economic growth and investment. The issue of the appropriate circumstances for Bank support of DSR is addressed in detail in the companion paper, "Implications of Debt Reduction Proposals."

V. DSR and the Adequacy of External Finance

Issue 5: What is the potential role for DSR in the provision of external finance in support of adjustment and growth and a return to creditworthiness in highly indebted countries?

23. The goal of the overall process of adjustment in the highly indebted countries is a restoration of sustained growth. A solution is envisioned as a situation in which a country's contractual debt service is consistent with a viable adjustment program and with the perceived ability of the debtor country to pay its bills without the need to revise contracts on an emergency basis. Full restoration of market access, or eventual creditworthiness, is likely to come some time after the debtor country is able to meet its bills regularly. DSR will be evaluated in terms of its contribution to the overall financing of adjustment.

24. Preliminary analysis undertaken by Bank staff indicates that debt reduction and debt service reduction, undertaken on the scale currently envisioned, will not, by itself, meet the external financing needs of many of the target countries. This result is, in part, because some of the IFI funds to support DSR would be diverted from other projects and programs in these countries. The effective net reduction in debt (calculated as the change in the present discounted value of future scheduled debt service payments), if DSR operations depend solely on the support of IFI resources, is also estimated to be relatively small. The gross reduction in commercial bank debt would, of course, be larger.

25. Given the proposed scale of the resources of the IFIs to support DSR, it is especially important that these resources be deployed effectively. In particular, support should be given only to countries willing to undertake adjustment programs that will be viable given prospective official and private financing, including that available through DSR. If debt and debt service reduction is large enough, new money from IFIs, bilateral official and other nonconcerted sources will be adequate. This result could occur in some of the smaller countries, where the relative scale of official resources in support of DSR, and the smaller absolute stakes for existing creditors, could permit substantial DSR. But given the resources available for DSR, such a result is unlikely to occur rapidly in the larger countries, in the absence of an effort to make DSR agreements more comprehensive along lines described in paragraph 31. Under these conditions, the role of DSR will be to speed the return to creditworthiness and growth rather than to achieve those goals very rapidly; and in every case, growth and creditworthiness will return only if countries continue to pursue adjustment programs.

26. In conjunction with DSR, new money needs from commercial banks, expressed as a percentage of interest payments owed to them to be capitalized to fill financing gaps, may actually increase, at least in the short run, for the following reasons:

(i) The new money base will be lower.

(ii) The set aside portion of Bank and Fund resources will not be available for import financing.

27. DSR initiatives can have two, potentially contradictory, effects on the new money process. First, debt reduction will put more pressure on banks to "mark to market" their portfolios. New money would imply an immediate loss, making it unattractive. Second, bargaining power may shift, to some extent, in the favor of debtor countries.

28. Both of these effects suggest that the bargaining over new money and DSR is likely to be protracted. It may involve a period in which debtors are in arrears to commercial banks. Some new money may be provided in the context of DSR packages in which it is one option. New money is most likely to be provided for the larger countries, with which commercial banks will want to maintain a long-term business relationship. However, it is unlikely that significant amounts of new money—other than trade credit—will be available outside the context of concerted packages.

29. Over time the concerted lending process should disappear as countries successfully overcome their debt difficulties. These countries may find their financing needs met through the natural growth of trade financing, project financing, and financing arranged by private entities in the debtor countries. In addition, increased foreign direct and equity investment and the reflow of flight capital will contribute to the financing of domestic investment, but only if the financing package, including DSR, significantly reduces the uncertainty surrounding the disposition of future returns on investment in high debt countries. It is important that countries engaged in DSR undertake policies that encourage the development of these alternative sources of finance.

30. In order to put countries on a path out of debt difficulties and to provide for the the external financing needs of debtor countries in the interim, given the serious questions about the ability of countries receiving DSR to attract significant amounts of new money from commercial banks, the DSR process would need to be reasonably comprehensive. The DSR process can be strengthened in three directions: a more supportive tax and regulatory environment, additional official funds, and official nonfinancial support for countries with strong adjustment programs that make well structured offers to creditors. Each of these could provide greater inducement to creditor participation but could put added risks on creditor governments.

31. Increased leverage through entanglement, discussed under forms of debt service reduction, is a substitute for greater IFI funding and could increase the amount of DSR and reduce the financing gap. However, the effects

of entanglement on the extent of DSR depend on the creditors' perceptions of the involvement of IFIs, and cannot be estimated with any precision. Further, entanglement, if it works, is not without cost to the IFIs. Caution should be used in the calculation of the effect of entanglement on DSR operations.

32. The success of DSR initiatives will depend on the process through which the bargains between debtor countries and creditors are reached. Official agencies will of course seek to ensure that the funds made available to debtors as a result of the DSR will be used efficiently by the debtor countries. In addition, the attitude of IFIs and creditor governments toward the accumulation of arrears--to creditors that are bargaining with debtor countries and to creditors that stay outside of arrangements endorsed by a large majority of creditors--in debtor countries with strong adjustment programs and credible DSR offers will play an important role in determining the magnitude of debtor country benefits from officially supported DSR.

33. The Bank will need to consider how best it can ensure that otherwise feasible adjustment programs should not be postponed or fail because a country cannot secure timely and adequate debt reduction and workable new financing agreements from its commercial creditors. Two considerations will be equally relevant. The first is to avoid the indirect use Bank resources for purposes other than support of adjustment and of appropriate investments. The second is to avoid the postponement of the adjustment process, and of Bank support to it, in order to await the conclusion of possibly protracted negotiations with commercial creditors. How best to proceed will obviously have to be decided carefully, on the basis of specific circumstances of each case. The issue may take on a particular urgency for those countries that have already reached agreement with the IMF, in the framework of its policy on financing assurances.

34. The major benefit for debtors of such official support for DSR would be an assurance of reasonable levels and timely provision of net external finance over the medium term adjustment horizon. Debtor countries could be encouraged to adjust, in return for DSR, through the following incentives: conditional IFI support for DSR; new money and forms of DSR that are conditional on policy performance; and conditional bilateral creditor support.

VI. Summary of Issues for Consideration by Directors

35. The preceding sections highlight and discuss issues of analytical relevance with regard to official support for debt and debt service reduction. Staff conclusions regarding those issues are summarized here as a guide to Board discussion.

36. The potential benefits of DSR are country-specific. Countries that have maintained access to international financial markets will find that the costs, in terms of lost output and investment as a result of a disruption of market access, far outweigh the benefits of DSR. In countries that have already lost voluntary access to international credit markets, DSR, financed by borrowing from IFIs, must be examined on a case-by-case basis. Gains can come from (i) increased incentives to adjust and invest in debtor countries as

a result of a reduction of the debt overhang and a reduction of uncertainty concerning external financing, (ii) the availability of new funds from IFIs, (iii) tax and regulatory advantages of new debt instruments, and (iv) a better sharing of risk between creditors and debtors.

37. It is impossible to say in advance which forms of DSR are likely to be most beneficial, from a debtor country's point of view. Debt exchange offers appear to retain most of the benefits of buybacks and to offer the potential of gains beyond buybacks, in terms of possible seniority, liquidity effects, and compatibility with conditionality. Buybacks at a discount have the advantage of unambiguously reducing the outstanding stock of debt.

38. Because World Bank support for DSR will be limited to operations producing a significant gain for the debtors, the Bank will have to form a judgment on the overall terms of a country's DSR arrangements. These issues are addressed in more detail in the paper, "Implications of Debt Reduction Proposals."

39. Given the scale of official support, it is important that official resources be deployed effectively, in support of countries willing to undertake meaningful adjustment programs. All participating countries should benefit if the operations are carefully structured, and some smaller countries may emerge from their crises. The likely DSR in most major debtors will need to be supplemented by a combination of: IFI lending, foreign direct and equity investment flows, reasonable increases in trade credit, and official and private project financing. The DSR process can be strengthened in three directions: a more supportive tax and regulatory environment, more official funds, and official support for well structured DSR proposals of debtor countries with strong adjustment programs.

Barber B. Conable

by Ernest Stern

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SecM89-1087

From: The Deputy Secretary

August 14, 1989

ILLUSTRATIVE EFFECTS OF WORLD BANK SUPPORT
FOR VOLUNTARY DEBT AND DEBT SERVICE REDUCTION OPERATIONS

On several occasions, the Executive Directors expressed interest in analytical information on three issues related to potential debt and debt service reduction operations supported by the World Bank: the relative effects of alternative types of debt and debt service reduction operations; their likely impact on secondary market prices; and the size of the overall debt and debt service reduction as a result of the available official support. This note addresses these three issues.

Questions on this document may be addressed to Mr. Lamdany (72945) or Mr. Underwood (33911).

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Technical Note

ILLUSTRATIVE EFFECTS OF WORLD BANK SUPPORT FOR VOLUNTARY DEBT AND DEBT SERVICE REDUCTION OPERATIONS.

I. Introduction and Summary

1. This note responds to requests by Executive Directors for analysis of three issues related to potential debt and debt service reduction operations supported by the World Bank. First, what are the relative effects of alternative types of voluntary debt reduction operations in highly indebted countries? Second, what is the likely impact of debt reduction operations on secondary market prices? Third, how large might the overall debt and debt service reduction be as a result of the official support available?

2. Voluntary debt and debt service reduction operations are a means for highly indebted countries to reduce their contractual obligations to creditor banks. By their very nature, voluntary exchanges imply that each party trades existing obligations for something of perceived equal or greater value. A debtor can benefit from such operations if it expects eventually to repay a larger share of its obligations than is reflected in the secondary market price for its outstanding claims, and if it can finance the cost of the operations by borrowing at an interest rate close to the risk free interest rate. This note discusses the effect of debt and debt service operations in which the official sector, and in particular the World Bank, would lend the required funds.

3. A distinction must also be made between the use of funds that the World Bank would divert from its regular lending program ("set aside" funds) and the use of additional borrowed funds. From the debtor's point of view the use of set aside funds for debt reduction yields an immediate negative cash flow effect, as the funds would not be available to finance other balance of payments requirements. Either imports would be cut or alternative finance would be required. But the use of the set-aside funds does not increase future debt service obligations to the World Bank, as these obligations would have existed in any case. In the case of additional funds, the debtor would avoid the initial negative cash flow effect linked to the set-asides, but its debt service obligations to the World Bank would increase. In general, debt and debt service reduction operations financed with additional funds would be of greater benefit to the debtor country than operations financed with set-asides.

4. The main conclusions of the technical note are as follows:

Effects of alternative types of debt reduction operations. For relatively small market-based operations, the overall benefits to the country under alternative techniques for debt and debt service reduction operations considered are likely to be very similar. Tax and regulatory benefits as well as the possibility of creating some degree of seniority for exit bonds, could enhance the benefits obtained through debt exchanges relative to buybacks. Concessional loan restructurings are the most difficult to evaluate, because the outcome hinges on the determinants of the bargaining strength of each side, as well as on the economics of debt reduction.

Effects on secondary market prices. In general, partial forgiveness of debt and debt service is likely to increase the market value of all remaining claims on a debtor. However, the creation of new senior claims, IFI loans from additional funds and potentially senior claims through debt exchanges, would tend to depress the prices of old claims. Secondary market prices of the debt of those countries for which debt and debt service operations are planned in the near future may not rise much beyond the original increase at the announcement of the change in the debt strategy, unless new developments occur that have an impact on the ability of these countries to service debt.

Impact on debt and debt service obligations. Present estimates regarding the potential contractual debt and debt service reduction that could be achieved through the use of US$20 billion to US$30 billion of official resources indicate that the benefits to debtor countries could be important. These estimates are based on the use of roughly half of the funds (set-aside funds) in support of principal reduction and half (the additional funds) to collateralize interest payments. Over the initial three years, an annual reduction of US$4 billion to US$8 billion in contractual interest payments is possible (or roughly 10 to 20 percent of the scheduled interest payments of the highly indebted middle income countries). The net cash flow effects over the first three years would be smaller, US$1 billion to US$4 billion, because the set-aside funds would not be available for import financing. Cash flow effects would be larger in later years. Measures taken by regulatory agencies and by IFIs, in coordination with creditor governments, could affect these results.

II. Alternative Debt Reduction Structures

5. This section analyses three types of voluntary debt and debt service reduction operations: buybacks, discounted and par debt exchanges, and concessional loan restructurings. It describes each of the operations, mentions recent experiences,[1] and compares their effects, initially assuming that the operations are relatively small and do not affect the secondary market price for the old debt, and that creditors would look at the unsecured portion of the new bonds as an unchanged credit risk. Subsequently the discussion is broadened to include several factors, such as accounting and tax regulations or the possibility of according seniority to the new debt instruments, that may render some leverage in the use of funds through debt exchanges or concessional restructurings relative to buybacks.

1/ A more detailed description of two such operations, as well as a discussion of their terms, can be found in "Voluntary Debt Reduction Operations: Bolivia, Mexico and Beyond," Discussion Paper No. 42, The World Bank (1988).

6. For simplicity, the analysis begins by disregarding the possibility of refinancing part of the interest payments due through new money loans. This limitation is important, especially in the case of debt exchanges, as the benefits to the debtor would be reduced if the country is able to refinance part of the interest on the old loans but cannot refinance the interest payments on the new instruments. This assumption is relaxed in subsequent analysis. In all cases, existing loans are assumed to have a bullet maturity of 30 years (or, equivalently, would be rescheduled to those terms) and to trade at a 60 percent discount (i.e., at a price of 40 percent of their face value) in secondary markets. In practice, the relationship between the terms of debt and debt service reduction agreements and pre- and post-agreement secondary market prices will depend critically on the framework within which debtors and creditors bargain.

Buybacks

7. Buybacks are equivalent to prepayment of commercial debt at a discount. In order to pursue such operations, the debtor country would have to seek waivers on prepayment and sharing clauses from all creditors, as was done by Bolivia and Chile before their recent buybacks. The debtor country can either offer a price (as Bolivia did), or call for bids (as Chile did). In either case, as long as the buyback is small relative to the total debt, the price that the debtor country will have to pay is likely to be similar to the secondary market price for its public sector debt, 40 percent of its face value in the example here.

8. The effects of the buyback on scheduled debt service payments are presented in Table 1 below. It is assumed that the Bank sets aside US$100 of its regular lending program to be used to finance a buyback of part of the debtor country's commercial debt. At a price of 40 cents per dollar of face value, the debtor would be able to buy back US$250 of its outstanding external debt, using the US$100 loan from the World Bank. Assuming an average interest rate on the retired loans of about 10 percent, this transaction would lead to an annual reduction in contractual interest payments of US$25. However, such an operation would have a negative cash flow effect of US$75 in the first year, since the World Bank loan would not be available to finance other balance of payments requirements. In the following years, the cash flow relief due to the buyback would be US$25, identical to the reduction in interest payments. The debt service on the World Bank loans is not included in the analysis, as it would have been incurred in any case. In addition, the buyback would eliminate the need to repay the principal of the loan at maturity (assumed to be 30 years). The rate of return to the debtor country is discussed below. Additional examples are presented in Annex 1.

TABLE 1
Illustrative Effects of a Buyback
Supported by World Bank Set Aside Funds
($100 to purchase $250 of loans)
(U.S. dollars)

	Year 1	Years 2-29	Year 30
Annual Reduction in Scheduled Interest Payments to Banks	25	25	25
Reduction in Principal	0	0	50
Reduction in Scheduled World Bank Disbursements for Other Purposes	-100	0	0
Net Cash Flow Effects for Debtor[a]	-75	25	275

Notes:
Assumes a transaction price of 40 cents per dollar.

a/ Accounting for debt on a scheduled payments basis.

Debt Exchanges

9. An alternative way for the World Bank to support voluntary debt reduction operations is to finance credit enhancement of new debt instruments to be used in debt exchanges. These operations would be designed to provide creditor banks with the option of accepting a lower contractual return in exchange for a new instrument with some form of credit enhancement. The new instruments could be structured as bonds to provide them with greater liquidity. Also, they could possibly be granted a formal exemption from participation in any current or future commercial bank new money arrangements, in which case they would be referred to as exit bonds. For example, within the framework of its 1988 financing package, Brazil exchanged US$1 billion of 6 percent convertible exit bonds for the same amount of commercial bank loans. The March 1988 Mexican exchange of bonds for loans had similar objectives, although it was not done in the process of negotiating new loans. Some highly indebted countries (Chile, Mexico and the Philippines, for example) would not be required to seek waivers from their commercial creditors for this type of operation, since exchanges of debt are allowed under their current restructuring agreements.[2]

10. The effects of debt swaps from the debtor's point of view depends on the funding of the credit enhancement, the structure of the new instrument, and the terms of the exchange. In a small market based operation the terms of the exchange between loans and bonds would be equal to their respective secondary market cash prices, corrected for whatever

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2/ However, collateralized exchange offers may require negative pledge clause waivers from other creditors, possibly including existing bondholders.

value banks ascribe to any explicit exemption from new money requirements and for possible tax and regulatory benefits. The factors that determine the value of the bonds are the type and amount of credit enhancement per bond, banks' expectations of debt service on the unsecured claims, and the bonds' terms (notably, interest rates and maturity).

11. Table 2 shows estimates of the results, in terms of scheduled debt service, of an exchange of credit enhanced new bonds for loans. It is assumed that the World Bank sets aside US$100 from its regular lending program which the borrower uses to collateralize the principal of an issue of 30 year bonds with a face value of US$1,745. The structure of the bonds in these examples is similar to the bonds Mexico issued for its 1988 exchange offer, except that the Mexican bonds were collateralized with 20 year zero coupon bonds and carried an interest rate higher than the rate on the old loans. The ranges presented in Table 2 were obtained by considering par and discounted swaps, and by estimating the effects of the operations using two different models of the formation of secondary market prices and of the evaluation of the bonds' unsecured obligations.[3] Although the results shown are specific to the chosen models, other models consistent with a secondary market price of 40 cents per dollar yield similar results.

12. In the example, the US$100 Bank loan is used to purchase US$1,745 in zero coupon bonds maturing in 30 years (assuming a market yield of 10 percent) to collateralize the principal of an issue of new bonds. In a discounted exchange, the debtor country would trade the new bonds with a face value of US$1,745 for between US$1,900 and US$2,000 of old loans (an exchange ratio of US$1.09 to US$1.15 of old loans for each US$1 of new bonds--see Annex 2). The exchange would lead to an annual reduction in contractual interest payments to commercial banks of between US$15 and US$24.50 (assuming an interest rate of 10 percent on both the old loans and the exit bonds). In addition, from the debtor's point of view, the exchange would extinguish between US$1,900 and US$2,000 of principal due, US$1,750 through collateralization and the rest through forgiveness. Under a par swap US$1,750 of old loans would be retired and the interest rate on the exit bonds could be set at between 8.6 percent and 9 percent (instead of 10 percent on the old loans), yielding interest payment reductions of US$15 to US$24.50.

13. As with the buyback, the exchange leads to a negative cash flow in the first year, here of US$75 to US$85 (because of the fall of US$100 in World Bank disbursements available for general balance of payments purposes). In the following years, up to maturity, the exchange would render a positive cash flow equal to the reduction in interest payments to commercial banks, US$15 to US$24.50 per year. While the savings in scheduled debt service in Table 2 appear to be much higher than the savings in Table 1, they are very close in a present value sense. For example, using a debtor country discount rate of 15 percent, the present value of scheduled debt service savings is US$170 for a buyback and in the range of US$130 to US$190 for a discounted debt exchange (see tables in Annex 1). This result illustrates an aspect of the near equivalence of buybacks and alternative forms of debt exchanges, under the above assumptions.

3/ The models are described in Annex 2.

TABLE 2
Illustrative Effects of Discounted Debt Exchanges and Par Swaps Supported by World Bank Lending
($100 to collateralize principal)[a]
(U.S. dollars)

	Year 1	Years 2-29	Year 30
Reduction in Scheduled Interest to Banks[b]	15 to 24.5	15 to 24.5	15 to 24.5
Reduction in Principal[b]	0	0	1,990 to 1,745
Reduction in Scheduled World Bank Disbursements for Other Purposes	-100	0	0
Net Cash Flow Effects for Debtor[c]	-85 to -75	15 to 24.5	2,015 to 1,760

Notes:
Assumes a cash price for old loans of 40 cents per dollar.

a/ Assumes collateralization of principal of US$1,745 due in 30 years. Ranges **are shown for terms on discounted swaps and par swaps, as well as for the alternative valuation models described in Annex 2.**
b/ Higher ranges of interest savings correspond to lower ranges of principal savings.
c/ Accounting for debt on a scheduled payments basis.

14. If the debt exchange includes interest enhancement, as well as principal collateralization, the cash-flow results would be different. A sample result for a bond with full principal collateralization (purchased from Bank set-aside funds) and with one-year roll-over collateral (funded from an additional World Bank loan) is shown in Table 3 below.[4] Although the total World Bank loan is again US$100, the results are not strictly comparable to those shown above because support for interest enhancement would come from additional funds instead of set-asides. Because of these additional funds, the negative cash-flow effect in the first year is smaller. The positive effect on the debtor country's scheduled debt service payments in the years in which debt service is due on the new World Bank loan is, of course, correspondingly smaller also.

4/ Annex 2 presents a discussion of the calculation of the value of the roll-over collateral.

TABLE 3
Illustrative Effects of a Discounted Debt Exchange
With One-Year Roll-Over Collateral
Supported by World Bank Lending
($100 split between collateral for principal and one year of interest)[a]
(U.S. dollars)

	Year 1	Years 2-4	Years 5-17	Years 18-29	Year 30
Reduction in Scheduled Interest to Banks[b]	20	20	20	20	84
Reduction in Principal	0	0	0	0	840
Reduction in Scheduled World Bank Disbursements for Other Purposes	-36	0	0	0	0
Principal on World Bank Loan for Interest Collateral	0	0	-5	0	0
Interest on World Bank Loan for Interest Collateral	-6	-6	-2[b]	0	0
Net Cash Flow Effects[c]	-22	14	13	20	924

Notes:
Assumes a cash price for old loans of 40 cents per dollar. Discount rate on unsecured debt based on a constant yield to maturity consistent with the transaction price. World Bank additional loan assumed to carry a maturity of 17 years with four years of grace. For simplicity, the interest rate on World Bank loans was taken as 10 percent, equal to the interest rate assumed on old and new commercial debt. Funds in the rolling collateral account are assumed to be used to meet interest payments in year 30.

a/ Assumes collateralization of principal of US$636 due in 30 years, financed by set-aside funds of US$36 and collateralization of one year of interest on a rolling basis, financed by an additional World Bank loan of US$64. Note that because of the use of additional funds, the results shown here are not comparable to the results in Tables 1 and 2.
b/ Average for period.
c/ Accounting for debt on a scheduled payments basis.

The Rate of Return on Debt and Debt Service Reduction Operations

15. In order to estimate the rate of return on the use of resources in a debt and debt service reduction operation, it is necessary to assess the country's economic situation with and without the operation. In the examples shown here, the only changes taken into account concern the expected cash-flow streams with and without the operation.[5] The expected rate of return reported below is the interest rate that would equalize the present value of the two cash flows.

5/ In actual practice, potential changes in investment and output as a result of debt reduction would also be important.

16. The Debt Service Stream Without Debt Reduction Operations. A key consideration in evaluating the rate of return on debt reduction operations is the potential for refinancing interest payments on the existing debt. Refinancing of interest payments is important because new money loans (or capitalized interest) may carry an interest rate that is substantially lower than the rate of return on the debt reduction operation; hence, any refinancing of payments would reduce the rate of return. Table 4 shows the effects on the rate of return on a buyback assuming alternative degrees of refinancing.

17. In order to assess the debt service stream before debt reduction it is also necessary to assess whether the principal would have been repaid on its contractual terms or rescheduled, and if rescheduled on what terms (tenor, grace and interest rate). The shorter the expected maturities in the absence of debt and debt service reduction operations, the higher their rate of return. This result can be seen in Table 4, which compares the rate of return on a buyback under the assumption that the original debt was a perpetuity to the rate of return assuming a 30 year bullet maturity on the old loans.

18. For the calculation of the rate of return, expected arrears on the old loans can be treated as a form of interest refinancing or of principal rescheduling. The assumption used here is that banks would charge approximately the same rate of interest on arrears as on explicitly refinanced or rescheduled debt service payments.

19. In theory, some claims may be unilaterally forgiven by banks, at no direct cost to the debtor, and these amounts should be taken into account in assessing the pre-debt-reduction debt service stream. More realistically, the debtor may be able to retire its obligation at some point in the future through some alternative debt and debt service reduction operation, which may be more or less "expensive" than the operations undertaken now. The calculations in Table 4 disregard these possibilities.

20. The Debt Service Stream With Debt Reduction Operations. In general, following a debt and debt service reduction operation the debtor will have two new types of obligations: (1) the new instruments given to participating creditors (new loans or bonds with reduced principal or lower interest rates); and (2) the loans linked to the financing of such operations (e.g., World Bank loans). However, not all transactions introduce both types of new obligations. Following a buyback the debtor would not have any obligation to participating banks on the repurchased debt; and a debt and debt service reduction operation financed using the debtor's own reserves does not create additional financing obligations.

21. Each of the issues raised above--expectations regarding refinancing and arrears on principal and interest, and potential future forgiveness--applies also to the scheduled debt service stream on each of the new debt instruments created as part of the debt and debt service reduction exercise. For example, the replacement of reschedulable loans by non-reschedulable or senior debt must be taken into account.

22. The results shown in Table 4 are based on a buyback assumed to be financed from the debtor's own reserves. Under these assumptions many of the issues raised above are avoided. Rates of return are highest under the assumption that the debtor would have paid in full and on time the debt service due on the repurchased debt. They are the lowest when a large share of the debt service on the old debt would have been refinanced or rescheduled.

Table 4
Rate of Return on the Use of Debtor Country Resources in Support of a Buyback
(percent)

Refinancing of Interest Payments on Old Loans	Transaction Price (cents per dollar of face value)			
	30	40	50	60
No Refinancing:				
Bullet Maturity (30 years)	33	25	20	17
Perpetuity	33	25	20	17
25 percent of interest due:				
Bullet Maturity (30 years)	28	21	18	15
Perpetuity	27	21	17	15
50 percent of interest due:				
Bullet Maturity (30 years)	22	18	16	14
Perpetuity	22	17	15	13
75 percent of interest due:				
Bullet Maturity (30 years)	18	15	14	13
Perpetuity	16	14	12	12

Notes:

Assumed interest rate on old loans: 10 percent.

The table shows the rate of return on the use of resources in a buyback financed by the debtor's own reserves.

The transaction price is the price at which the loans are retired.

The refinanced interest is assumed to be capitalized explicitly or implicitly (new money or arrears) at the same interest rate and maturity as the old loans. It is assumed that bullet maturity principal payments would have been made in full.

23. In actual practice, the rate of return calculations have an additional complication. The transaction prices are not independent of expectations regarding repayments and arrears. Those expectations are, in turn, influenced by the effect of the operations on the domestic growth and investment rates in the debtor countries. Case by case analysis of each operation, based on detailed economic projections, will be essential.

Concessional loan restructurings

24. The more complicated a debt exchange becomes, the more difficult it is to negotiate and market. As a result, both creditors and debtors may consider the alternative of simply renegotiating the terms on which the commercial bank loans have been restructured rather than try to design a complex, and potentially inadequate, set of exit instruments.

25. In principle, most concessions that are obtained through loan restructuring could also be replicated by debt exchanges with exit bonds carrying similar terms. However, in practice, there are several differences between concessional loan restructurings and exchange offers that could lead to different results.

26. First, the structure of exit bonds tends to be simple, as exit participants seek enhanced liquidity and tradeability. Concessional restructurings can be designed in a more complicated manner, since loan values are not linked to their tradeability. For example, the concessions on the terms of existing loans could--more easily than exit bonds--include stepwise increases in interest rates after a certain number of years, recapture clauses depending on the terms of trade, or reversion to old interest rates in the event of prolonged arrears. These types of structures may enable the debtor to capture a larger share of debt reduction as immediate cash flow relief.

27. Second, in some creditor countries changes in loan terms would not be treated as an accounting event, while an exchange of loans for exit bonds may. Avoiding the need to report an accounting event may provide creditor banks more flexibility in terms of regulatory and tax treatment.

28. Third, concessional loan restructurings may avoid the "free rider" problem, as all creditors would be bound by the same concessional terms. In most cases, changes in the terms of existing loans would require the agreement of all creditors. This puts pressure on potential free riders because without their signature the new terms would not become effective for any creditor. In new money loan arrangements or exit bond subscriptions, individual banks have the incentive not to participate, forcing other creditors to "top up" the corresponding deficiency. Past experience indicates that it is not as difficult to achieve the consensus necessary for changes in restructuring agreements as it is to convince reluctant banks to provide new money or subscribe to exit bonds.

29. Fourth, concessional restructurings would keep bank syndicates intact, and may result in better legal protection for remaining creditors and in a greater capacity for creditors to enforce agreements reached with debtors. All these factors may render benefits to banks that are not expecting to dispose of their exposure, hence allowing debtors to structure transactions so as to share part of those benefits. With sharing clauses intact, individual banks would not be tempted to go to court to seize debtor country assets in the case of arrears.

30. The last two factors are related to possible differences in the negotiating environment in which concessional loan restructurings and debt exchanges may take place. Concessional loan restructurings are more likely to occur in a concerted environment, where the advisory committee banks negotiate directly with the debtor and where most banks end up choosing from a set of options which are more or less equivalent. Debt exchanges are more likely to be market-based, with each bank pricing the transaction on its own and deciding accordingly on the terms under which it would participate. In practice, concessional loan restructurings may include a debt exchange option as an alternative to the terms of the main agreement, allowing some banks to choose the exit option.

Other Issues Affecting the Terms and Effects of Debt Reduction Operations.

31. The previous analysis is based on three simplifying assumptions. First, it was assumed that the operations would be small enough that they would not affect secondary market prices. Second, it was assumed that creditors would ascribe the same value to the unsecured portion of the exit bonds as to the existing loans. Third, the analysis disregarded the possibility that the debt and debt service reduction achieved through these operations may affect economic policy and private sector expectations in the debtor country. These issues are addressed in the following discussion.

32. Regulatory and tax considerations.[6] The regulatory and tax environments in which most creditor banks operate may enhance the benefits that debtor countries obtain in exchanges and concessional loan restructurings, relative to buy-backs. Regulatory policies determine how participation in voluntary debt reduction affects the timing of the recognition of lost capital. Tax polices determine the timing and the extent to which banks' losses on their developing country portfolios can be shared with other taxpayers.

33. Regulatory policies may favor debt exchanges over buybacks. A bank selling loans in a buyback is required to immediately recognize a loss of regulatory capital equal to the difference between the carrying value (face value minus provisions previously taken out of capital) of the loan and the cash price received. Accounting and regulatory policies exist in some creditor countries that allow banks that restructure their loans on concessional terms or that exchange their loans for exit bonds to retain the debt on their books at its full face value. Banks then recognize their capital loss over time in the form of reduced income.[7] The timing of the recognition of capital loss is important because the amount of assets (loans and other claims) that banks are allowed to hold is determined as a proportion of their regulatory capital. Therefore, following a sale, banks that are currently operating at or near the mandatory capital asset-ratio would have to reduce other assets or raise capital. Either action would

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6/ For a more detailed consideration of these issues see "Tax, Accounting and Regulatory Treatment of Sovereign Debt", The World Bank, SecM89-932, July 1989.

7/ The Brazilian exit bonds, for example, qualified for this type of treatment in the United States.

reduce earnings for existing shareholders. Hence, the gains for banks from participating in a debt exchange which allows them to delay the recognition of capital loss, could induce them to accept a lower (implicit) price for the old debt--in terms of the resources used to collateralize debt exchange instruments--relative to a buyback.

34. In certain creditor countries, the regulatory benefits for banks participating in a debt exchange rather than in a buy-back may be partly offset by potential differences in the tax treatment of the transactions. In most creditor countries, a bank participating in a buy-back would be able to recognize a loss for tax purposes equal to the difference between the bank's tax basis in an existing loan (its pre-operation valuation for tax purposes) and the amount of cash received. Conversely, in a debt exchange, tax authorities in creditor countries that allow banks to delay regulatory capital losses may require the same delay in tax benefits. However, it is possible that given the official support for these operations, creditor governments could allow participating banks to immediately recognize the loss for tax purposes, even though they will recognize the capital loss for regulatory purposes over a number of years.[8] The importance of the tax treatment differs across creditor countries depending on whether provisions on the old loans are tax deductible, and on whether such provisions are included in regulatory capital. Also, the importance of these considerations will vary across banks depending on their specific tax positions.

35. The tax and regulatory treatment of most types of debt reduction operations are still uncertain because of the novelty of the transactions, and they are likely to vary with the structure of the operations and across creditor countries. The extent to which any tax and regulatory benefits could be shared by the debtor and, correspondingly, the degree of leverage in the use of official resources that can be achieved through exchange offers (relative to a buyback) depends critically on the structure of the specific transaction, the bargaining power of debtor and creditors, and the attitude of the official sector. While these effects can be marginal, as in the 1988 Mexico exchange, analytical work indicates that, under quite plausible circumstances, tax and regulatory benefits could increase the amount of debt reduction that can be bought per dollar used in enhancement of an exchange offer, relative to a buyback.

36. Effects on the value of the unsecured portion of exit bonds. An additional potential source of efficiency of debt exchanges over buybacks is linked to the possibility of creating some degree of explicit or, more likely, implicit seniority for the new instruments. There are several factors that may lead creditors to ascribe a higher value to the unsecured portion of the new instruments relative to the old claims and which, therefore, could improve the terms of the exchange transactions. Some of these factors are:

8/ Of course, increased tax benefits and relaxed regulatory standards for banks are not without cost for creditor governments.

- Explicit legal seniority of exit bonds conferred by subordinating old commercial bank loans. However, such subordination would have to be agreed by non-participating banks, which is unlikely to occur, unless the issue of exit bonds is small or the exchange takes place at a very steep discount.

- A formal exemption from new money calls. This formal exemption, provided by other creditors and the debtor government, would give the new instruments some degree of de-facto seniority. In addition to the formal exemption, the holders of exit bonds may, in practice, be placed in a better position than other creditors to avoid lending new money if the debtor moves into temporary arrears. If the exit bond interest payments are partly secured, they could continue to be current while other creditors' claims would move into a non-performing status without new loans.

- In general, exit bonds would be exempted from existing sharing clauses. This exemption would permit exit bond holders to receive interest payments in circumstances in which other creditors were not being paid, as well as to reach separate arrangements on the settlement of the claims with the debtor.

- As long as the face value of new instruments outstanding is relatively small, the country would be more likely to service credit enhanced debt than the old instruments.

- The debtor may want to show good will towards those creditors that participated in debt reduction by giving preferential treatment to the new instruments, in practice if not formally. An additional incentive for the debtor to give preferred treatment to these claims could be created by establishing that the terms of the new instruments would revert to the terms of the old loans, if debt service on the new claims is in arrears.

- Creditors may perceive that the new instruments are somehow covered by the "umbrella effect" of the preferred status usually granted to the IFIs, because of the IFI involvement in the creation of the new instruments.

37. All these factors could substantially enhance the value of the unsecured part of exit bonds. Potentially, the bonds could trade at close to par if their amount is very small and their seniority very credible, leading creditors to evaluate future payments using a discount rate close to the risk free interest rate. Short of that, the potential to achieve some degree of leverage may be large, especially when secondary market prices for the country's debt are very low. For example, if creditors were to evaluate the unsecured portion of the exit bonds considered above using a discount rate of 22 percent--just slightly lower than the 25 percent they were assumed to use to evaluate unsecured claims in the previous discussion--the market value of the exit bonds would increase by almost 15 percent. The amount of debt and debt service reduction that the debtor could achieve through such a debt exchange relative to a buyback would increase by approximately the same proportion.

38. Effects of a reduction in the debt overhang. In large operations, the reduction in debt and debt service may result in additional benefits of a different nature to those outlined above. The term "debt overhang" has been used to describe the negative incentive effects inherent in a large external debt. Countries are less willing to save and invest when a substantial share of the increased output may to go to external creditors; austerity measures aimed at increasing future growth are also discouraged by a large external debt. While a reduction in debt and debt service is likely to improve the macroeconomic performance--in terms of domestic savings and investment--of a debtor country, the effects are difficult to quantify.

III. Factors Affecting the Impact on Secondary Market Prices

39. The impact of voluntary debt service reduction on secondary market prices is important. Changes in secondary market prices of debt will affect the cost and the returns to debtor countries of voluntary market-based debt and debt service reduction operations.[9] If the secondary market price rises sharply, the amount of debt that a country can purchase or exchange for new claims is reduced. A price rise should not be viewed as a totally negative outcome, however. One of the goals of debt and debt service reduction operations is an eventual return of the debtor countries to creditworthiness; and the debt of a creditworthy country sells near par.

40. The exact impact on secondary market prices of the official support for voluntary debt and debt service reduction operations will vary from country to country and will depend, in part, on the amount of official resources devoted to each individual country, and on the distribution between set asides and additional funds. Officially sponsored debt reduction operations may also affect secondary market prices through the effects they may have on the economic environment in debtor countries. In addition, the enforceability and seniority status of remaining old claims, vis-a-vis any converted claims, will affect their relative secondary market prices.

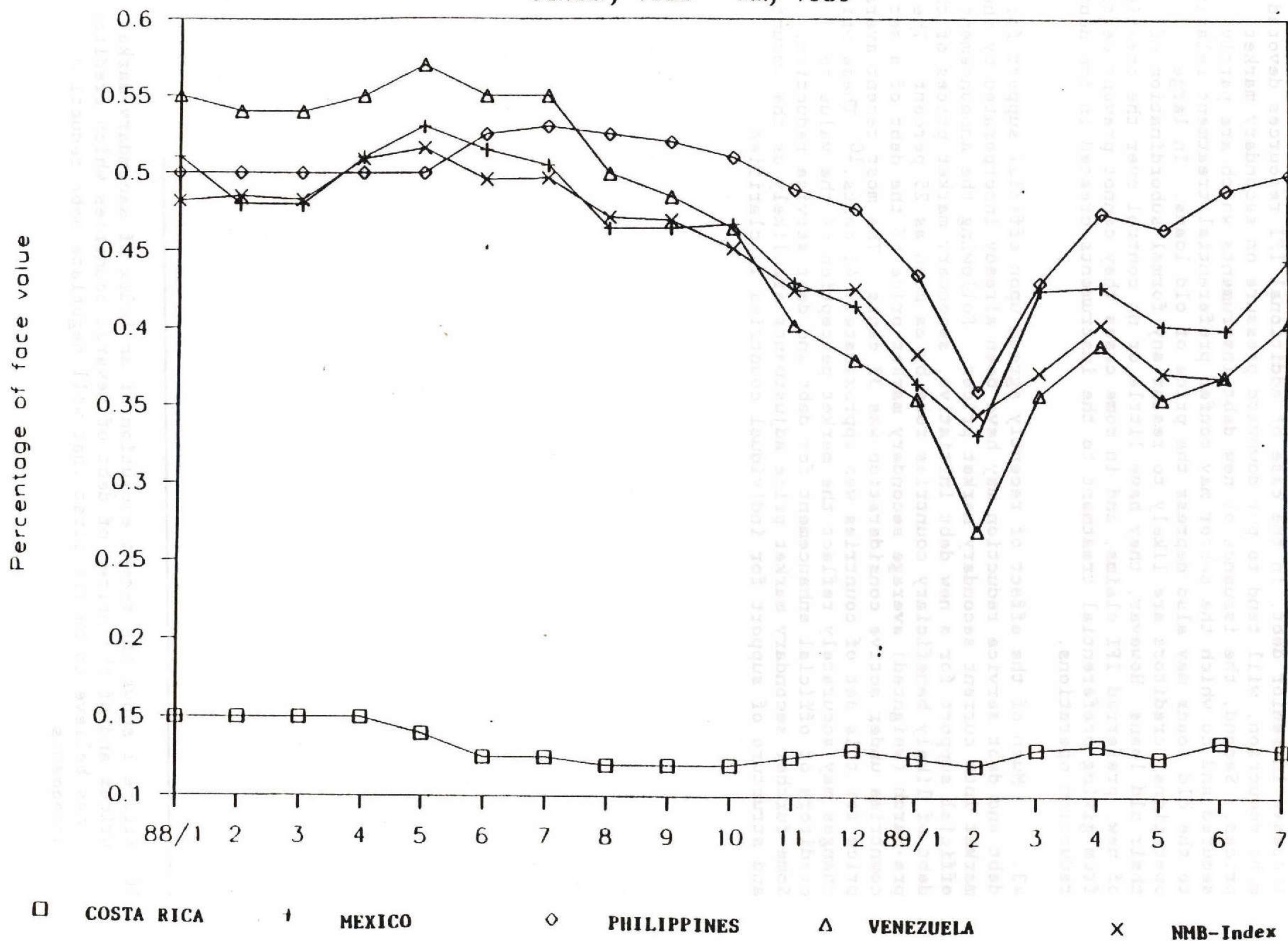
41. At least three factors will tend to increase prices. First, the injection of additional resources devoted to debt reduction will tend to increase secondary market prices. Set-aside funds, funds diverted from regular lending and earmarked for debt reduction, may have less of an impact on market prices since a proportion of these funds were already expected to be partially available, indirectly, for debt service (as most external resources are fungible). Second, any reduction in outstanding claims will tend to increase the value of remaining claims. Third, economic reforms undertaken in connection with IFI lending for debt reduction operations will improve the outlook for the country and raise secondary market prices.

9/ The relationship of secondary market prices to the underlying economic situation in debtor countries and to the likelihood of future debt servicing is a subject of debate among economists and market participants.

42. Two other factors may tend to decrease prices. First, the increase in senior debt, in the case of additional IFI resources devoted to debt reduction, will tend to put downward pressure on secondary market prices. Second, the issuance of new debt instruments which are partly secured and to which the debtor may confer preferential treatment relative to the old loans may also depress the price of old loans. In large operations, creditors are likely to resist any formal subordination of their old loans. However, they have little or no control over the creation of new, preferred IFI claims, and in some cases they cannot prevent debtors from giving preferential treatment to the instruments created in the debt reduction operations.

43. Much of the effect of recently agreed upon official support for debt and debt service reduction may have been already incorporated by the market into current secondary market prices. Following the announcement of official support for a new debt initiative, secondary market prices of the debt of likely beneficiary countries rose by as much as 25 percent. The pre-March (weighted) average secondary market price of the debt of a set of countries under active consideration was 33 cents. The most recent average price for this set of countries was approximately 41 cents.[10] These price changes may accurately reflect the market perception of the value to creditors of official enhancement for debt and debt service reduction. Some further secondary market price adjustments are likely as the amount and structure of support for individual countries is clarified.

10/ Figure 1 shows the recent evolution of an index of secondary market prices and of the prices of debt of several countries which creditor banks believe to be the first that will negotiate debt reduction agreements.


Secondary Market Prices
January 1988 - July 1989
Percentage of face value
0.6
0.55
0.5
0.45
0.4
0.35
0.3
0.25
0.2
0.15
0.1
88/1
2
3
4
5
6
7
8
9
10
11
12
89/1
2
3
4
5
6
7
COSTA RICA
MEXICO
PHILIPPINES
VENEZUELA
NMB-Index

IV. Potential Impact of Officially Supported Debt Reduction

44. This section assesses the potential debt and debt service reduction that could be achieved through the use of US$20 billion to US$30 billion dollars of official resources. That is the range of the amount of official support commonly assumed in discussions of recent official initiatives. As the discussion in the previous sections indicates, it is impossible to assess the impact that can be achieved through the use of those official funds without specifying the environment within which the operations would take place, the distribution of funds across debtor countries, the structure of each specific operation, and the degree of additionality. Projections are presented for the overall effect of the operations on debt and debt service, followed by net cash-flow estimates that take into account the reduction in import financing as a result of the use of set-aside funds.

45. The use of US$20 billion to US$30 billion of official funds is projected to lead to a reduction of the face value of external debt of US$35 billion to US$45 billion. In the case of par exchanges at reduced interest rates this amount would represent the present value equivalent of scheduled debt service evaluated at a rate close to the risk free rate. This amount is net of the additional official loans for debt and debt service reduction, except for those loans used to establish collateral accounts.[11] The above results are based on the following assumptions: (1) the official resources are distributed across countries proportional to current projections for IBRD adjustment lending (using the High Case projections) and proportional to each country's IMF quota; and (2) a fixed allocation of funds in support principal reduction and interest enhancement, consistent with those in recent IMF and World Bank Board documents. This represents a reduction between 10 percent to 15 percent of the amount of commercial medium and long term external debt outstanding in the corresponding countries, or 8 to 12 percent of total public and publicly guaranteed medium and long term debt.[12]

46. Debt and debt service reduction operations under the above assumptions could result in an annual interest payment reduction in the initial three years of US$4 billion to US$8 billion, or 10 to 20 percent of interest payments due in the absence of debt reduction programs. These amounts include the corresponding increase in interest payments to the official sector and account for the interest earned on collateral accounts. The interest reductions translate to savings on the order of 0.5 percent to 1.0 percent of the estimated GDP in 1990 of the assumed beneficiary countries. Over time, the gross interest savings would increase (primarily due to interest savings on the reduction achieved in financing requirements in previous years) and are estimated to be US$5 billion to US$11 billion in 1995, translating again into 0.5 percent to 1.0 percent of 1995 GDP.

11/ The reason for excluding those loans is that they may be seen as not increasing the debtor's net liabilities, as the collateral account could be considered an off-setting asset.

12/ See Annex 3 for calculations under alternative assumptions.

47. The net cash flow impact on the countries over the period will be smaller. as to some extent official resources will be non-additional and the diversion of these resources to debt reduction will increase the need for import financing or will have to lead to a reduction in imports. As it is envisioned that approximately US$10 billion of official funds will be non-additional over the next three years, the net cash flows effects will be approximately US$1 to US$4 billion per year for these countries.

48. These aggregate projections do not enable us to assess the viability of officially supported debt reduction packages. The assessment of the adequacy of debt reduction in terms of external support for growth and of filling financing gaps can only be done on a case by case basis and will depend on the specific allocation of the US$20 billion to US$30 billion across debtor countries. The assessment also depends on the entire range of external support, including new money from commercial banks and support from official bilateral creditors, as well as the policy environment in the debtor countries.

49. The above analysis assumed that the official resources would be allocated across countries roughly pro-rata to the projected IBRD High Case adjustment lending programs and to Fund quotas. As noted in the Board Memorandum, "Implications of Debt Reduction Proposals," (SecM89-521, April 28, 1989) a more concentrated targeting of resources may occur, in light of factors such as eligibility criteria and rate of return calculations. If so, the percentage reductions in external debt and interest payments, relative to GDP, in a beneficiary country could be much higher than the averages presented above (with, of course, lower or zero benefit accruing to the other countries).

Annex 1

Effects of Debt Reduction Operations at Different Prices

1. Tables I.1 and I.2 present, respectively, the effects of buy-backs and debt exchanges that take place at prices for the old debt of 20 percent to 70 percent of face value. The figures presented are calculated under the following assumptions:

- The operations are financed through a US$100 set aside loan from the World Bank.

- Old loans are assumed to have a 30 year bullet maturity and to carry an interest rate of 10 percent.

- The cash flow effect is the difference between the reduction in scheduled debt service on the old loans and the reduction in World Bank disbursements for other purposes.

- The present value of debt service savings is calculated relative to the scheduled debt service on the retired old loans.

In addition, for debt exchanges it is assumed that:

- The new instruments have a 30 year bullet maturity and carry an interest rate of 10 percent. The principal (a face value of US$1,745) is collateralized by a high quality, 30 year zero coupon bonds (yielding a 10 percent interest rate).

- Creditor banks treat the unsecured portion of the new instruments as an unchanged credit risk, which implies that they value it at the same price as they value the old loans. The tables have been calculated using the "Fixed Yield to Maturity" valuation model described in Annex 2.

- The upper portion of Table 1.2 shows the market value of the new bonds as a percentage of their face value, as well as the total market value of the new bonds collateralized by using the US$100 World Bank loan. In each case the face value of new bonds is US$1,745, the face value of a 30 year, 10 percent yield, zero coupon bond costing US$100. The table also shows the exchange ratio (i.e. amount of old loans exchanged for US$1 of new bonds), and the total amount of debt reduction.

Table I.1: Illustrative Effects of Buybacks Supported by World Bank Lending

(In US$ per US$100 Loaned)

Net Effect on Scheduled Cash Flow

Transaction Price	Year 1	Years 2-29	Year 30
20%	-50	50	550
30%	-67	33	367
40%	-75	25	275
50%	-80	20	220
60%	-83	17	183
70%	-86	14	157

Present Discounted Value of Savings on Scheduled Debt Service

Transaction Price	Debtor Discount Rate 10%	15%	20%	25%
20%	500	336	251	200
30%	333	224	167	134
40%	250	168	126	100
50%	200	134	100	80
60%	167	112	84	67
70%	143	96	72	57

Assumptions: - Old loans carry an interest rate of 10%.

Table I.2: Illustrative Effects of A Discounted Debt Exchange Supported By World Bank Lending

(in US$ per US$100 Loaned)

Transaction Price	Market Value of Bonds per US$100	Market Value of Bonds Total	Exchange Ratio	Debt Reduction
20%	26	449	1.29	500
30%	36	623	1.19	332
40%	46	796	1.14	245
50%	55	965	1.11	186
60%	65	1130	1.08	139
70%	74	1291	1.06	99

Net Effect on Scheduled Cash Flow

Transaction Price	Year 1	Years 2-29	Year 30
20%	-50	50	550
30%	-67	33	366
40%	-76	24	269
50%	-81	19	204
60%	-86	14	153
70%	-90	10	109

Present Discounted Value of Savings on Scheduled Debt Service

Debtor Discount Rate

Transaction Price	10%	15%	20%	25%
20%	474	331	251	202
30%	313	218	166	133
40%	231	161	122	98
50%	175	122	92	74
60%	131	91	69	55
70%	93	65	49	39

Assumptions:
- **Old loans carry an interest rate of 10%.**
- **The new instrument will have a 30-year bullet maturity.**
- **The principal is collateralized by a 30-year high quality zero coupon bond with a price of US$5.73 per US$100 of face value.**

Annex 2

Valuation of Debt Instruments

1. This annex discusses the valuation models used in the main text to estimate the terms of debt exchanges. First, it describes two models that explain the secondary market price of existing loans. Next, it applies these models to the valuation of a bond with collateralized principal. Finally, it discusses possible ways of evaluating the collateralization of the interest payments on exit bonds on a roll-over basis.

2. The Formation of Secondary Market Prices. Many different models can be used to explain the formation of secondary market prices of debt of highly indebted countries. These models differ in their assumptions about how creditor banks view the distribution of future repayments. The two most commonly used models are the following:

- The "Fixed Probability Model." This model assumes that the secondary market price represents the creditors' estimate of the probability of the debtor servicing in full the obligations coming due in each period. This model assumes that the probability of repayment is fixed throughout the duration of the loan. Similarly, the discount represents the creditors' estimate of the probability of default in each period. For example, a secondary market price of 40 percent of face value corresponds to a 0.40 fixed probability of repayment in full (with a 0.60 probability of default in any given period).

  Alternatively, this model can be interpreted as assuming that secondary market prices represent the share of debt service due in each period that creditors expect to be repaid. This interpretation could allow for the possibility that creditors expect different levels of partial repayment to occur with different probabilities. In that case, the secondary market price would represent the mean of the corresponding probability distribution of expected debt service.

- The "Fixed Yield to Maturity Model." This model assumes that creditors evaluate unsecured future payments using a constant discount rate which reflects the corresponding credit risk. This rate is equal to the yield to maturity implicit in the secondary market price of existing loans. In other words, the present value of the scheduled debt service on the loans is equal to their secondary market price when it is calculated using the corresponding fixed discount rate. This model is consistent with a probability of expected repayment that falls exponentially over time. For example, a secondary market price of 40 percent of face value corresponds to a fixed yield to maturity of about 25 percent (assuming a fixed interest rate of 10 percent for the duration of the loan). The corresponding expected probabilities of repayment in each year fall from almost 0.9 in the first year, to about 0.3 in the tenth year, and to less than 0.1 in year twenty.

  As with the first model, each period's probability of repayment could alternatively be interpreted as the share of debt service due in the period that creditors expect actually to be paid.

3. The Market Value of a Partially Collateralized Bond. A bond with collateralized principal but unsecured interest payments must be decomposed into two parts in order to assess its market value. The market value of the bond is likely to be similar to the sum of its two components. The collateralized principal should be evaluated using a discount rate appropriate for the credit risk of the issuer of the security used as collateral, e.g., a US Treasury bond would be evaluated using the risk free rate. In the main text, it is assumed that creditors evaluate the collateralized part of new bonds at their cost to the debtor. For example, in Table 2 in the text it is assumed that the zero coupon bonds (with a face value of US$1,745) used to collateralize the principal of the new bonds are valued at US$100 by the creditors, equal to the price that the debtor has to pay to purchase the zero coupon bonds.

4. The unsecured portion of the bond, in this case the interest payments, should be evaluated using a discount rate corresponding to the credit risk of the original debtor. In the main text, as well as in Annex 1, it is assumed that creditors view those unsecured obligations as an unchanged risk from the old loans. Hence, it is assumed that creditors would evaluate the unsecured portion using one of the two models described above. For example, in Table 2 in the text it is assumed that the value of the unsecured interest payments of the exit bonds to the creditors would be between: (1) 40 percent of their present value evaluated at the risk free discount rate (US$37.71 for each US$100 of face value of exit bonds), and (2) the present value of scheduled interest payments evaluated using a discount rate of 25 percent (US$39.95 for each US$100 of face value of exit bonds). As explained in the main text, it could also be possible that creditors ascribe a better credit risk to the unsecured part of the bonds than to the old loans, leading to a higher market value for the bonds.

5. Collateralization of Interest Payments on a Roll-Over Basis. The World Bank is expected to lend for the establishment of a special account to support, on a roll-over basis, one or more years of interest payments on new bonds to be used in debt exchanges. Creditors would be paid out of the roll-over collateral account whenever the debtor fails to make interest payments, for as long as there are funds in the account.

6. The value of the roll-over collateralization depends on three main factors:

- The amount of funds in the account. For the same initial cost, the roll-over collateral account enhances the value of the exit bonds by at least the same extent as the collateralization of specific payments. The example in Table 3 in the main text assumes a roll-over collateral account covering one year's interest payments.

- Whether creditors view the roll-over interest support as the vehicle through which some type of preferential status is implicitly extended to the unsecured part of the exit bonds. This factor was disregarded in the calculations in Table 3 in the main text.

- The value that creditors ascribe to the "option" of being able to call the support at the time in which it is needed rather than at a predetermined time. This factor, which is referred to as the "option value," may increase the value of the roll-over collateral account over and above the present discounted value of the funds in the first years in which they can be used.

7. The option value given to the roll-over collateral account by the creditors depends on the conditions attached to the use of the collateral funds.[13] In the example in Table 3, it is assumed that because of the restrictions on their use, as would exist in practice, the collateral funds would only be used in those periods when the debtor would not have otherwise serviced its debt. The value of the exit bond in the example of Table 3 of the main text was calculated under this assumption and using the fixed yield to maturity valuation model described above. In the example, the roll-over collateral account results in a larger value for the exit bond than would be the case if the same funds were used to collateralize the first year's interest payments (US$528 with the roll-over collateral relative to US$467 when the first year's interest payments are collateralized).

13/ This is important because debtor's opportunity cost of funds is likely to be much higher than the rate it earns on the roll-over account. Hence, in the absence of restrictions on their use the debtor would have an incentive to use the funds as soon as possible. This would be discounted in advance by the creditors, eliminating the "option" value of the roll-over structure and making it more like a collateralization of an early payment.

Potential Effect of Debt and Debt Service Reduction Operations

1. Tables 3.1 and 3.2 present estimates of the potential effects of debt and debt service reduction operations supported by official resources of about US$20 billion and US$30 billion respectively. The tables show the effect of such operations on the stocks of commercial and total outstanding debt, as well as on interest payments due and the debtors' cash flow. The tables present estimates based on different average prices for the operations overall.

2. The calculations assume that only buy-backs take place. In order to use these table to evaluate the potential effect of other forms of debt and debt service reduction operations (e.g. debt exchanges) it is necessary to calculate their buy-back equivalent, both in terms of the amounts of resources used and the prices paid. Other type of corrections may be needed to account for specific operation, e.g. calculate the debt reduction equivalent of par swap. The calculations in terms of buy-backs only may not be completely accurate, but provide a good first approximation.

3. The estimates of total debt reduction take into account the increase in debt to the official sector due to the additional resources. The increase in indebtedness due to "set asides" is not included since such increase would take place even in the absence of debt reduction operations. Similarly, the figures shown for interest savings are net of interest payments on the additional official resources. The average annual interest payment reduction is larger for the 10 year period than for the 3 year period because the estimates take into account the cumulative effect of debt reduction operations on the need to pay interest on gap financing.

Table III.1: **Potential Impact of Debt Reduction Operations Supported by Official Resources of US$20 billion**

(in US$ per US$100 Loaned)

Average Price Paid for Loans	Debt Reduction				Initial 3 Years (Average)			Initial 10 Years (Average)		
	Total Debt Reduction	As % of Total Debt	Commercial Debt Reduction	As % of Commercial Debt	Interest Savings	As % 1990 GDP	Cash Flow Relief	Interest Savings	As % 1995 GDP	Cash Flow Relief
20%	90	20	100	40	10	1.0	7	14	0.9	13
25%	70	16	80	32	8	0.8	4	11	0.7	10
30%	57	13	67	27	6	0.6	3	9	0.6	8
35%	47	10	57	23	5	0.5	2	8	0.5	7
40%	40	9	50	20	4	0.4	1	6	0.4	5
45%	34	8	44	18	4	0.4	0	5	0.4	4
50%	30	7	40	16	3	0.3	0	5	0.3	4
55%	26	6	36	15	3	0.3	0	4	0.3	3
60%	23	5	33	13	3	0.3	-1	4	0.2	3
65%	21	5	31	12	2	0.2	-1	3	0.2	2
70%	19	4	29	11	2	0.2	-1	3	0.2	2

Assumptions:
- Official resources of US$20 billion will be composed of US$10 billion in Set Asides and US$10 billion in Additional Loans.
- Buybacks will be undertaken at the specified price.
- Prices are expressed as percentage of face value.

Table III.2: Potential Impact of Debt Reduction Operations
Supported by Official Resources of US$30 Billion

(in US$ per US$100 Loaned)

Average Price Paid for Loans	Debt Reduction				Initial 3 years (Average)			Initial 10 years (Average)		
	Total Debt Reduction	As % of Total Debt	Commercial Debt Reduction	As % of Commercial Debt	Interest Savings	As % 1990 GDP	Cash Flow Relief	Interest Savings	As % 1995 GDP	Cash Flow Relief
20%	130	29	150	60	14	1.4	11	21	1.4	20
25%	100	22	120	48	11	1.1	8	16	1.1	15
30%	80	18	100	40	9	0.9	5	13	0.8	12
35%	66	15	86	34	7	0.7	4	10	0.7	9
40%	55	12	75	30	6	0.6	3	9	0.6	8
45%	47	10	67	27	5	0.5	2	7	0.5	6
50%	40	9	60	24	4	0.4	1	6	0.4	5
55%	35	8	55	22	4	0.4	0	6	0.4	5
60%	30	7	50	20	3	0.3	0	5	0.3	4
65%	26	6	46	18	3	0.3	0	4	0.3	3
70%	23	5	43	17	3	0.2	-1	4	0.2	3

Assumptions:
- Official resources of US$30 billion will be composed of US$10 billion in Set Asides and US$20 billion in Additional Loans.
- Buybacks will be undertaken at the specified price.
- Prices are expressed as percentage of face value.

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SecM89-520

FROM: Vice President and Secretary

April 28, 1989

ANALYTIC ISSUES IN DEBT REDUCTION

Attached is a memorandum from the President entitled "Analytic Issues in Debt Reduction" for discussion together with the President's memorandum "Implications of Debt Reduction Proposals" (SecM89-521) in a meeting of the Committee of the Whole on May 9, 1989.

Questions on this document should be referred to Mr. Ishrat Husain (X33801).

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THE WORLD BANK
Washington, D.C. 20433
U.S.A.

BARBER B. CONABLE
President

April 28, 1989

MEMORANDUM TO THE EXECUTIVE DIRECTORS

ANALYTIC ISSUES IN DEBT REDUCTION

I. Introduction

1. A preliminary question that must be answered with respect to recent initiatives in support of debt reduction is: "Why is debt and debt service reduction needed?" The aim of debt and debt service reduction (DSR) is to make adjustment programs more effective in terms of higher levels of investment and a resumption of growth. DSR operations supported by the Bank and the Fund should be set in a framework in which the debtor countries would pursue strong short- and medium term adjustment policies, with a greater likelihood that their debt servicing burden would be reduced to the point that it becomes compatible with their capacity to service debt.

2. The general argument in support of DSR is that many debtor countries have been unable to return to growth in the presence of their very large debts. Although it has been possible to write down optimistic scenarios in which, with favorable external circumstances, new money, and rigorous internal policies, countries' debt indicators would eventually improve to the point where they would return to creditworthiness, such scenarios did not eventuate even for countries that had undertaken major adjustment efforts.

3. One reason for the persistence of slow growth is that the debt overhang acts as a tax on increases in current and future income: to the extent that the country improves its economic performance, a large share of the benefits accrues to the creditors rather than domestic residents. This inhibits investment and, therefore, slows growth. Put another way, creditors, both domestic and foreign, appear to be increasingly skeptical of the sustainability of adjustment in the face of the external debt burden, contributing to a vicious circle in which negative expectations feed on themselves. By reducing the creditors' share of the benefits from the adoption of adjustment policies and by reducing the uncertainty surrounding the sustainability of adjustment, DSR encourages investment. To be successful, the amount of debt reduction or cash flow relief provided to the debtor would have to be adequate in relation to overall financing needs.

4. The benefits to a country of using for DSR resources that would otherwise be available for investment depend on the country's economic situation. It is possible that DSR may not represent the most efficient use of resources in a number of countries where alternative investment opportunities may yield higher returns. This is one of the arguments for a case-by-case approach to DSR.

5. The remainder of this paper examines a set of issues that arise in considering the benefits of DSR from the debtor country point of view. It evaluates the impact of the instruments that are available to achieve DSR

under the various recent initiatives. It takes for granted that DSR will be undertaken on a country-by-country basis in the context of credible adjustment programs supported by the Bank and the Fund. The extent of the benefits to the debtor countries of DSR initiatives can be substantially affected by tax regulations and accounting rules in place in the creditor countries and the stance of official agencies in support of well formulated DSR offers from debtor countries. But given the differing tax, regulatory and accounting rules now in place in the creditor countries it is not possible to specify, a priori, a single set of instruments or techniques that would be generally preferred over others in all debtor countries or for all of the debt of a given debtor country. The choice of DSR techniques for a debtor country will vary according to the creditor country, the weight of the debtor country in the creditor's portfolio, and balance sheet considerations. From a debtor's point of view, the maximum cash flow relief that can be generated over time with a given pool of investible resources is the preferred result. Interest payment reductions in the early years may be preferable to debt reduction for some debtor countries.

II. Benefits to a Developing Country

Issue 1: When is debt and debt service reduction (DSR) beneficial to a debtor country?

6. Debt and debt service reduction (DSR) is not necessarily beneficial to all debtors. DSR financed by external borrowing should be considered, like any other use of foreign financing, in the light of the alternative potential uses of the funds. Borrowing at market terms for DSR is not sensible in those countries that have maintained normal market access and whose debt is not selling at a discount. The countries likely to be eligible for DSR generally do not have access to voluntary credit, except in very limited amounts, and their debt is selling at a discount because marginal creditors do not expect the current high levels of debt to be serviced in full. Therefore, the alternative for comparison must be a realistic assessment of debt servicing prospects in the absence of DSR.

7. If DSR is to make both debtors and creditors better off than they were before the introduction of the scheme, it must provide a bigger pie for the debtor and its creditors to share. The larger pie could come from the following sources:

(i) By increasing the incentives for the debtor country to adjust, and for investment, DSR can lead to more rapid growth. As noted in the introductory paragraphs, the debt overhang inhibits growth both by accentuating the uncertainty surrounding economic reform in the debtor countries and by acting as a tax on current and future incomes. DSR would reduce both the uncertainty and the implicit tax, and thereby encourage economic growth and future debt servicing capacity.

(ii) The availability of additional funds from International Financial Institutions (IFIs) for DSR allows both creditors and debtors to gain, but at some risk to the IFIs.

(iii) Tax and regulatory changes could enhance the value of the new claims to the creditors, with some of the gain shared with the debtors, but at a potential cost to creditor governments.

(iv) In conjunction with DSR, risk sharing features can be built into new claims that reduce the risk to the debtor country without adversely affecting the creditors. Benefits of such improved risk sharing, in the context of DSR, can be split between debtors and creditors. Examples of risk sharing features include recapture clauses that allow banks to share in exogenous windfalls to the debtor country, commodity price linked bonds, bonds that capitalize interest in periods of high interest rates, and contingent new money.

8. Because DSR is envisioned to proceed on a voluntary basis, the terms of the operations must leave the participating creditors at least indifferent to the alternative of staying out of the debt reduction scheme. It follows that DSR will be less costly to achieve, in terms of official financial support, when the alternative of nonparticipation is perceived by creditors to be less valuable. Accordingly, the effectiveness of any given level of official financial support for DSR would be enhanced by measures that reduced the benefits of creditor nonparticipation relative to participation.

9. DSR cannot be examined in isolation. Its effect will depend on its contribution to the medium term viability of a country's adjustment program, including the overall external financial support available to it. The assessment of that contribution will need to take account of various indicators of the country's ability to service its debt in the longer run, including the ratios of debt and interest service to both GDP and exports, as well as the impact of reduced debt service payments on the country's fiscal position. Issues relating to external resource requirements are addressed in Section VI.

Issue 2: What are the incentive effects of DSR on country policies and performance?

10. Consensual debt and debt service reduction (DSR) offers incentives to heavily indebted countries to pursue policies that will make them eligible for DSR. The prospect of higher growth and investment accompanied by lower debt service payments is certainly one that debtor governments will welcome. Provided that it is available only for countries pursuing serious adjustment programs, DSR will encourage debtor countries to pursue such adjustment programs, and thereby provides incentives to improve economic performance.

11. Would the prospect of DSR persuade countries that have so far managed to service their debts and have otherwise pursued prudent economic policies to pursue imprudent policies now in the hope of becoming eligible for DSR? Such

countries have generally maintained market access and have grown at reasonable rates. They have avoided the need for the wrenching adjustment undergone by heavily indebted countries with debt servicing difficulties. In many cases, they have also continued to receive large amounts of official financing, sometimes on partly concessional terms. If their economic performance or debt servicing record were to deteriorate sharply now, DSR could at best intervene only after a delay, and after the painful disruptions attendant upon debt crises and their aftermath that other countries have experienced. No realistic expectation of ultimate debt service reduction is likely to justify such a cost.

12. The issue might perhaps arise for countries that have lost regular market access because of geographic contagion, despite good economic policies and a good debt servicing record. This possibility should encourage commercial lenders to restore reasonable market access to those countries in a voluntary or concerted fashion.

13. In summary, the incentive effects of DSR are, on balance, likely to be favorable. The prospect of DSR should encourage (as well as facilitate) improved performance by governments; it should also encourage lenders to restore reasonable market access to debtors that have lost it despite their continued respect of contractual obligations and otherwise good economic policies; it should not encourage worsened performance simply in the hope of thereby obtaining debt reduction.

III. Forms of Debt and Debt Service Reduction

Issue 3: From the country's point of view, which forms of DSR are most beneficial, bearing in mind the potential benefits outlined above?

14. Some forms of DSR may be more beneficial than others to debtor countries. The following types of exchanges will be considered:

(a) Buybacks.
(b) Partially collateralized or guaranteed exchanges of old debt for new bonds with new terms:
   - Lower face value.
   - Lower interest rate, possibly for a limited period of time.
   - Payments contingent on commodity prices, interest rates or other exogenous events with an impact on the debtor country.
(c) Debt-equity swaps.

15. To a first approximation the financial markets will evaluate alternative DSR instruments as a combination of the old debt and the amount of new resources provided. (As an example, consider $1 million borrowed and used either for a cash buyback or to purchase a zero coupon bond to collateralize payments on a new instrument, traded for old debt. Assuming an interest rate of 10 percent and a secondary market price of 40 cents on the dollar, both these operations reduce the country's debt service payments by $150 thousand per year. They are equivalent because they involve an exchange of old debt for a new instrument that combines the features of 1) old debt, with no change in its value, and 2) an assured asset with a present value of $1 million.)

The relative efficiency of alternative types of DSR operations thus depends on the detailed characteristics of the new instruments and operations being undertaken.

16. In actual practice the costs and benefits of alternative forms of DSR will be affected by a number of factors, including:

(i) Subordination of old claims: if the old debt is junior to the new claims, the price at which old claims can be purchased will not rise as much. The benefit for the debtor in this case comes through a shrinking of the pie for the old creditors. They would stand behind other creditors and would face the largest risk of less than full debt service payments. There is a question as to whether creditors would voluntarily agree to a scheme that effectively subordinated their claims.

(ii) Entanglement (a special case of seniority): To the extent that the new claims are viewed as closely tied to Bank and Fund claims, they may have an enhanced value to creditors. To the extent that it is true, entanglement comes at a cost to the IFIs.

(iii) Tax, regulatory, and accounting treatment: For banks seeking tax advantages, current rules favor buybacks or exchanges at a discount in the United States and Japan; par exchanges with reduced interest rates would be favored by U.S. banks seeking accounting advantages.[1] Banks in most European countries have little incentive to sell their claims, because they have already received the tax benefits from provisioning against their debts. Rules that maximized both the tax advantage and the accounting advantage would combine tax relief up front for DSR operations with accounting losses amortized over the life of the loan, together with rules that differentiated between new claims and claims not offered for exchange.

(iv) Liquidity effect: a significant impact on a country's short-run cash flows can be achieved by sharply reducing interest payments for a specified period, such as five years. The interest rate could then be stepped up to a higher level. The reduction in interest payments in the first five years could be forgiven, or might be capitalized, perhaps on a contingent basis as part of a recapture clause. The reduction would be more likely to be forgiven if the lower interest payments were credit enhanced. Interest capitalization can be thought of as the automatic provision of new money. While reducing interest for only a few years rather than the full life of a bond in the provision of liquidity increases the leverage afforded by credit enhancement, it does increase the possibility that the debtor would face a significant debt service bulge that could lead to renewed debt difficulties.

17. The benefits and costs of each instrument will vary across creditors and debtors (the debtor can offer a range of instruments designed to appeal to creditors in different countries, based on tax and regulatory rules, for

example). The debtor countries and creditors will need to do a case by case analysis. A matrix that identifies the attributes of alternative instruments is attached.

18. A general point that emerges from the staff's economic analysis is that debt exchange offers can be so designed to have, in most cases, all the advantages of buybacks, while providing the potential for added gains. The most important gain is that the amount of debt relief can be linked directly to economic performance and policy conditionality, which is more difficult with buybacks. Other gains would come through the potential subordination of old claims and through the possibility of incorporating features that improve the cash flow to the debtor. A partial recapture clause in case of windfall gains to the debtor country also can be built into an exchange offer. Recapture clauses may persuade creditors to accept lower payments now in return for the possibility of higher payments later when the liquidity situation improves. However, relative to debt exchanges, buybacks have the important benefit of unambiguously reducing the outstanding debt stock.

IV. Official Coordination and the Pricing of Debt Buybacks

Issue 4: Should the Bank relate its support of DSR to the pricing of debt buybacks and exchanges?

19. Secondary market prices will tend to rise as new resources are devoted to buybacks and debt exchanges and as banks less willing to part with their claims must be induced to sell or exchange; and commercial banks may tend to benefit disproportionately. Secondary market prices of the debt of likely beneficiary countries have risen as much as 20 percent since early March, indicating that commercial banks expect to benefit from official support for DSR.

20. It is not clear that recent price rises in secondary markets will be ratified by events. If negotiated DSR settlements result in the subordination of old claims, the secondary market price of these junior claims may not be appreciably higher than prices before indications of official support for DSR were publicized.

21. There may be a moral hazard problem in using current secondary market prices. Debtor countries may have the incentive to drive down these prices in order to facilitate the repurchase of debt.

22. Because World Bank support will be limited to transactions in which DSR produces a significant gain to the country, the Bank will have to take into account the terms of DSR operations. The significance should be judged not simply by the percentage reduction in the stock of debt or the level of interest payable, but rather by the improvement over time in the key debt

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1/ U.S. financial accounting rule FASB 15 allows banks, under certain circumstances, to hold reduced interest assets on their books at face value. Brazil's exit bonds appear to qualify for FASB 15 treatment.

indicators discussed in paragraph 10 and in economic growth and investment. The issue of the appropriate circumstances for Bank support of DSR is addressed in detail in the companion paper, "Implications of Debt Reduction Proposals."

V. DSR and the Adequacy of External Finance

Issue 5: What is the potential role for DSR in the provision of external finance in support of adjustment and growth and a return to creditworthiness in highly indebted countries?

23. The goal of the overall process of adjustment in the highly indebted countries is a restoration of sustained growth. A solution is envisioned as a situation in which a country's contractual debt service is consistent with a viable adjustment program and with the perceived ability of the debtor country to pay its bills without the need to revise contracts on an emergency basis. Full restoration of market access, or eventual creditworthiness, is likely to come some time after the debtor country is able to meet its bills regularly. DSR will be evaluated in terms of its contribution to the overall financing of adjustment.

24. Preliminary analysis undertaken by Bank staff indicates that debt reduction and debt service reduction, undertaken on the scale currently envisioned, will not, by itself, meet the external financing needs of many of the target countries. This result is, in part, because some of the IFI funds to support DSR would be diverted from other projects and programs in these countries. The effective net reduction in debt (calculated as the change in the present discounted value of future scheduled debt service payments), if DSR operations depend solely on the support of IFI resources, is also estimated to be relatively small. The gross reduction in commercial bank debt would, of course, be larger.

25. Given the proposed scale of the resources of the IFIs to support DSR, it is especially important that these resources be deployed effectively. In particular, support should be given only to countries willing to undertake adjustment programs that will be viable given prospective official and private financing, including that available through DSR. If debt and debt service reduction is large enough, new money from IFIs, bilateral official and other nonconcerted sources will be adequate. This result could occur in some of the smaller countries, where the relative scale of official resources in support of DSR, and the smaller absolute stakes for existing creditors, could permit substantial DSR. But given the resources available for DSR, such a result is unlikely to occur rapidly in the larger countries, in the absence of an effort to make DSR agreements more comprehensive along lines described in paragraph 31. Under these conditions, the role of DSR will be to speed the return to creditworthiness and growth rather than to achieve those goals very rapidly; and in every case, growth and creditworthiness will return only if countries continue to pursue adjustment programs.

26. In conjunction with DSR, new money needs from commercial banks, expressed as a percentage of interest payments owed to them to be capitalized to fill financing gaps, may actually increase, at least in the short run, for the following reasons:

(i) The new money base will be lower.

(ii) The set aside portion of Bank and Fund resources will not be available for import financing.

27. DSR initiatives can have two, potentially contradictory, effects on the new money process. First, debt reduction will put more pressure on banks to "mark to market" their portfolios. New money would imply an immediate loss, making it unattractive. Second, bargaining power may shift, to some extent, in the favor of debtor countries.

28. Both of these effects suggest that the bargaining over new money and DSR is likely to be protracted. It may involve a period in which debtors are in arrears to commercial banks. Some new money may be provided in the context of DSR packages in which it is one option. New money is most likely to be provided for the larger countries, with which commercial banks will want to maintain a long-term business relationship. However, it is unlikely that significant amounts of new money—other than trade credit—will be available outside the context of concerted packages.

29. Over time the concerted lending process should disappear as countries successfully overcome their debt difficulties. These countries may find their financing needs met through the natural growth of trade financing, project financing, and financing arranged by private entities in the debtor countries. In addition, increased foreign direct and equity investment and the reflow of flight capital will contribute to the financing of domestic investment, but only if the financing package, including DSR, significantly reduces the uncertainty surrounding the disposition of future returns on investment in high debt countries. It is important that countries engaged in DSR undertake policies that encourage the development of these alternative sources of finance.

30. In order to put countries on a path out of debt difficulties and to provide for the the external financing needs of debtor countries in the interim, given the serious questions about the ability of countries receiving DSR to attract significant amounts of new money from commercial banks, the DSR process would need to be reasonably comprehensive. The DSR process can be strengthened in three directions: a more supportive tax and regulatory environment, additional official funds, and official nonfinancial support for countries with strong adjustment programs that make well structured offers to creditors. Each of these could provide greater inducement to creditor participation but could put added risks on creditor governments.

31. Increased leverage through entanglement, discussed under forms of debt service reduction, is a substitute for greater IFI funding and could increase the amount of DSR and reduce the financing gap. However, the effects

of entanglement on the extent of DSR depend on the creditors' perceptions of the involvement of IFIs, and cannot be estimated with any precision. Further, entanglement, if it works, is not without cost to the IFIs. Caution should be used in the calculation of the effect of entanglement on DSR operations.

32. The success of DSR initiatives will depend on the process through which the bargains between debtor countries and creditors are reached. Official agencies will of course seek to ensure that the funds made available to debtors as a result of the DSR will be used efficiently by the debtor countries. In addition, the attitude of IFIs and creditor governments toward the accumulation of arrears--to creditors that are bargaining with debtor countries and to creditors that stay outside of arrangements endorsed by a large majority of creditors--in debtor countries with strong adjustment programs and credible DSR offers will play an important role in determining the magnitude of debtor country benefits from officially supported DSR.

33. The Bank will need to consider how best it can ensure that otherwise feasible adjustment programs should not be postponed or fail because a country cannot secure timely and adequate debt reduction and workable new financing agreements from its commercial creditors. Two considerations will be equally relevant. The first is to avoid the indirect use Bank resources for purposes other than support of adjustment and of appropriate investments. The second is to avoid the postponement of the adjustment process, and of Bank support to it, in order to await the conclusion of possibly protracted negotiations with commercial creditors. How best to proceed will obviously have to be decided carefully, on the basis of specific circumstances of each case. The issue may take on a particular urgency for those countries that have already reached agreement with the IMF, in the framework of its policy on financing assurances.

34. The major benefit for debtors of such official support for DSR would be an assurance of reasonable levels and timely provision of net external finance over the medium term adjustment horizon. Debtor countries could be encouraged to adjust, in return for DSR, through the following incentives: conditional IFI support for DSR; new money and forms of DSR that are conditional on policy performance; and conditional bilateral creditor support.

VI. Summary of Issues for Consideration by Directors

35. The preceding sections highlight and discuss issues of analytical relevance with regard to official support for debt and debt service reduction. Staff conclusions regarding those issues are summarized here as a guide to Board discussion.

36. The potential benefits of DSR are country-specific. Countries that have maintained access to international financial markets will find that the costs, in terms of lost output and investment as a result of a disruption of market access, far outweigh the benefits of DSR. In countries that have already lost voluntary access to international credit markets, DSR, financed by borrowing from IFIs, must be examined on a case-by-case basis. Gains can come from (i) increased incentives to adjust and invest in debtor countries as

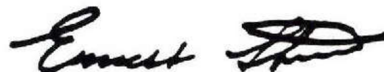
a result of a reduction of the debt overhang and a reduction of uncertainty concerning external financing, (ii) the availability of new funds from IFIs, (iii) tax and regulatory advantages of new debt instruments, and (iv) a better sharing of risk between creditors and debtors.

37. It is impossible to say in advance which forms of DSR are likely to be most beneficial, from a debtor country's point of view. Debt exchange offers appear to retain most of the benefits of buybacks and to offer the potential of gains beyond buybacks, in terms of possible seniority, liquidity effects, and compatibility with conditionality. Buybacks at a discount have the advantage of unambiguously reducing the outstanding stock of debt.

38. Because World Bank support for DSR will be limited to operations producing a significant gain for the debtors, the Bank will have to form a judgment on the overall terms of a country's DSR arrangements. These issues are addressed in more detail in the paper, "Implications of Debt Reduction Proposals."

39. Given the scale of official support, it is important that official resources be deployed effectively, in support of countries willing to undertake meaningful adjustment programs. All participating countries should benefit if the operations are carefully structured, and some smaller countries may emerge from their crises. The likely DSR in most major debtors will need to be supplemented by a combination of: IFI lending, foreign direct and equity investment flows, reasonable increases in trade credit, and official and private project financing. The DSR process can be strengthened in three directions: a more supportive tax and regulatory environment, more official funds, and official support for well structured DSR proposals of debtor countries with strong adjustment programs.

Barber B. Conable



by Ernest Stern

International Bank for Reconstruction and Development

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SecM89-521

FROM: Vice President and Secretary

April 28, 1989

IMPLICATIONS OF DEBT REDUCTION PROPOSALS

Attached is a memorandum from the President entitled "Implications of Debt Reduction Proposals" for discussion together with the President's memorandum "Analytic Issues in Debt Reduction" (SecM89-520) in a meeting of the Committee of the Whole on May 9, 1989.

Questions on this document should be referred to Mr. Bock (ext. 72942), Mr. Shilling (ext. 72773) or Mr. Wood (ext. 72784).

Distribution:

Executive Directors and Alternates
President
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THE WORLD BANK
Washington, D.C. 20433
U.S.A.

April 28, 1989

BARBER B. CONABLE
President

MEMORANDUM TO THE EXECUTIVE DIRECTORS

IMPLICATIONS OF DEBT REDUCTION PROPOSALS

I. Introduction

1. Over the past year, former Finance Minister Miyazawa of Japan, President Mitterrand of France, and most recently Secretary Brady of the United States have made proposals to include debt and debt service reduction more formally in the debt strategy and to promote some form of official support for such action. The April meetings of the Interim and Development Committees agreed that it would be appropriate for the World Bank and the IMF to provide resources to assist members undertake debt and possibly debt service reduction. These Committees further indicated that the policy issues and specific modalities of such support should be considered by the respective Boards of the two institutions.[1] In addition, during the discussion of the Memorandum on the "World Bank's Operational Strategy in Heavily Indebted Middle Income Countries" a number of Directors asked for further analysis of these issues.[2]

2. The purpose of this memorandum and of the companion paper "Analytic Issues in Debt Reduction" is to outline for discussion and review by the Executive Directors the key issues relating to debt and debt service reduction along the lines discussed in the Development Committee communique.[3] Guidance is sought from Executive Directors on the principles that should govern the Bank's actions in debt and debt service operations in specific countries, the first of which are likely to come to the Board's attention in the near future.

3. The framework supported by the Development Committee represents a particularly important step forward in achieving a consensus on the role of debt reduction. The Committee agreed that a portion of the funds allocated by the Bank for quick disbursing adjustment operations in heavily indebted countries should be "set aside" to support debt reduction operations. A similar portion of expected IMF programs was also proposed to be "set aside" for this purpose. The Committee also agreed that, "in addition, the Bank and the Fund should examine the possibility of limited interest

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1/ See Press Communique of Development Committee, April 4, 1989, particularly paragraphs 7-12.

2/ Memorandum (R89-21, February 17, 1989) discussed on March 14, 1989.

3/ Debt reduction is used throughout this memorandum to mean reduction in the outstanding principal, while debt service reduction is used for reductions in the amount of interest payments compared to the original instrument.

support for transactions involving significant debt or debt service reduction".[4]

4. The Committee also requested the Bank and the Fund to move expeditiously to develop and implement specific proposals to support debt alleviation operations, and stressed that this be done in a way that would preserve the financial integrity of the Bank and the Fund and not adversely affect other members.

5. The endorsement of debt and debt service reduction as a legitimate part of the debt strategy has already raised expectations among the debtors and some concerns among the creditors. While these instruments are not sufficient by themselves to solve the debt overhang problem, the availability of debt and debt service reduction instruments, backed by resources from the international financial institutions, represents a very significant expansion of the tools available to alleviate debt burdens in countries where it is appropriate and feasible and where country performance justifies this extraordinary action by the international financial institutions. However, undertaking such operations is not without risk to these institutions, since their share of debt would increase, and their responsibility in resolving the debt crisis may become greater. Thus while Management is moving rapidly so that the Bank could provide support for debt and debt service reduction on a case-by-case basis, subject to further guidance from Directors, it will act only when it has assured itself and its shareholders that in so doing, it would be providing substantial development assistance to the recipient, that it would not dilute its ability to provide assistance to all eligible borrowers over the long term, and that it would protect the integrity and credit standing of the Bank.

6. This paper addresses the issues concerning the Bank's support of debt and debt service reduction schemes under four main headings:

- Which countries should be eligible for Bank support of debt and debt service reduction operations?

- To what extent should Bank resources be devoted to debt and debt service reduction operations, would this limit or constrain the Bank's ability to implement currently planned lending to other borrowers, and what exposure risks would be entailed by providing support for debt and debt service reduction on the scale envisioned?

- What modalities of debt reduction and credit enhancement should be used, and how should Bank support be allocated among them?

- What should be the Bank's operational relations with other creditors to implement debt and debt service reduction actions?

Each of these questions will be addressed in a separate section below.

4/ Paragraph 10 of the Communique.

II. Country Eligibility

7. Authority under the Articles for the Bank to lend for debt and debt service reduction operations would fall under the "special circumstances" conditions for lending in a manner similar to the justification for structural adjustment lending.[5] Such lending must meet the criteria of materiality and offer a significant enhancement of the recipient country's development prospects. There would have to be a material contribution to a country's prospects to increase growth or expand productive investment resulting from Bank participation in the reduction of the debt burden for such an operation to be justified. In addition, the Bank's economic evaluation criteria would have to be satisfied to the extent possible. From this it follows that financial support from the Bank for arrangements to reduce debt or debt service should only be provided if certain conditions are met. The most important would be (i) an adequate medium term adjustment program, (ii) a viable medium term external financing plan consistent with the adjustment program which would be facilitated by debt and debt service reductions, and (iii) reasonable prospects that the additional resources will enhance the country's growth and development prospects, primarily by increasing investment.

8. The Medium Term Adjustment Program. Our current analyses indicate that a satisfactory resolution of the debt overhang and reform of the underlying economic distortions and disequilibria in a number of countries will take several years at least, even with significant debt and debt service reduction. In view of this, a satisfactory medium term adjustment program normally covering the first two to three years in some detail is essential. There must be a reasonable expectation that the implementation of this program will result in growth and adjustment over the period concerned and will both reduce the country's dependence on external financing of public sector deficits and bring it significantly closer to normal access to commercial credit markets. This implies that countries should not plan to rely on large amounts of concerted new money from commercial creditors for budget or balance of payments support if they are also engaging in large scale debt reduction. Bank support for the medium term program must be based upon satisfactory understandings regarding the macroeconomic framework, the credibility of the government's willingness and ability to undertake the policy and institutional reforms in the adjustment programs, and the availability of the external financial support, including reductions in debt and debt service and rescheduling.

9. In view of the difficulty in designing and reaching agreement on medium term adjustment programs, most countries suffering from severe debt burdens are unlikely to have appropriate programs in place and to have completed debt or debt reduction operations in less than three years. However, in order to limit the length of this exceptional program, we would propose that during the coming three year period debtors could initiate medium term adjustment programs to benefit from debt or debt service reduction, and then allow up to three years from the agreement on the program for the country to complete its debt or debt service reduction

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5/ See the opinion of the General Counsel, "Authorized Purposes of Loans Made or Guaranteed by the Bank" (Sec. M88-517, May 10, 1988), for a detailed discussion of this issue.

operations supported by the Bank. This should provide an adequate incentive for countries currently without programs to begin them, while preserving the essentially temporary nature of the program, which is a central objective of any initiative involving substantial implicit or explicit rewriting of debt contracts. The risk and exposure discussion in Section III is based on the time limited nature of the proposal.

10. Because of the extraordinary and temporary nature of these debt and debt service operations in each country, the sustainability of the related adjustment programs is vitally important. In considering sustainability, attention must be given to maintaining acceptable levels of per capita consumption, especially of the most vulnerable groups, and to increasing investment for renewed growth. Particular attention must also be given to policies which encourage the return of capital now held abroad and which promote direct foreign investments. Debtor countries need to sustain relations with their commercial banks, and the medium term adjustment programs and the financing plan should be designed accordingly. Consequently, a willingness to undertake serious negotiations with creditor institutions will be viewed as an important element in the country's commitment to its adjustment program.

11. The Need for Debt Reduction. In general, debt or debt service reduction, as distinct from obtaining additional resources through increased borrowing, may be necessary when a country's debt burden is so large that servicing it would seriously impair, if not prevent, the country from attaining satisfactory growth rates. Moreover, access to capital markets may be so constrained that new loans are simply not available in the amounts necessary to fund a financing plan for orderly, growth oriented adjustment. Where debt or debt service reduction is deemed to be a critical part of a financial plan supporting a satisfactory adjustment program, this may provide justification for the Bank to finance such arrangements, provided that the potential benefit can be estimated to have a material impact upon the prospects for growth oriented adjustment when compared with alternative uses of these resources. These considerations imply that debt reduction would be supported by the Bank only if the discount or service reduction involved were adequate to provide a basis for a viable external financing plan for the adjustment program. Since the relevant circumstances differ greatly between countries, a case-by-case approach is necessary.

12. Contribution to Growth Potential. The arrangements for the reduction of debt and debt service to be supported by the Bank will concern public and publicly guaranteed sovereign debts outstanding to commercial banks. The resulting reductions in debt service obligations must add in a clear and significant way to the resources which are available and devoted to productive uses, generally investment, in accordance with the Articles.[6] The concept of investment may be broadly defined to include development expenditures, i.e., not only fixed investment, but also investment in human capital (particularly expenditures for nutrition, health and education) and the maintenance of economic and social infrastructure.

6/ See the opinion referred to in footnote 6.

13. These criteria are fairly restrictive because we would not wish to risk unduly the credibility or the credit standing of the institution in support of debt or debt service reduction operations that do not have a high probability of success and a significantly favorable impact on the debtor country's prospects. As a consequence, these operations would be confined to member countries which have credible adjustment programs. In addition, if debt and debt service reduction operations are to lead to sufficient benefits, negotiations would have to yield substantial discounts. Only a few countries are expected to satisfy these criteria in the near term.

14. For those countries which have yet to put in place a sustained and viable adjustment program, the possibility of obtaining support for debt and debt service reduction from the international financial institutions should provide an added incentive to put such a program in place. On the other hand, those countries which have managed their economies so that there is no need for debt restructuring and whose debt trades at or near par do not require the extraordinary measures contained in this program. They have, moreover, benefited from much stronger growth and from continued access to commercial credit.[7] They are in far better shape than the countries whose debt trades at steep discounts, and they have laid the basis for continued satisfactory growth. Despite political arguments that may arise on occasion in those countries for driving down the price of their debt, the costs of such actions would far outweigh any possible benefits. These countries need to retain their access to commercial markets, and the Bank is currently proposing other initiatives to enhance these countries' access to credit.[8]

15. The debt of the heavily indebted low income countries is largely to official creditors. However, a portion of their debt is to commercial banks and is available at a substantial discount in many cases. Since these countries are not creditworthy for Bank lending, IBRD funds would not be available for reducing their debt or debt service to commercial banks. Directors may wish to explore at a later date whether it would be appropriate to use IDA funds for debt and debt service reduction activities in low income countries with significant amounts of commercial debt and to review the appropriate eligibility criteria for such cases.

III. Potential Resources Allocation and Exposure Issues

16. World Bank resources to support debt and debt service reduction could be made available from two sources. First, the Development Committee in its communique "agreed that the Bank and the Fund should set aside a portion of members' policy-based financing to support debt-reduction operations." Second, where the adjustment program justifies a larger response by the Bank, additional funds could be allocated to participating countries over and above the programmed lending level. There are potential

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7/ Some have also benefited from substantial amounts of concessional assistance.

8/ See "IBRD Role in Financial Intermediation Services: Expanded Cofinancing Operations", R89-37, March 13, 1989.

impacts of these approaches on the Bank's resource position, as well as exposure and risk implications.

17. Potential Impact on IBRD Resource Position. In comparison to the situation in the IMF, the Bank has no quantitative benchmarks, such as country quotas, to guide the volume of support provided by the Bank to individual borrowing countries. The scale of Bank lending depends upon country circumstances, including the depth and breadth of adjustment programs for which the country seeks Bank support, the magnitude of the overall financing requirements, the contributions that can be reasonably be expected from other creditors, and the Bank's own guidelines on acceptable levels of exposure.

18. In assessing the potential impact of the pending proposals, it has been assumed that approximately 25% of the adjustment lending envisaged for the upper end of the lending range (or the "high case") in individual heavily indebted countries could be set aside for debt reduction purposes. This amounts to approximately 10% of the overall "high case" lending program in these countries. Since the set aside resources would be taken out of planned adjustment loans, which are assumed to be fast-disbursing, the resource impact on the Bank from this part of the proposal would be minimal. The country would, however, need to find alternate sources of finance for the imports that would have been financed by the set aside funds. To the extent the availability of Bank and Fund support for debt reduction encourages more countries to adopt or pursue comprehensive adjustment efforts, the impact would be equivalent to a slight acceleration of the Bank's overall lending program as compared to the mid point of the lending range or "base case".

19. If, however, the Bank were to provide resources in addition to the set aside, this would have both resource and exposure implications. For purposes of analysis, we have assumed that additional resources equivalent to about 15% of "high case" lending plans might be provided to catalyze financing packages involving substantial debt or debt service reduction. The form this support might take (e.g. using escrow accounts or guarantees) is considered in the following Section.

20. The resource consequences of additional commitments would obviously depend upon how many heavily indebted countries adopt programs that meet the eligibility tests outlined in Section II. Our calculations indicate that additional support could in theory reach $2 billion per annum (or $6 billion for three years) based on the 15% assumption. Experience, however, suggests that actual volumes would probably be considerably less. Nevertheless, even if additional support were to be $2 billion per annum, this would not create serious resource pressures for the Bank either in terms of lending authority (the sustainable level of lending) or in terms of borrowing capacity, provided that the additional support is defined as a temporary expansion of a country's lending program.

21. With respect to lending authority, the GCI which is now being subscribed should raise the sustainable level of lending to about $22.5 billion. This should comfortably suffice to cover the Bank's level of activity over the next three years, even with additional support at the upper limit of the scale described. Hence, Bank support for countries that do not participate in debt reduction would not be jeopardized. The

temporary character of the program is very important to this conclusion, however, and one of the major risks is that it will, in practice, prove difficult to enforce the intended temporary character.

22. On the borrowing side, the resource implications depend on the form of support provided by the Bank. If this support takes the form of loans (e.g. into escrow accounts), then additional Bank borrowing of something on the order of $3 to $4 billion could be required over the next three fiscal years. This amounts to roughly 10% of the borrowings currently planned and would not pose a serious problem either in terms of volume or cost. If the form of support were guarantees, the borrowing implications could be less, depending on the extent to which potential calls on the guarantees would be covered in advance through increases in Bank liquid holdings.

23. Exposure and Risk Concerns. The provision of additional funds above and beyond the "high case" program would result in additional exposure to heavily indebted countries. In assessing the creditworthiness of a borrowing country, Bank staff analyze the ability and willingness of the borrower to service its debt to all creditors in general and its debt to the IBRD in particular. While a debt reduction program can be expected to receive Bank support only if it promises to improve a debtor country's ability to service its debt on a sustainable basis, there are risks associated with such a strategy that will need to be carefully managed.

24. Increased Bank disbursements for debt reduction or interest support will boost Bank net disbursements in the near-term, but they will add to the borrower's repayment obligations and reduce net flows from the Bank in the longer-term. The decline in net disbursements from the Bank could well take place in circumstances in which the preferred creditor status of the Bank would be more difficult for the borrower to sustain, either financially or politically. Since Bank loans receive preferred creditor treatment mainly because of the Bank's special relations with the country, care must be taken to preserve that relationship. It is also relevant to note in this regard that the Bank holds a relatively small share in the outstanding debt of most heavily indebted countries, which facilitates the preferred treatment of its debt. Debt obligations to preferred creditors (especially the Bank and the Fund) would rise in both absolute and relative terms under these debt reduction transactions. Preliminary estimates indicate that for the typical country which might participate in the scheme, the share of preferred creditor debt service in total public debt service may rise from 25% to 30% over the next three years.

25. While this in itself is not an exceptionally large increase, there could be, in addition, a potentially large new stock of partially secured debt whose service would be officially enhanced, depending on the type of debt reduction operations undertaken. Debt service on this new, partially secured debt may account for an additional 15-25% of total public debt service.[9] This expansion of preferred creditor debt plus partially secured

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9/ Debt buybacks would directly increase the level and share of debt held by international financial institutions in the total. Debt reductions with enhancement would increase the portion of partially secured debt,
Continued on next page

debt substantially reduces the flexibility in the country's debt structure in case of less favorable than expected developments. This would pose substantial risks to the Bank unless there is a reasonable assurance that external financing will be available on suitable terms and in adequate volume to meet the country's minimum requirements.

26. The inherent uncertainty of macroeconomic forecasts underlines the importance of maintaining flexibility in the structure of debt. The risk that a country will be financially or politically unable to sustain preferred creditor status for the Bank (and other preferred creditors) is less to the extent that there is a "cushion" of more easily restructurable debt that can absorb the consequences of unforeseen developments. This suggests that in cases where resource constraints or relatively low discounts indicate that debt and debt service reduction would be relatively modest, it will generally be preferable from a risk management standpoint to achieve debt service reduction through transactions which encourage larger discounts and provide partially secured status to a smaller portion of the total debt, rather than through transactions which result in smaller discounts with larger volumes of old debt participating and receiving partially secured status.

27. In cases of very comprehensive debt or debt service reduction, the Bank could, from a risk management standpoint, consider transactions which result in relatively greater rigidity of the remaining debt stock, if as a result the country's debt servicing capacity were substantially strengthened in relation to the remaining obligations. The possibility of unforeseen adverse shocks will need to be carefully considered, with special attention paid to the contingent resources available (possibly including recourse to certain IMF facilities or in the form of higher levels of official reserves) to provide support in the event of such shocks.

28. The risk consequences for the Bank's overall loan portfolio will obviously depend on the number of countries meeting the eligibility criteria and the character of the adjustment programs and financing packages that receive Bank support. If participation were to include most of the heavily indebted countries, the share of Bank net disbursements going to these countries over the next three years could increase from slightly less than 50% currently projected to about 60%. Such a shift, along with a relatively high profile, direct involvement of the Bank in debt reduction, is bound to raise questions in the financial markets and indeed has already done so. But the Bank, as a major creditor of most of the heavily indebted countries, should not minimize its risk by sticking with the <u>status quo</u>. On the contrary, it has an important stake in strengthening the debt strategy's capacity to help resolve the debt crisis and to encourage sustainable growth with adjustment in these countries.

Continued from previous page
and to the extent support is provided in the form of loans, would also increase the share of official debt.

IV. Modalities of Bank Support

29. There are four basic debt and debt service reduction approaches the Bank could support, assuming, of course, that the criteria of materiality and efficiency discussed in Section II are met. They are discussed in the paper on Analytic Issues in more detail. They are debt buybacks; debt swaps with a reduction in principal but with market interest rates; debt swaps with principal at par but with fixed interest rates below the market; and renegotiated loans. Financial ingenuity provides an almost unlimited number of potential combinations of these approaches, including interest rate reductions for limited periods; linkage to commodity prices, growth of export earnings, (e.g., with recapture clauses), capitalization of deferred interest, etc. But for purposes of this policy discussion, we will focus on their simple form.

30. Reduction of Principal. Reduction in the stock of debt can be achieved through buybacks or swaps of debt for new instruments at a discount. A special case of debt reduction is debt equity swaps, which are not discussed here. The debt overhang is both a major political problem and a major deterrent to increased investment. Therefore, measures to reduce the stock of debt have important political significance and would be expected to increase incentives and resources for investment. Debt reduction contributes to a reduction in external financing requirements by the amount of interest saved on the discounted debt. This saving is permanent.

31. However, with limited resources, buying a stream of savings over 20-30 years may not be the most efficient use of resources in all cases. Not all countries require substantial reductions in the stock of debt; in other cases, resources may not be adequate, particularly for the larger countries, to get a sufficiently large reduction in the stock of debt to provide meaningful cashflow relief; yet this may be important to achieving a viable financial plan in support of the adjustment program. Moreover, measures to reduce the stock of debt are difficult to do in stages, linked to performance conditions.

32. Setting aside a portion (about 25%) of Bank adjustment lending matched by parallel resources from the Fund, to support debt buybacks or debt swaps at market interest rates provides the borrower resources to exercise this option in negotiations with creditors. This approach may be supplemented by arrangements to reduce interest payments, particularly in the larger borrowers. With limited resources to support debt and debt service reduction measures, and with the focus on assuring financing for the next three to five years in an effort to restore the momentum of growth and investment, it will be important to allocate, on a case by case basis, the amounts devoted to reducing the stock of debt and those supporting cashflow relief by reducing interest rates so as to achieve the most favorable results for the debtor.

33. Reduced Interest Rates. A second approach to debt relief is to reduce interest rates while preserving principal. Interest rates can be reduced either for a limited period or for the life of the new instrument. If this is done for a portion of the debt, it is similar to debt exchange with the principal discounted. It may be preferred by banks that wish to defer recognizing any loss of principal, and may be especially relevant in

countries where the need for cash flow relief is particularly important in the near term but where prospects of substantial growth in the medium-term are good. In addition, this approach lends itself, from the view point of the banks, to a better link to maintenance of performance if the interest reductions are agreed for an initial period with the possibility of subsequent renewal. Concentrating resources on a sharper reduction in cashflow requirements in the early years may also serve to reduce, or eliminate, the need for new money. If par swaps with interest reduction were to apply to the total debt, it is tantamount to a renegotiation of all the outstanding loans.[10] While limited enhancement for the interest stream may be required, there would be no presumption that there should also be support to collateralize the principal. Interest support may also permit Bank resources to achieve more "leverage".

34. The key to obtaining "leverage", i.e., a higher discount than expected on strictly commercial grounds, is to influence the value which commercial banks assign to the interest payment stream on the instruments acquired in the debt exchange. If there were official support for interest payments, even if it were for a relatively short period (say, one year) but rolling forward if not used, then the value assigned to the whole interest stream may be higher, and the terms of the exchange may be more attractive from the standpoint of the borrowing country.

35. The likelihood that a higher value will be assigned to the whole interest stream and not just to the payments directly supported by the Bank depends on creditors' perceptions concerning the posture of the Bank in the event the country encounters difficulties in maintaining interest service. To the extent creditors believe the Bank is "entangled" (i.e., is bound to take action to prevent or cure a default on the interest stream), creditor banks may be expected to assign a higher value to the whole stream.

36. There is no way to be sure in advance how creditor banks might evaluate the "entanglement" that would follow from Bank support of interest, or how this would affect the value they assign to the unsecured interest stream. The influence the Bank could have in averting or curing interest servicing problems will obviously depend on the amount of debt that is covered by the interest support, as well as the size and character of the Bank's ongoing role in the particular country. In addition, it will depend on the specific rights and obligations of the Bank under the interest support contract.

10/ See, for example, the discussion of the role of official support for reduced rate loans in "The World Bank's Operational Strategy in the Heavily Indebted Middle Income Countries: Review of Recent Developments (R89-21), page 36 and seq. Strictly market based operations are likely to be evaluated by commercial banks in terms of their risk adjusted discounted present value compared to the market value of holding the existing asset. In cases where obtaining sufficient debt relief in this manner is not feasible (or perhaps too costly), renegotiation of existing contracts with some modest enhancement may be possible, particularly if the regulatory environment were to make sharper distinctions between, for example, arrears and renegotiated assets on which some official support is provided.

37. While Bank support of interest thus offers the potential for leverage, this potential carries with it important risks. One risk --described in Section III--is that partially secured debt will diminish the country's flexibility to cope with unanticipated shocks and thereby make it more difficult for the country to maintain the preferred creditor status of the Bank. A second aspect of risk which arises when interest is supported (but not when there is non-accelerable support for repayment of principal) is that problems can arise as soon as the first interest payment is due. In those cases where the medium-term adjustment program remains fragile, even after debt reduction, the Bank is likely to have a critical role as a policy advisor over the next few years, and special caution would need to be exercised in protecting the Bank's ability to operate in a manner that is clearly independent of its role as a guarantor of current payments to commercial banks. Third, to the extent creditors perceive the Bank's support as a de facto guarantee of the entire interest stream, others in the financial market or among the public at large may be concerned that the Bank is jeopardizing its own standing by becoming excessively involved in underwriting the risks of the commercial banks.

38. The existence of these risks should not rule out Bank support of interest in situations where substantial leverage can be achieved, but they do mean that this type of involvement must be confined to cases where the reduction of debt and debt service is very substantial, so that the risk of further debt servicing difficulties in the aftermath of debt or debt service reduction is much reduced. Perceptions in the financial markets can be addressed by drawing attention to the improved overall risk position and to the reduction in overall debt service burden for the country. The form in which the Bank provides its support may also affect these perceptions.

39. Forms of Bank Support. The Bank could support such interest reduction measures in several ways: by guaranteeing one or more interest payments,[11] by lending for escrow accounts, or by establishing lines of credit. These alternative forms of Bank support must be assessed against the background set out above.

40. Guarantees are a familiar commercial device though they have been used sparingly by the Bank. To the creditor banks, they may offer *prima facie* the prospect of more protection than the nominal amount of the capital committed by the Bank because of their potential to "entangle" the Bank in helping avoid future debt servicing problems associated with the debt covered by the interest guarantee. In other words, there could be an expectation that the Bank would exercise remedies to prevent or cure a default on the covered debt, which could in effect raise the whole of that debt to a preferred creditor status and thus achieve effective seniority.

11/ For details of the conditions of the Bank's guarantee of interest payment, see the legal memorandum of the General Counsel: "Guarantee by the Bank of Interest Payments Under Debt Service Reduction Schemes". This memorandum calls for an interpretation by the Executive Directors of Article IV, Section 5(c) of the Articles of Agreement as to whether and how it applies to the guarantee of interest payments only.

41. The extent of such an "umbrella" effect depends on the amount of interest guaranteed relative to the size and character of the Bank's ongoing role in the particular country. It will also depend on the specific rights and obligations of the Bank under the guarantee contract and on the Bank's policies with respect to remedying calls on its guarantees, especially whether it is prepared to convert the guarantee into a loan when called or demand immediate payment.

42. An alternative to guarantees is to make a direct loan to a country to fund an escrow account to cover interest payments (again assuming the Fund would make matching amounts available to support the interest payments). This approach also provides effective support for interest payments, but it sharply reduces the risk management concerns. Some of these concerns might arise if the Bank were to be the escrow administrator but this is not essential. In any event, no expectations would be created that the Bank is committed to any action beyond the provision of its funds. The risk of default would be no greater than for any other loan to the country. In addition, such an approach could facilitate cooperation with the IMF or other potential sources of finance for interest support which might either not be able to make guarantees or would prefer the provision of funds. The impact on the Bank's capital would be approximately the same as for a guarantee. While direct loans would need to be funded, the amounts involved would be well within the Bank's borrowing capacity. Also, borrowers would be required to obtain waivers of negative pledge clauses, but other waivers would be required in any debt reduction scheme.[12] However, it is unclear whether an approach that largely eliminates the entanglement problem would achieve adequate leverage.

43. A variant of this approach would be lines of credit. This is similar to lending for an escrow account, except that the funds would only be disbursed if the country were unable to make interest payments under the terms of the line of credit. Since the Bank would have already committed the line, it would not strictly be seen to be lending into a default situation, as might be the case under a guarantee. If the line is revolving, the repayment terms may be shorter than a normal loan, thus discouraging its use.

44. The decision on which tool to use must be made in the context of the Bank's objective to contribute effectively to a substantial reduction of the external debt burden and to do so at the least additional risk. The preferred approach, therefore, would be to use direct loans or lines of credit wherever this is feasible, since it minimizes the financial entanglement of the Bank. While the mere preference by the borrower and/or the commercial banks for one approach over another would not be determinant, there may be cases where guarantees are more appropriate and the additional advantages would outweigh the additional risks. Since it is impossible to predict the outcome of the case by case negotiations, it is important to maintain the current flexibility to use guarantees in exceptional circumstances.

12/ Consideration could also be given to an approach that would have the Bank issue guarantees in the capacity as administrator of an account created for that purpose. This approach may provide a way to further insulate the Bank's own balance sheet from entanglement.

V. Coordination With Other Creditors

45. The negotiation of "conventional" rescheduling and new money packages has become increasingly difficult as commercial banks are better provisioned against their LDC exposure and less willing to raise their exposure in these countries. Secondary market transactions have changed and reduced the base for new money. These factors have reduced the flexibility of the conventional debt strategy and introduced significant delays in assembling adequate financing packages. These delays have in turn impeded the provision of support by the international financial institutions and, in consequence, the implementation of adjustment programs. Official support has often been retarded due to the "critical mass" guidelines which have governed the official approach to meeting financing requirements.[13] In response, the international institutions have been moved to reduce their adherence to this objective, and the IMF and the Bank have disbursed funds in some cases where a critical mass has not been in hand. However, these have so far been viewed as exceptions to a general rule. There is now reason to consider introducing further flexibility by more formal recognition that in certain circumstances, the international institutions would continue their adjustment lending without having all the financing program in place.

46. The practice of the Bank in its own adjustment operations has been to base tranche release decisions on progress under the country's program and a satisfactory overall macroeconomic situation. By its Articles and mandate, the Bank has a stronger interest in the longer term development and structural transformation of its members, and this orientation is reflected in our judgments on adjustment and other lending decisions. While acknowledging the IMF has its primary responsibility in the "aggregate aspects of macro economic policies and their related instruments",[14] the medium term nature of the programs gives added importance to the sectoral and structural components of the adjustment programs, and thus it is expected that the macro policy adjustments would be fully consistent with the longer term sectoral and structural objectives.

47. In instances of lending for debt service reduction, it should be expected that both institutions would normally have operations in the country or be working with the authorities in the preparation of an operation. Close coordination would be called for between the Bank and the IMF to reach, with the country, a consistent view on a viable medium term adjustment program and on a financing plan, particularly concerning the amounts of set asides and additional lending, if any. Caution would be called for where lending for debt and debt service reduction would increase the risk to the Bank through increased exposure or an expansion of the

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13/ The "critical mass" concept in debt restructuring countries is generally understood to mean that the vast majority (90-95%) of the financing must be in place prior to IMF approval of its operation.

14/ Memorandum to the Executive Board of the International Monetary Fund and the Board of Executive Directors of the World Bank on Bank-Fund Collaboration in Assisting Member Countries, March 30, 1989. See particularly paragraphs 9, 10, and 13-20.

share of preferred credit, as discussed in Section III, or where the financing plan involved debt or debt service reduction that had not yet been agreed with the commercial banks. In the latter case, if the adjustment program were moving on track, the international financial institutions should consider disbursing in such cases. In these circumstances, the Bank will have to exercise prudence and judgement to minimize the risk of accumulating arrears and to maintain an impartial stance in relation to both the debtor and its commercial creditors in order to promote equitable debtor-creditor arrangements.

48. As indicated above, the borrower's medium-term adjustment framework and financing plan would outline the broad parameters of the financing package (debt reduction, interest reduction, new money) that it would expect to negotiate with its banks and the amount of support for this that the Bank and Fund could provide. While individual banks would have flexibility in deciding which elements to take up, the aggregate sum of the individual bank decisions would have to be broadly consistent with the financing package supporting a viable medium-term scenario. The Bank would not normally expect to participate in the negotiations between the debtor country and its creditors; but, as is currently the practice, it would make known to both parties its position and the extent of support it was prepared to offer.

49. Bank support for the debt and debt service reduction actions would normally be provided as a component of a larger adjustment operation. To the extent an increased or "front loaded" disbursement pattern is required for debt and debt service reduction, a good track record of implementation of adjustment measures would be expected in order to justify the added risk to the Bank of these extraordinary measures.

50. Once a debt restructuring agreement is negotiated between the commercial banks and the debtor, the banks may request that the total amount of Bank and Fund support for the debt and/or debt service reduction envisioned in the agreement be definitely committed and available for disbursement when the terms have been consummated (e.g., a sufficient number of banks subscribed or a minimum amount of debt offered). In these circumstances, some modification of Bank's disbursement procedures may be called for to assure the funds are available as and when needed.[15] Under appropriate conditions, disbursements under an adjustment operation could be "front loaded" to provide the amounts agreed for debt or debt service reduction. Or if front loading were not contemplated, the amount authorized for debt and debt service reduction could be allocated to the first tranche, rather than an equal portion in each tranche.

51. The structure of debt and debt service reduction operations is likely to differ between countries with large absolute amounts of commercial debt and those with small amounts. For the latter, it is conceivable that the international financial institutions' resources would be sufficient for a comprehensive operation that would bring total debt service within a range that the debtor could, with a sound medium term

15/ If the debt or debt service reduction operation is to be jointly funded with the IMF, disbursements would have to be coordinated in relation to the particular operation.

program, be expected to service fully. For those countries with large amounts of debt, it is unlikely that such comprehensive workouts would be possible, and Bank disbursements for debt and debt service reduction may be more easily coordinated with the usual structure of tranche releases, (e.g. to support a program of buybacks or exit bonds). Flexibility will be important, and the structure of each operation would have to be designed to assure both that the maximum amount of debt or debt service reduction is obtained and that the integrity and monitorability of the medium term adjustment program is maintained.

52. Countries that are engaging in extensive debt and debt service reduction activities may not be able to obtain significant amounts of new money from commercial sources for general budget or balance of payments support purposes on a concerted basis. If this occurs, the more comprehensive reduction packages would need to be designed so that any requirements for new capital inflows be kept within the envelope that could be expected from the official sector, after taking into account of direct foreign investment and other voluntary flows.

53. As the reform program takes hold over the medium term, more trade and project related financing can be expected to be forthcoming from private creditors to supplement official resources. Support for debt reduction would only be a temporary _modus operandi_ for the Bank, and when heavily indebted countries begin to restore more normal relations with credit markets, it would be appropriate that the Bank increase its efforts to catalyze private source financing. This would occur along the lines that are evolving to assist countries which have managed their economies well and which have been able to carry their debt burdens without extraordinary support to increase their access a broader range of financial markets and to make use of sophisticated special purpose financial instruments.

VI. Conclusions and Issues

54. Bank management fully supports the increased emphasis on debt reduction, on which a consensus has recently emerged among member governments. It is clear, however, that World Bank support for debt reduction should only be provided where it makes sense in specific country circumstances. Support for debt reduction transactions must represent appropriate and efficient use of Bank resources that contribute in a material way to an enhancement of the prospects for growth and development as well as to the country's capacity to service its debt. Full resolution of the debt problem in many countries will require a number of years, and our expectations and use of resources will have to be adjusted accordingly. It is also important to recognize that the initial steps in this direction will be modest. The volume of resources that the Bank and the Fund can devote to debt reduction is limited and the impact on the debt overhang problem in most of the heavily indebted countries will depend on the terms which can be negotiated between creditors and debtors. The Bank will need to continue careful management of its risk exposure in these countries. Furthermore, it is unlikely that a large number of countries with serious debt burdens will qualify for such support in the near term, and discussion of an appropriate time frame for such operations would be welcome.

55. In preparing operations in light of the above considerations, Management would envisage applying the country eligibility criteria outlined in Section II requiring strong medium term adjustment programs, an adequate medium term financing plan, demonstrated government commitment, and a material contribution to the country's growth prospects from reducing the debt burden. Do the Directors agree that these criteria are appropriate?

56. Once a satisfactory medium term program is agreed, the support to be provided by the Bank would be allocated from existing lending programs, plus any additional amounts that would be justified by the comprehensiveness of the proposed debt reduction and the Bank's own prudential concerns about its risk and exposure, as discussed in Section III. This might be in the range of 10% up to 25% (where additional funds are justified) of a country's planned "high case" lending program. Do the Executive Directors support this approach?

57. The specific designs of the debt or debt service reduction schemes are, of course, not known at this time. As a consequence, it is likely that the Bank will have to exercise flexibility in the allocation of its funds between debt stock reduction and interest support and between direct lending and guarantees, subject to the concerns expressed in Section IV. While there could be a preference for direct lending, would Directors support the Bank's retaining the option to employ a wider variety of instruments where appropriate, particularly if a comprehensive resolution of the debt overhang were achieved? Do Directors agree that the specific nature of the Bank's support might best be handled on a case-by-case basis?

58. In specific operations, the Bank would coordinate closely with the Fund in helping countries prepare the medium term adjustment programs to be supported by debt and debt service reduction operations. The Board's attention would be drawn in particular to those cases where the Bank proposed to initiate or continue disbursements when negotiations had not been completed with commercial creditors and/or when arrears to them were rising. These situations would be monitored closely, as discussed in Section V. It is likely that in some cases, front loading or other modification in normal Bank disbursement procedures would be called for. Management would appreciate guidance from Directors on whether the approach outlined in Section V to handle these issues would be satisfactory, and on the suggestion that the Bank maintain an impartial role vis a vis the negotiations between creditors and debtors.

59. Reactions from Directors to the issues raised in this memorandum will help in further shaping the Bank's response to proposals for debt and debt service reduction.

Barber B. Conable

By: Ernest Stern

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

CONFIDENTIAL

TO: Mr. Barber B. Conable

FROM: Ernest Stern, FINSV

SUBJECT: Debt Strategy

February 27, 1989

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WBG ARCHIVES

The U.S. is in the process of revising its debt strategy and these changes presumably will be unveiled when the Treasury reports to the Congress in about two weeks time. It is very likely that you will be invited to visit Mr. Brady this week so that he can brief you on the proposals. We are not familiar with all the details but from what I have been told I would have the following comments:

1) The approach seems to involve an earlier statement of financial support of the Bank and the Fund and then leaving it to the debtor country to find such additional resources as it is able rather than provide assurance that the financing requirements needed for a minimum rate of growth will be met. The theory seems to be that the public institutions should not become involved in endorsing a specific financial target, but rather make their commitment based on an assessment of the situation and leave a further adjustment effort to the country in case resources from other creditors turn out to be inadequate.

2) Conditionality relating to private foreign investment and policies necessary to attract flight capital would be strengthened. Here to, the proposition is that countries must take a greater share of the responsibility to find the financing for their development.

3) Debt reduction would be facilitated by a three year moratorium on payment sharing arrangements among the banks. While desirable, it is not clear how the commercial banks will be induced to accept such a proposal. In any event, I know of no instance where a debt buyback proposal (Chile, Bolivia) has not quickly obtained the necessary approvals.

4) To facilitate debt buybacks the Fund and the Bank would be asked to hold back portions of their loans which would be disbursed only against expenditures incurred in debt buybacks. The legal aspects of this are not clear and it certainly will be a politically sensitive way to use World Bank Funds. Moreover, the debt buyback should not be the exclusive instrument for implementing debt reduction. Setting aside portions of our adjustment loans for the purpose, merely substitutes our funds for other funds for needed imports. This makes no sense except if the objective is to force countries into debt buybacks.

5) The Fund and the Bank would also provide cover for interest payments on fixed-rate loans below market rates. Whether such cover is also to apply to the interest rate of new debt, issued in debt reduction schemes, is unclear. In any event, you are familiar with the arguments against interest rate guarantees. They would put the Bank

in the highest risk position if any country ran into difficulty. It is not enough to say that the risk is small in the case of Mexico because there is no way in which such a program could be limited to Mexico.

My understanding is that this proposed revision in debt strategy has been developed by a very small group in the Treasury. The implications for the various actors in the debt strategy do not appear to have been thought through. In particular, the political reaction in borrowing countries seems to have been largely, if not completely, ignored. My sense is that these proposals will be seen as a further attempt by the official sector to opt out of its responsibilities. While the borrowing countries may benefit from debt buybacks and interest guarantees, these benefits will not come for free: buybacks will be financed with additional debt and interest guarantees will presumably substitute for direct Bank or Fund lending and will carry non-trivial guarantee fees. It will not escape notice that buyback funds are going to commercial banks now, whereas the cash flow relief will only accrue to borrowing countries over time.

The commercial banks will welcome the proposed interest guarantees, but I doubt that they will respond favorably to other elements. At a time when the concerted lending process has already been declared defunct by many observers, the U.S. proposes to withdraw even further from the negotiation process, leaving it to the banks and the borrowers to fight it out amongst themselves. For most borrowing countries this seems more likely to result in protracted arrears than in confidence-building financing packages.

Finally, the implications for the Bank and the Fund could be very damaging. Involving us in the details of debt buyback arrangements -- and holding back loan funds for this purpose -- is fraught with dangers, as is the idea of having us guarantee near-term interest payments. Acceptance of additional risk is not objectionable in itself, but it is crucial that it be part of an approach that enlists the active support of the other participants in the debt strategy and that reduces the uncertainty regarding the availability of external finance or debt relief to support sound adjustment efforts.

From what we now know of the U.S. proposals, they will raise expectations regarding additional risk-taking by the Bank and the Fund, while leaving the roles of the other participants obscure and probably more uncertain than they are at present. We should strenuously object to such a plan.

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File Title	Barcode No.
Financial Files - Debt initiative - Correspondence - Volume 2	1782430

Document Date	Document Type
Jun 16, 1988	Letter

Correspondents / Participants
To : Mr. David R. Bock, Director
From : R. T. McNamar

Subject / Title
Conover & McNamar, Inc Agreement with the World Bank

Exception No(s).

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THE WORLD BANK

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NAME	ROOM NO.
Mr. Conable	

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REMARKS

The attached provides further information about the McNamar Study. The first draft report from McNamar and his team is expected on or about Sept. 15.

FROM

H. Vergin

Record Removal Notice

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File Title	**Barcode No.**
Financial Files - Debt initiative - Correspondence - Volume 2	1782430

Document Date	**Document Type**
Aug 3, 1988	Memorandum

Correspondents / Participants
To : Mr. Robert B. Keating, Executive Director
From : Anthony Toft, Acting Director, DFS

Subject / Title
Conover & McNamar - Study

Exception No(s).

☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐ 6 ☐ 7 ☐ 8 ☐ 9 ☐ 10 A-C ☐ 10 D ☐ Prerogative to Restrict

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«data c:\clients\banks.doc»

August 1, 1988

«recipient»

Dear «addressee»:

Our firm has been retained by The World Bank to conduct a study of the concerted lending program in which commercial banks and The World Bank are presently participating. The overall objective of the engagement is to provide an assessment of the coordinated lending process and the prospects of net new lending for the major creditor countries. We have also been asked to evaluate the options currently available to cope with possible shortfalls in new money programs.

An important component of this study is ascertaining first hand the commercial banking industry's perspective on The World Bank's present LDC debt strategy, the banks' views of the continued viability and structure of the concerted lending process, and their thoughts on the prospects and options for change.

We have identified a select group of the largest commercial banks in the world that we feel would provide the most useful insights and comments relative to the study. We are hopeful that either you or a designated representative will be available to meet with us to discuss your perspectives on the LDC debt issue. It is our intention that findings from these discussions will be handled on a non-attributed basis, thereby maintaining individual bank anonymity.

We plan to be in «area» during the week of «time» and would like to schedule a meeting for that time if you are available. I will have a representative from our firm contact your office later this week to see if this is a mutually convenient time to get together. Our present plans call for the completion of all interviews by the end of August in order to complete our review prior to The World Bank's Annual Meeting in September.

We look forward to meeting with you.

Very truly yours,

R. T. McNamar

MESSAGE NUMBER

1 2 DFS

YOU WILL RECEIVE SHORTLY A LETTER FROM THE FIRM OF CONCVER AND MCNAMAR REQUESTING AN APPOINTMENT WITH YOU TO DISCUSS A STUDY BEING UNDERTAKEN BY THAT FIRM. IN THE COMMUNIQUE REQUESTING THE APPOINTMENT, MESSRS. CONOVER AND MCNAMAR HAVE INDICATED THAT THEY HAVE BEEN ENGAGED BY THE WORLD BANK TO CONDUCT A STUDY OF THE CURRENT INTERNATIONAL FINANCING ENVIRONMENT WITH RESPECT TO THE HIGHLY INDEBTED MIDDLE INCOME COUNTRIES.

I WOULD JUST LIKE TO CONFIRM TO YOU THAT THE WORLD BANK HAS ENGAGED THE SERVICES OF CONOVER AND MCNAMAR, INC. TO CARRY OUT A SURVEY OF INTERNATIONAL COMMERCIAL BANKS IN ORDER TO PROVIDE US WITH AN OBJECTIVE ASSESSMENT OF THE CURRENT ATTITUDES, CONSTRAINTS AND OBJECTIVES WHICH AFFECT BANKS' DECISION MAKING IN THIS IMPORTANT AREA. WE BELIEVE THAT AN ACCURATE UNDERSTANDING OF VIEWS OF COMMERCIAL BANKS WILL FACILITATE THE WORLD BANK'S CONSTANT STRIVING TO MAXIMIZE THE MOBILIZATION OF FINANCIAL RESOURCES ON BEHALF OF OUR MEMBER COUNTRIES.

WE WOULD APPRECIATE ANY COURTESY AND ASSISTANCE WHICH YOU ARE ABLE TO PROVIDE MESSRS CONOVER AND MCNAMAR IN THE CONDUCT OF THEIR ENGAGEMENT.

END OF TEXT

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2 2 DFS

I LOOK FORWARD TO SEEING YOU AND YOUR COLLEAGUES DURING THE ANNUAL MEETING OF THE WORLD BANK IN BERLIN. BEST REGARDS.

DAVID BOCK, DIRECTOR, DEBT MANAGEMENT AND FINANCIAL ADVISORY SERVICES DEPARTMENT, WORLD BANK

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TELEX NO. BOOK OF 48

DATE 8/2/88

SUBJECT

DRAFTED BY: DFlannery/mjw

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cc: Mr. Bock (o/r)

AUTHORIZED BY (Name and Signature): Anthony Toft, Acting Director

DEPARTMENT: DFS

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THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: May 3, 1988

TO: Mr. Barber B. Conable

FROM: Stanley Fischer

EXTENSION: 33774

SUBJECT: Debt Study and Conference

1. As discussed with you recently, we are currently undertaking a major study of the debt problem, aimed at both an internal Bank audience and the external audience.

2. We will avoid taking any policy position, intending rather to set out the facts of this and past debt crises and to describe the pro's and con's of options for dealing with the problem. The proposed set of papers is attached.

3. We are planning to have initial drafts of the papers available in September, when they will be subjected to internal review within the Bank.

4. After the papers have been revised, we hope to hold an academic style conference at the Bank to discuss them. December or January seems to be the right time. We have not yet focused on the participant list, but will seek the right balance among academics, bankers, and policy-makers. We will probably want to keep open the option to move it in a more or less academic direction until much nearer that time.

5. Why should the Bank do this? The advantages are

   (a) we will be seen to be active in the area;
   (b) we will clarify our own thinking about the options;
   (c) we may influence the public debate.

   The disadvantage is that we may well take flak from

   (a) shareholders, for stepping out of line
   (b) critics, for not stepping far enough out of line.

I believe the advantages outweigh the disadvantages, and will take care that we do not make Bank policy recommendations in the study.

cc: Messrs. W. David Hopper, Jean Baneth, Ishrat Husain

Attachment

Dealing with the Debt Crisis: The Evolution of Developing Country Debt Difficulties and a Range of Policy Options

Forward: Stanley Fischer, VPDEC

Paper 1: Analysis of the Causes of the Debt Crisis

Paper 2: External Debt and Growth in Middle-Income Developing Countries

Paper 3: The External Debt Difficulties of the Low-Income Countries of Sub-Saharan Africa

Paper 4: Implications for Commercial Banks and the International Financial Systems of Continued Developing Country Debt Problems

Paper 5: The Empirical Evidence of Negative Incentive Effects of a Debt Overhang

Paper 6: An End to the Debt Crisis: General principles

Paper 7: A Review of the Schemes for dealing with the Debt Crisis

Paper 8: Market-Based Menu approach

Paper 9: The Analysis of Proposed Alternatives to end the Debt Crisis

Paper 10: Beyond the Debt Crisis: Alternative Forms of Financing Growth

Paper 11: Past Sovereign Debt Service Interruptions and their Resolution

IHusain:
5/4/88

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

Note marking below

Original returned to Fischer 5/16

DATE: May 2, 1988

TO: Mr. Barber B. Conable

FROM: Stanley Fischer SF

EXTENSION: 33774

SUBJECT: Internal debt study

1. As a follow-up to the Policy Committee discussion of the Debt Task Force Report, and your decision that we undertake further study, I have set up a small task force with members from the Finance complex, Legal, Debt and Financial Services (David Bock's department), and the International Finance Department.

2. The task force is to examine and develop some options for dealing with the debt crisis, and the Bank's role in each.

3. An initial issues paper has been prepared, and is attached. It sets out eight problems that have to be addressed by any debt scheme, and then proposes three classes of scheme for serious study:

   (a) a debt facility;
   (b) the anology of bankruptcy proceedings;
   (c) guarantees.

There is not necessarily much difference between (a) and (b)

4. I have asked the Task Force to work discreetly and not to involve other staff. They are capable of producing a first draft by June. However, you may prefer the option of aiming now to be in a position to either have or not have the report done by the time of the Annual Meetings.

5. Please let me know whether you want us

   (a) to proceed to a June first draft; BBC
   (b) to slow down and make a decision on the completion date sometime next month (June);
   (c) to hide the study.

cc: W. David Hopper

Attachment/-

Draft/finrel
3/23

Financial Relief for the HIC's
Issues Paper

The objective of the quick big think piece is to develop some strategic options for the World Bank in dealing with the debt problem of the HICs. A large number of proposals that have been presented from within and outside the Bank have met with little success so far. It may be pertinent to inquire as to why these proposals could not draw wider acceptance or breakthrough. In any scheme trying to bring about consensus among several parties with divergent and conflicting interests the inherent difficulties are quite substantial and should not be underestimated. But the nature of these difficulties should be clearly understood and managed. Thus the starting proposition of yet another proposal or idea in this widely discussed field must be to specify some basic pre-conditions that should be satisfied to gain acceptance or minimize the conflicts among the parties concerned. These conditions are not likely to remain fixed and will evolve over time but at this juncture there are some well articulated concerns which should be addressed.

First, it is time that we should begin to think in terms of stratifying the countries in the group of HICs on the basis of their initial economic conditions and the likely prospects in the medium term. There is hardly a possible way out whereby a scheme designed for Costa Rica and Bolivia would either be applicable to Mexico or Brazil or acceptable to the concerned parties even if applicable. Further differentiation and sub-groupings may enable us to find solutions that are presently out of reach for the whole

group of HICs. The group itself should not be closed end but the right of entry to and exit from the group should be exercised with diligence and circumspection. Is it valid to include Colombia and Chile with Peru and Argentina in the same group when Colombia can acquire new money on a close to voluntary basis in the same international markets that are closed to Peru?

Second,any scheme studied by the task force would need to be evaluated in light of probable call on public funds that may be made.Since it is clear that there is a great reluctance amongst the governments and the public of the major industrial countries to the commitment of Treasury funds for the purpose of debt relief the presumption should be that that the less public funds are required for the scheme the better.Most schemes require at least the contingent pledging of public funds or the contingent use of IBRD capital.The use of public money,whether contingent or not,should not of itself rule a scheme out but it would rather be an important factor in assessing the feasibility of the scheme.

Third, the "free rider" problem among the commercial banks has been a powerful deterrent to evolution of any sensible financial relief. The fear that some creditor banks may not actually participate in the debt reduction arrangements but benefit through strengthening the value of their claims in the post reduction period has been uppermost in the minds of most bankers. The scheme should therefore aim at devising a mechanism whereby the agreement reached by the majority of the commercial banks is binding on all creditor banks irrespective of the fact whether they participated in the relief or reduction measures or not. The backing by the regulatory agencies in the OECD countries is an essential ingredient for the enforcement of these agreements and minimisation of the "free rider" problem.This issue needs furthe

exploration and investigation by the Legal Department.

Fourth, the 'moral hazard' issue has also so far defied any reasonable and credible response.There are two different questions to address.The first concerns the past bad behavior of the countries receiving relief.How can relief be provided readily to those who had mismanaged their economies and resources in the past while at the same time asking prudent borrowers to service their debt at its full face value?The second question is related to the future behavior after the relief is granted to the debtor country. How can we be assured that those provided relief will not misbehave or talk down the present value of their claims in order to extract further discounts and reduction? Under what set of circumstances can the perverse incentive for misbehavior give way to responsible and prudent behavior? As suggested later,a close link between the economic performance and the grant of relief as an essential ingredient of the scheme will improve the probability of its success

Fifth, the case by case, negotiated, market based solutions between the creditor banks and the debtor countries do not easily lend themselves to an agreement on "market value" of the existing claims. The secondary market is too thin and thus a poor guide while the cost-minimization or damage limitation value perceived by the creditor banks is not always feasible from the debt workout viewpoint of the debtor countries. Thus there is a need to bridge this wedge and determine a "fair and reasonable" price at which the deals can actually be consummated. Whether this takes the form of mediation, adjudication or arbitration some third-party intervention may be necessary.

Sixth, any transfer of risk under proposed schemes(e.g. from the commercial banks to the IBRD) should be carefully evaluated so as to avoid

subsidization of commercial banks and to ensure the efficient use of the Bank´s(or other guaranteeing agency´s) capital. In agreeing to the use of its capital in catalytic or credit enhancement roles,the World Bank will pay due attention to the importance of maintaining intact its privileged creditor status and it will agree to participation in schemes only after a carful study of the costs involved for which it will endeavor to charge a proper fee.

Seventh, what are the financial dimensions involved and related to it, the timing of the relief that assures compatibility between restoartion of growth and capacity to service the existing debt. Financial relief should be phased in such a way that while removing the disincentive effect of the debt overhang,it is conditional upon the policy performance of the debtor country. Instead of a one-shot write down of the value of all outstanding claims of all the HICs a more gradual and graduated response should be followed depending on the economic performance and policy implementation record of the countries.However,to avoid serious dislocation for the commercial banks,some mechanism should be found that the annual financial relief does not exceed the loan-loss provisions of the commercial banks.

Eighth,within the above agreed framework some contingency financing mechanism should be developed to provide adequate provision against unforeseen external developments to countries undertaking adjustment programs.In the past a number of good programs were abondoned due to unexpected events such as fall in oil prices or escalation in international interest rates,over which the governments had no control. Such a link could be established through the Fund´s proposed Contingent Funding Facility and the CFF.The application ofthis principle should be symmetrical in so far if there are windfall gains accruing

to the country these should also be shared with the creditor banks providing relief in the first place

The task force should evaluate the relative merits of several of the more promising schemes for debt relief that have been advanced in the recent past in light of the eight propositions outlined above.Particular attention should be paid to the realism and feasibilty of the scheme and will study the role the Bank could/should play were they to be put into effect.Most of the current initiatives fall into one of three broad types:

(a)those proposing a new agency(possibly affiliated with the IMF or World Bank) for the purpose of purchasing(or exchanging) debt at a discount and passing on the relief to the debtors,

(b) those proposing a central management of sovereign debt in a manner analogous to domestic bankruptcy laws,and

(c) those proposing a major increase in the guarantee facilities provided by the World Bank,whether through establishing an insurance subsidiary(riskless or risk bearing),or through an expansion of our existing facilities.

There is a large element of commonality to several of the schemes proposed:thus the first two call for the reorganisation and writing down of debt under central management with relief to be offered on highly conditional terms,and the insurance scheme also requires adherence to a Bank/Fund program.The extent to which the Bank should be involved under debt relief schemes,whether as an intermediary/negotiator/administrator and whether it should extend credit-enhancing facilities and if so,at what prices and amounts,are important questions for the task force.

(

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

file

CORRESPONDANCE DATE : 88/03/07 DUE DATE : 00/00/00
LOG NUMBER : 880308001 FROM : W. Wapenhans
SUBJECT : Operational Strategy in Heavily Indebted Middle-Income Countries.
OFFICE ASSIGNED TO FOR ACTION : Mr. B. Conable (E-1227)

ACTION:

- ____ APPROVED
- ____ PLEASE HANDLE
- _✓_ FOR YOUR INFORMATION
- ____ FOR YOUR REVIEW AND RECOMMENDATION
- ____ FOR THE FILES
- _✓_ PLEASE DISCUSS WITH BBC
- ____ PLEASE PREPARE RESPONSE FOR ________ SIGNATURE ✓
- ____ AS WE DISCUSSED
- ____ RETURN TO ________

COMMENTS : As requested by BBC.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: March 7, 1988

TO: Mr. B. B. Conable

FROM: W. A. Wapenhans

EXTENSION: 75656

SUBJECT: Operational Strategy in Heavily Indebted Middle-Income Countries

1. You asked for further comments on the latest draft (3/6/88) of the debt paper. The draft successfully deals with a most complex subject and puts the Bank's role rightly in the operational context of restoring creditworthiness rather than managing debt relief. I have very few additional comments.

2. The Bank's Country Assistance Strategy as portrayed in Section B makes an impressive story. However, at the end of para. 16 (page 8) the Bank's emphasis on a recovery of growth is justified in terms of its comparative advantage based on long-standing experience. This should be a secondary consideration. The primary reason clearly must be that growth with restoration of creditworthiness is the most promising strategy - irrespective of institutional comparative advantage.

3. In para. 19 the Bank's contribution to adjustment lending is shown in terms of lending i.e. commitment volume. Several of the Highly Indebted Middle Income Countries were also beneficiaries of the Special Action Program under which accelerated disbursements became possible even on the then existing portfolio of projects. I suspect para. 19 thus understates the total efforts made by the Bank especially in the period '82 to '87.

4. Section C, and especially paras 47 & 48 detail the financing requirements for requisite growth performance. I continue to be somewhat sceptical that a 2 - 2.5% rate of growth of OECD countries will be sufficient to provoke 4 - 5% growth in the HIMCs with financing requirements of not more than $16 - 17 billion p.a. To achieve this kind of result would seem to require adjustment programs of a very high quality and sustainability throughout. Recent experience would not support such an assumption. My concern here simply is the creation of expectations that we may be hard put to meet.

5. Chart 2 following para. 53 shows the dramatic increase in the share of MLT net flows from the Bank (7% in '80 - '82; 32% in '85 - '87). The presentation of the stock of debt (Chart 3 on page 25) shows Bank exposure at 7% for both 1982 and 1986. I am somewhat puzzled by these two sets of data: the rapid rise in share of flows should be reflected in relative growth in exposure. There may well be a time lag but the question is nevertheless likely to arise as to the relative growth of commercial stock of debt needed to support $3 billion p.a. net financing from the Bank (Table 4 page 20) without excessive growth of Bank exposure.

6. The catalytic role of the Bank is well developed in Chapter E. In para. 68 there is reference to Consultative Groups. In my experience they have contributed little in the case of HIMCs to enhance a concerted approach to work out programs. Of course, in relation to many of these countries such Groups do not exist and yet the application of the principles spelled out in para. 70 would seem to call for some coordination mechanism. The Bank could well offer its good services to set up and manage such coordination groups if so requested by both debtor and creditors. It could provide the framework within which "free-riding" could be kept under control and burden-sharing reasonably well respected.

cc: Messrs Qureshi
Bock

FORM NO. 75
(6-83)

THE WORLD BANK/IFC

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B Conable = only	

✓	APPROPRIATE DISPOSITION		NOTE AND RETURN
	APPROVAL		NOTE AND SEND ON
	CLEARANCE		PER OUR CONVERSATION
	COMMENT		PER YOUR REQUEST
	FOR ACTION		PREPARE REPLY
✓	INFORMATION		RECOMMENDATION
	INITIAL		SIGNATURE
	NOTE AND FILE		URGENT

REMARKS:

Perhaps reception of your comments on debt might be better received if presented positively rather than deferentially. I have no expertise in the substance of this issue, but did this note to demonstrate a form in which Bank efforts might be presented with greater effect.

FROM: [signature]	ROOM NO.:	EXTENSION:

File - debt

The World Bank is doing many things on a case by case basis to assist those countries unduly burdened by debt. While we do not profess to have the all-encompassing solution contained in one brightly-wrapped package, the series of actions being taken in conjunction with the Bank's development responsibilities do comprise a significant response to the problems resulting from the heavy debt burdens of the developing and middle-income nations. Our role in the international financing community might be better understood if we described it in the positive terms which these actions justify. We can cite the following steps as reflecting the World Bank's policies for providing sound support and aid to those countries seeking a firm path out of their present financial debt problems:

* The World Bank is the largest source of lending to the highly indebted countries, but with conditions requiring that the countries take steps that will strengthen their economies, sustain their development, assist growth and enhance their creditworthiness.

* Our lending is directed toward helping those countries improve their development, increase production and thereby deal with their indebtedness, but not to bail out their private creditors. Our primary mission is economic development to facilitate poverty alleviation.

* As a result of extensive staff analysis of the economies of the debtor nations, the Bank is able to provide extensive and critical advice to debtor nations and their creditors for dealing with their economic problems; This is a substantial element of Bank assistance.

* We seek to expand direct private investment in those countries by supporting economic policies with our loans that encourage such investment, and by direct actions by the IFC and soon by the new MIGA Agency.

* The Bank engages in financial intermediation with creditors and borrowers to expand the menu of methods, from debt/equity swaps to exit bonds, for dealing with debts as a means of meeting our mandate for development.

* The Bank provides extensive research and policy information to improve decision making of all parties on the problems affecting investment, trade, structural adjustment and other multilateral and unilateral aid.

We have offered some or all of this guidance and support to most of the nations currently facing serious problems of indebtedness. Some have embraced the entire array of reforms and assistance, others have not. The Bank cannot direct sovereign nations to adopt economic policies; they make that determination for themselves. But we are always ready to help.

Finally, it should be recognized that the World Bank cannot unilaterally deal with the debt crisis. It is unrealistic to think that any single institution holds the solution to improving these troublesome conditions. The IMF, the major industrial nations, the commercial banks and the debtor countries themselves are all critical to overcoming the present financial difficulties. The Members of the World Bank have given the Bank a mandate to advance economic and social development as the central thrust of worldwide efforts to reduce global poverty. Our role on debt is designed to further the realization of that primary mandate.

The World Bank
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

1818 H Street, N.W.
Washington, D.C. 20433
U.S.A.

(202) 477-1234
Cable Address: INTBAFRAD
Cable Address: INDEVAS

January 18, 1988

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To Barber Conable, President

through J. William Stanton, Acting VPEXT

From Frank Vogl, Director of Information

Subject: World Bank Debt Strategy

Following the Walter Mossberg interview we talked briefly about finding better ways to articulate our position on the debt crisis. In response to this I have drafted the attached.

The attached has not been circulated. It is much, much shorter than typical Bank statements/speeches on this subject. It assumes the audience knows the situation. It is not defensive, as so many of our statements have been in the past. It offers nothing that our existing organization and staff is not capable of directly providing. It suggests no simple quick-fix solutions to the debt crisis. It simply outlines and defines our roles as advisor, lender, intermediary and catalyst for non-IBRD resource flows.

This does not amount to a " grand design " or the Barber Conable Debt Plan to rival other plans. But it seeks to crisply articulate what we can do and provide a forceful offer to all participants to use the Bank more fully.

There will be some who will dismiss this because it offers nothing new, or because it fails to capture all the nuances of the debt crisis, or because it raises expectations about Bank actions in the future, or simply because it is too simple.

Naturally, I would gladly work further on this if you feel this could help. I do most strongly believe we need to have very soon some direct statement on our roles in this vital area.

CC: Ms. Haug, Mr. Nicholas

DRAFT Speech Possibly for Bretton Woods
Annual Meeting in mid-February.....

WORLD BANK STRATEGIES IN RESOLVING THE DEBT CRISIS

We are meeting at a time of deep concern about the prospects of the highly indebted,middle-income, countries. The World Bank is playing a central role in assisting these nations and it will continue to do so. This is not the role of a debt relief agency, but rather that of a long-term development institution.

Our approach in this area rests solidly upon the basic mandate given to the Bank 44 years ago at Bretton Woods, New Hampshire, when the founders of the institution declared in the Bank's Articles of Agreement that the Bank should " promote the long-range balanced growth of international trade and the maintanance of equilibrium in balances of payments by encouraging international investment for the development of productive resources of members, thereby assisting in raising productivity, the standard of living and conditions of labor in their territories. "

The stock of outstanding debt of these nations remains very high and servicing that debt is placing formidable strains on the social and political fabric of many of these nations. The governments have shown courage and they deserve forceful support.

The probability of a slow-down in global economic growth calls for special actions and measures by the World Bank in assisting the highly indebted, middle-income, countries. My remarks today focus solely on such Bank actions and measures for this group of countries.

Without special measures the effectiveness of major policy reforms that these countries have undertaken in recent years may be underminded. Without special actions the hopes for meaningful social and economic progress for these countries may be dashed.

The World Bank's lending and advice to these countries has been significant in recent years. Our strategies may not always have been well articulated, but they have been effective. The measures and actions that I am outlining today represent additions to our proven strategies. The timing of announcements on this front reflects both the bleaker economic forecasts of recent weeks, as well as the forthright encouragement that we have received from our shareholders. They have agreed in principle on a $ 75 billion general capital increase for the World Bank.

Our strategies focus on our work as a lender, as a financial intermediary and as a catalyst for non-World Bank capital flows. Each of these aspects of our work overlap and need to be seen together as a comprehensive package.

Lending:

We are ready to assist all nations in formulating programs of economic policy reform and we stand ready to support effective such programs with record amounts of fast-disbursing funds. We will evaluate, negotiate and process economic reform program loans - be they of a broad structural adjustment nature or of a narrower sectoral adjustment nature - with great speed.

We shall be seeking to support programs that aim to raise the living standards of the very poor, eliminate waste in public spending, strengthen business competition, and stimulate foreign and domestic private investment. We will provide major loans for such broad-based, durable, growth-oriented economic reform programs.

As we negotiate such loans we will seek to develop multi-year understandings with governments on the thrust of their reform plans, on the timing and phasing of their policy initiatives and on the likely scale of direct multi-year World Bank lending that these governments can expect in support of their proposals. We see such planning covering a 3 to 5 year framework. Providing such multi-year policy reform plans, together with estimates of likely World Bank lending flows, can directly assist borrowers as they seek to raise their creditworthiness with commercial lenders.

Our support will be strongest and most productive for those countries willing to promote effective and sustainable reform plans - plans that will revive the momentum of development and pave the way for restored creditworthiness. We will not lend for programs that fail to provide, in our view, viable economic paths to growth. Our lending will be squarely based on the quality of the proposals before us.

For the next 5 years the IBRD will be able to make new lending commitments well above $ 80 billion to all borrowers. This may include quick disbursing, policy reform supporting, loans of well in excess of $ 20 billion.

Let me stress that such figures are not targets for us, but estimated probable maximum volumes. Whether or not we commit such substantial sums is going to depend on the quality of the reform programs pursued by our member countries. Those nations willing to demonstrate the pragmatism and courage that is now required will be those that will secure the most World Bank backing and I am talking about record level lending on a scale likely to impress creditors and relieve some external finance pressures for borrowers.

Financial Intermediation :

Nations must accept that they cannot hope to escape their debt difficulties and remain respected trading and investment partners in the global economy without putting in place viable, effective, economic reform programs backed by the World Bank. We are willing to put our reputation on the line in evaluating and monitoring such programs and assisting governments in presenting these programs to official and commercial creditors.

Creditors must accept that nations willing to move ahead with effective programs and ones that receive full World Bank support, should be viewed as serious partners for the development of medium-term debt work-out programs.

The international community must strive to move away from piecemeal and last minute rescheduling negotiations and ad hoc and often confusing financial deals. There can be no equitable and effective generalized debt solution for all nations. There can, however, be medium-term, debt work-out, plans on a country-by-country basis. The World Bank stands ready to serve as a central intermediary promoting such plans.

We intend to encourage each of the highly indebted, middle-income, countries with whom we have an active lending program, to discuss with us its medium-term external financing plan. A key component of such a plan will be estimated multi-year World Bank resource flows to the country.

Our experts will work with the authorities of these nations to formulate strategies concerned with securing steady debt-servicing and seeking over time to reduce the burden of external debt. Such work will include estimates of possible official capital flows to the debtor country from diverse sources, determinations of the appropriateness for the borrower of assorted financial devices, from rescheduling to debt-equity swaps and exit bonds, to the design of specific proposals aimed at attracting direct foreign investment, including the return of flight capital.

For those debtor nations desirous of exchanging views with us on financing plans of this kind,that can lead to comprehensive debt work-out strategies, we will spare no effort to seek support from creditors and potential investors for this effort. I will seek to lead this effort. Meetings of borrowers and creditors and potential investors will be convened. Alternative approaches will be offered by the World Bank's expert staff, which I firmly believe enjoys the respect from all parties to serve as effective ' honest brokers ' in this critical process.

Catalyst For Capital Flows :

Flows of resources well in excess of those that the IBRD can directly provide will be essential to secure brighter prospects for the heavily indebted, middle-income, nations. As we strive to intermediate between debtors and creditors we shall leave no stone unturned in our quest for additional resource flows.

As appropriate, we shall strengthen coordination with the International Monetary Fund in developing medium-term framework economic strategies with borrowers. We will intensify cooperation with the regional development banks, bringing them more directly into partnership in support of economic reform program loans and in determining multi-year support levels for borrowers that we and they can provide.

We will seek to expand the flows of resources to these nations from official export credit agencies, encouraging specific credits in cofinancing with our economic reform program loans. We have made a good start here with the Japanese authorities and I shall be urging the Japanese to sharply increase the resources they place in such programs. At the same time I will be urging the agencies of other major industrial nations to step forward and tailor programs more directly to this purpose.

We will ensure increased support by the International Finance Corporation by much more directly involving it at the outset in working with borrowers on their debt work-out programs. With its ability to take direct equity positions in private corporations and with its important skills in the capital markets arena, the IFC can make a significant contribution.

We will also consider, in exceptional circumstances, the use of guarantees and direct World Bank resources, to cement comprehensive agreements between debtors and creditors.

Conclusion:

Today I have outlined the strategies that we will be pursing to assist with the resolution of the debt crisis that confronts many of the middle-income developing countries. Our approach will involve us in enhanced policy advice; record level lending; the filling of an existing void in bringing debtors and creditors together in efforts to develop work-out proposals; and increased catalytic efforts to stimulate capital flows.

These efforts offer no assurance of solutions to the debt crisis. Our work must be seen within the context of global economic winds over which we have little influence. There can be no effective solution of the debtor nations are unwilling to take advantage of the services that we seek to provide and take the courage that is necessary to promote and sustain effective economic reform programs. Moreover, the prospects for a resolution of the debt crisis rest to no small extent in the hands of the major industrial nations, whose efforts to secure open and expanding world trade and strong international investment flows are absolutely crucial.

Our mandate to work in this area is crisply outlined in our basic Articles of Agreement. Our founders saw us as being a force for development and for international economic cooperation. We are such a force and we are determined to become still more flexible, responsive and effective in this area. I urge the borrowers and the creditors today

use the World Bank to the maximum, seeking from it the creativity, the expertise, the resources and the trust that can make a real difference as together we meet the challenge of the debt crisis.

Thank you.

****

1/13
Debt Initiative

THE WORLD BANK
Washington, D.C. 20433
U.S.A.

(Discussed at Volcker mtg. of January 13, 1988.)

BARBER B. CONABLE
President

January 4, 1988

Dear Paul:

I would appreciate your reviewing the attached report on the debt problems of highly indebted middle-income countries so that we can discuss it when you come to the Bank on January 13th. This is one of several issues I would like to discuss with you at that time.

Needless to say, another issue of continuing concern is the Bank's headroom, and I want to discuss this further with you, as well.

Looking forward to seeing you on the 13th.

Sincerely,

Barber Conable

Enclosure

The Honorable Paul A. Volcker
c/o Geoffrey Bell & Co., Inc.
780 Third Avenue
46th Floor
New York, New York 10017

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<u>C O N F I D E N T I A L</u>

DATE: 17 December 1987

TO: Barber B. Conable, President

FROM: Jean Baneth, Chairman, Debt Task Force

SUBJECT: Report on the debt problems of highly indebted middle-income countries.

1. In response to your instructions of August 7 1987 to David Hopper, the Debt Task Force has reviewed the problems confronting highly indebted middle-income countries (HIC). This note reflects its findings and recommendations. On most of these, a consensus has been reached by Task Force members, except when disagreements are specifically mentioned. Because we have concentrated on finding a consensus, the document is longer, contains more qualifiers, and perhaps also covers less ground than any of us might have wished for a document drafted under his sole responsibility. We nevertheless believe that our report provides substantive grounds on which to base the next stages of the Bank's debt strategy.

SUMMARY

2. The Task Force has agreed that whatever other elements may threaten the viability of adjustment programs, financing from commercial banks in the form of "new money" has been inadequate in the past, and is likely to be even more inadequate in future. The Bank should continue, and strengthen, its efforts to mobilize such financing, but stop short of substantially engaging its own credit for that purpose. In countries where despite these efforts adequate new money financing cannot be mobilized in support of otherwise adequate adjustment efforts, the Bank should not support inadequately financed programs, nor, on the other hand, should it allow its lending to be blocked by the inability or unwillingness of other lenders to accept reasonable financial burdens. In appropriate cases, it should be prepared to accept the accumulation of financial arrears to other creditors as a source of financial relief. It should seek to play a key role in maintaining a constructive relationship between the country and its creditors, notwithstanding unresolved arrears problems.

3. Three working groups were constituted to deal with the three main points of your instructions. Separate reports on their findings are attached. The background against which the Task Force's work must be viewed includes the stock-market crash of October 19, the widespread subsequent perception of heightened down-side risks to the global economy, and the recent and expected slide of the dollar, with its implications for the Bank's *headroom* and remaining lending ability until the GCI becomes effective.

To what extent is the prospect for successful adjustment constrained by financial difficulties? *(Point a of your instructions)*

4. Our general conclusion is that the financing constraint remains very serious. The country analysis prepared within the Operations complex and presented by Vinod Dubey shows that under some assumptions regarding the effectiveness of country adjustment programs and the availability of external financing, viable work-out scenarios relying on new money flows can be established for most HICs. *Viable* in this context implies the near-term resumption of income growth permitting gradual increases both in investment and in consumption, and an improvement of debt service ratios over the medium term. However, four factors qualify this prognosis.

First, the financial resource flows required are much larger than those provided over the past several years and expected to be provided over the next few years (see Chart p.3.).

Secondly, the scenarios are vulnerable (in many cases, extremely vulnerable) to deteriorating global economic conditions (demand slow-down, falling terms of trade, rising interest rates, protectionism...).

Thirdly, it is unlikely that adequate adjustment programs will be undertaken and sustained by all the 17 HICs during the next ten years. For a variety of reasons, including domestic political ones, several countries are unlikely to embark on adequate programs of policy reform, or to sustain them. These countries cannot be clearly identified in advance.

5. There is *a fourth factor on which the Task Force has not reached a consensus. It concerns the feasibility of the country work-out scenarios* if assumed global conditions prevail and if the projected capital flows are in fact available. *In the view of Operations, the projections represent outcomes of reform programs which are considered feasible and in most cases likely* in the judgment of country economists and managers. *PPR Task Force members feel that in many cases truly heroic policy changes need to be implemented and sustained* to produce the projected impacts. However, there is a broad consensus within the Task Force that in the absence of new initiatives at the official level actual new capital flows are likely to fall short of the aggregate amounts required by the country projections, and that therefore *the difference between the Operations and PPR positions is moot since the viability of the scenarios depends on their financing requirements being substantially met.*

6. To respond more directly to your question a), there is some disagreement within the Task Force as to what other factors may constrain the prospects for successful adjustment; but there is a consensus that the current debt workout strategy is in serious danger of failing soon, and visibly, for lack of adequate net financing to support it. One may therefore temporarily lay aside part the debate (what would be the likelihood of the ultimate success of debt-increasing strategies if adequate financing for them were available), and *concentrate on the actions the Bank should pursue when adequate external resources cannot be secured through the conventional concerted lending approach.*

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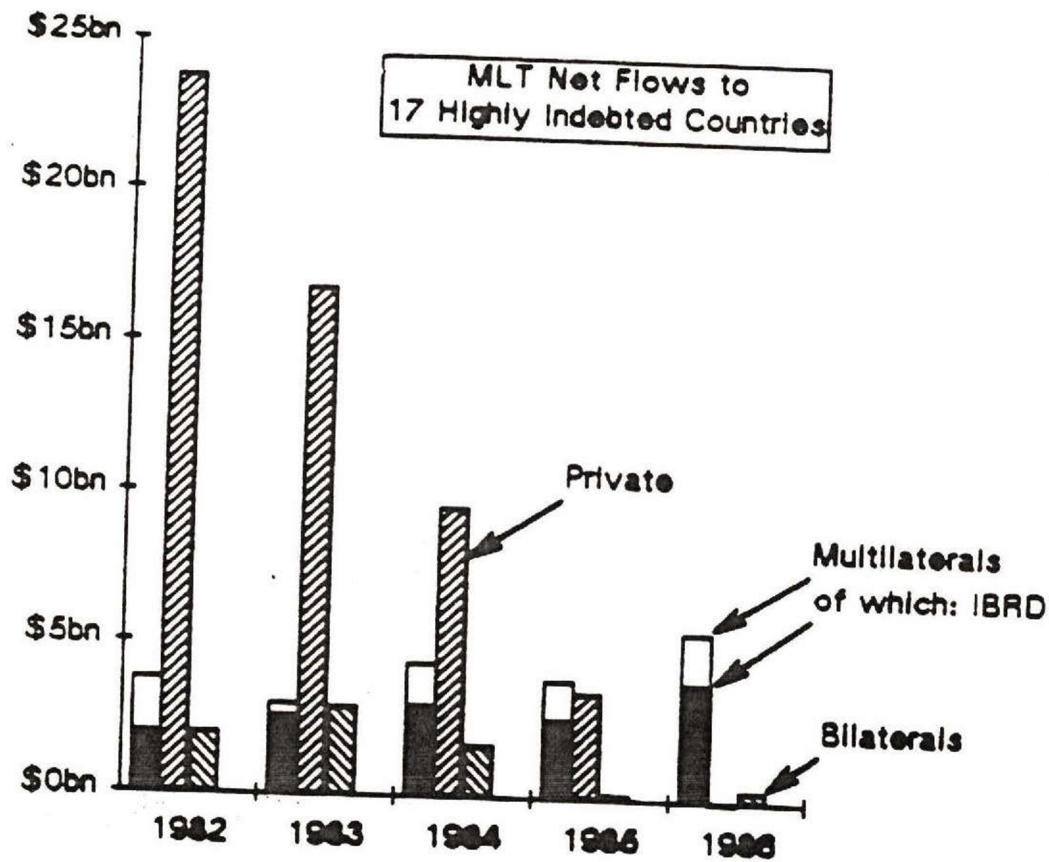

Source: Report of Bock Working Group, page 5.

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The World Bank's role in addressing financial problems (point b).

7. The working group on Bank actions was chaired by David Bock. This group's major recommendation, on which there is a broad consensus within the Task Force, is that in those countries where *reasonable prospects for regaining access to financial markets exist*, the Bank's main role continues to be to strengthen these prospects by policy conditionality, direct financing and the mobilization of new money from financial markets. With official lenders, mainly export credit agencies, the Bank will need to adopt a pro-active stance, explaining the merits of the adjustment program in the debtor country, the reasonableness of the assumptions underlying the financial requirements and the consequences of failure to approve an adequate volume of assistance at suitably concessional terms. With commercial creditors, such steps are equally relevant, and the Bank should play a catalytic role in specific negotiations to the extent it can. It should be made clear that *fast disbursing Bank assistance to the debtor will be made available only if other creditors assume an appropriate share of the financing burden.*

8. The Bank may be requested to support the flows of new money from commercial banks with some form of credit enhancement. This will have to be done on a highly selective basis as the Bank's capacity to take on additional risk is itself very limited. Moreover, the Bank should not use its credit enhancement powers to override market judgments about a given borrower's creditworthiness. It should avoid overly exposing itself in its efforts to mobilize financing. This argues, in particular, for the judicious, and increased, use of the Bank's guarantee powers, rather than direct participation cofinancing. A sustained effort should be made to explain this more attractive alternative to the Board. The Bock working group also clarified the limitations of some potential "menu" items, such as the Bank assuming the functions of trustee, billing agent and lender of record. In countries where it is still pursuing efforts to raise new money, the Bank should be selective in its support of debt reduction techniques, and stay generally clear of large scale securitization for the time being. However, it should not exclude selective participation in consensual debt reductions when they also further specific additional objectives. In particular, for countries whose commercial debt is low and is highly discounted, Bank involvement may be warranted in exchange offers or even in buy-back schemes.

9. Notwithstanding such Bank help, even countries willing and able to undertake appropriate adjustment programs may not be able to mobilize adequate new money. The Bank might then either have to make up the difference on its own, and thus assume an excessive share of a country's debt; provide financial support in a situation rendered clearly unviable by the inadequacy of overall financing; or suspend its support, thus aborting promising adjustment efforts and, incidentally, also enhancing the risk to its existing claims. *Fundamentally, none of these choices is acceptable.*

10. Task Force members do not fully agree how likely and how widespread such shortfalls will be. However, they are in full agreement that when such shortfalls do occur, in general *the Bank should not try to substitute its own lending for that of commer-*

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cial lenders; nor support an inadequately funded adjustment program. *It should avoid unduly raising its shares in HIC debts, indirectly devoting an undue share of its resources to financing debt service to other lenders, and also avoid committing its own resources to countries with such low investment levels (or such high austerity-induced social tensions) as to compromise the security and development impact of Bank loans. In cases where appropriate efforts fail to raise enough* new money *to meet financing needs,* the Bank should be ready to accept interest capitalization and other forms of debt servicing arrears as appropriate parts of the overall financing framework, even if this is not contractually agreed by the creditors concerned, *and proceed with an appropriate lending program. In this context, financing needs must, of course, relate to the resumption of growth (in combination with appropriate policies), not just to the ability to continue debt service. It is to be noted that recent Fund documents also stated that the IMF* may *have to take such a position in some circumstances.*

Accepting arrears as part of an *adequate* financing package.

11. The Bank already lends to some countries that are in arrears to commercial banks (e.g. Brazil, Côte d'Ivoire) but these are cases where negotiations are continuing and formal rescheduling agreements, including the treatment of arrears, are expected shortly. The problem arises when a negotiated agreement between a debtor and its commercial creditors is not in sight, in adequate amounts and terms. If the Bank agrees with the debtor that an accumulation of arrears may be used in such cases as a means of enhancing financial inflows, it may be accused of encouraging debtors to declare unilaterally the capitalization of interest, and of contributing to the breakdown of the international financial system. It is vital that the Bank should not become directly involved in a confrontation between the debtor and its creditors. Therefore, the acceptance of arrears as part of a financing plan is a grave step that the Bank can take only as a last resort, with the support of its major shareholders, after consultation with the IMF, and in circumstances that are very carefully circumscribed:

First, the debtor should have a *sound adjustment program.* Inability to service debt may be caused by past policy failures but, when the financing package is finalized, there should be solid evidence that well-designed adjustment policies are being implemented. The strength of the adjustment effort should be fully commensurate with the underlying economic and political realities.

Second, the debtor country should have made appropriate *efforts to reach a negotiated agreement with its creditors.* The Bank will have to assess the reasonableness of the demands put forward by the debtor and the flexibility shown during the negotiating process. The terms offered by the creditors should be evaluated by the Bank in the light of the country's requirements (rather than demands) and of standards of reasonableness that are openly defensible.

Third, the absence of an agreement on new money flows should leave a *major shortfall in financing,* leading to a disruption in adjustment efforts and to the serious likelihood of severe economic hardship or political instability. In particular, it should be clear that IBRD cannot compensate for this

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financing shortfall by expanding its own lending, without taking on excessive exposure and unacceptable portfolio risk.

Fourth, the resulting *financing package, including the accumulation of arrears, should be adequate to support macro-economic adjustment and growth.* It would be unwise to tolerate payments arrears if these still leave a significant financing shortfall, thus making it likely that the adjustment program would fail, jeopardizing the servicing of IBRD claims and damaging the Bank's credibility.

12. It is important to recognize that the buildup of arrears, like new money, is a "debt-enhancing" solution. There is *no consensus on a fifth condition*: how widely is this specific solution applicable.

Some Task Force members hold that the Bank should only support such solutions when it is convinced, on the basis of plausible assumptions and forecasts, that the debtor is likely to emerge from the debt crisis within a reasonable time horizon and be able to resume the service of all debt, including arrears, on terms consistent with reasonable negotiated agreements, while maintaining a satisfactory pace of economic expansion. These Task Force members recognize that reaching such a conviction will require difficult judgments relative to the uncertainties of the international environment, to the likelihood that a country would adhere to a given adjustment program, and to the adequacy of the amounts and terms of new lending from official and commercial sources. The Bank should freely share its assumptions with other creditors so as to allow them to make independent judgments on the economic prospects of the debtor country. Even so, if the Bank turns out to be wrong, its credibility will be seriously impaired. According to these Task Force members, if in the Bank's judgment a debt-enhancing solution is unlikely to be viable, the Bank may focus primarily on mobilizing concessional aid flows and on supporting debt reduction measures. It is, in the view of these Task Force members, *definitely inappropriate to continue IBRD lending to such countries (even if accompanied by accumulation of arrears to other creditors), when the Bank expects the country to stay unable to meet its full debt service obligations.* In addition to having misled other creditors, this will have increased IBRD exposure in countries that are not creditworthy. These Task Force members believe that this runs against the Bank's Articles of Agreement and is obviously imprudent from many points of view.

13. Other members of the Task Force hold sharply different views on this point.

They note that even if the acceptance of non-consensual arrears as a means of financing reduces the uncertainty in debt workout scenarios, uncertainties and risks would nevertheless remain. Even if the projected capital needs are met, several HICs would not be able to complete successful adjustment programs. In some arrears situations, which cannot be confidently identified in advance, it would not be possible fully to repay all accumulated arrears, capitalized at market rates of interest. *It would generally be neither necessary nor desirable for the Bank to take a position on the exact terms on which the debt resulting from the capitalization of arrears will ultimately be*

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serviced. *The Bank should only pronounce on the adequacy of the borrower's policy effort, and on the net capital inflow (maximum tolerable net resource outflow) needed to support it. Naturally, in judging how well both these crucial requirements are met, an important consideration will be their likely impact on enhancing future debt servicing capacity. These Task Force members also feel that the alternative approach, that of obtaining official aid for such middle-income countries, would be impractical, particularly if this were to serve, even in part, to service commercial bank claims.*

14. The legal and policy implications of the Bank's lending into arrears situations are discussed in the Legal Department papers (Annex). The obstacles to the proposed course of action are real but not insurmountable. Assessing whether the proper general criteria are met involves a series of complex judgments; more specific considerations will also affect individual cases. The stakes are extremely high. Tolerating arrears should not be seen by other creditors and the Bank's shareholders as a generalized policy of the Bank or routine practice. *The responsibility for decisions relating to the implementation of this policy should be confined to senior management.*

15. There is a consensus in the Task Force that the Bank should endeavor to reduce the conflictual elements between the debtor and its creditors. An important component of such endeavors would be to convince creditors (or at least the larger ones among them) that only through adequately financed adjustment programs can they maximize the expected value of their claims, and that if no other financing means is found, even the accumulation of partial arrears *within the framework of a viable adjustment program* may serve the creditors' best collective interest. Many creditors would realize that such arrangements would at least protect them from troublesome free riders.

16. The principle of case by case evaluation would remain central, but would inevitably require judgments in each case on the appropriate use of arrears; in effect, *a decision as to what constitutes a reasonable use of arrears*. Clearly, a complete moratorium by a middle-income country experiencing fast consumption growth would not be acceptable either to creditors or to the international community, while a partial moratorium by an impoverished country deliberately compressing domestic consumption under an agreed adjustment program might well find wider support. For the Bank to be actively involved in making such judgments seems unavoidable, but raises critical issues for its relationships with the debtor countries, with creditors and with its own shareholders.

17. Despite the better assurance of financing, an ongoing adjustment program may break down, because of a country's own failure to implement earlier agreed and reasonable policies, or because of a deterioration in external circumstances. In the former case, the Bank would have to cease lending. In the latter, situations may emerge (as they have for previously middle-income countries like Bolivia and Zambia, which have declined to low-income levels) in which a debt-enhancing strategy becomes clearly and visibly unviable. In such extreme cases it may become appropriate for the

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Bank to support debt reduction measures. These could take a variety of forms (discussed in the working group report).

Some major issues.

18. One important issue is to what extent should Bank management take a firm position in requiring an adequate and operational financing plan before agreeing to Bank lending? The Bank has made specific adjustment loans contingent upon a "satisfactory" financing plan, but the actual evolution of its share in net lending to HICs over the past few years has nevertheless risen sharply above earlier expectations. By emphasizing agreement with the creditors, the Bank may in some circumstances have encouraged financing packages that were not consistent with the restoration of growth and creditworthiness. *This report takes the position that adequate policy packages and adequate financing are equally indispensable preconditions to viable adjustment, and should be defined with equal care and demanded with equal toughness,* even in situations in which continued arrears may constitute the only viable financing plan available to the country.

19. A second issue relates to the implications of the Bank's firm position on an adequate financing plan in circumstances where new money flows are not forthcoming (at all, or in the amounts required). It may be argued that the Bank's stance leads to the conclusion that under such circumstances the building up of arrears is a prerequisite to Bank support. A related issue is the extent to which the Bank may pronounce upon the "reasonableness" of the debtor country's continuing, but diminished debt servicing efforts, thereby apparently "endorsing" the debtor's partial suspension of debt service payments to commercial creditors.

20. Political, financial and legal prudence would require that in a non-consensual scenario the Bank's stance be reactive rather than causative. *The Bank should neither seek nor receive contractual or other forms of commitment that the debtor country will suspend payments* to its creditors, and the Bank should not endorse the debtor's position before the fact. However, *if the Bank is faced with a situation where a country has decided* that, in the absence of adequate new money flows and of any other consensual solutions to its debt problem, it cannot meet more than a part of its current obligations, and thus proceeds to accumulate arrears, then this is a factual situation which will be reflected, indirectly, in its financing plan. In this context, if the Bank concludes that the country is making a genuine and reasonable effort to pay what it can, and that the financing plan is adequate, *then it should be acceptable and appropriate for the Bank to proceed* with its support. Every effort should be first made to achieve a consensual situation derived from bilateral agreement or through mediative efforts. However, in the absence of these *there is no real alternative to the recognition and support by the Bank by lending into a "self-help" situation within the framework described above.* There is obviously a rather narrow line between encouraging or even requiring debtors to build up arrears as a prerequisite to Bank support, and recognizing post-hoc the debtors' decisions as reasonable and deserving of Bank support; but the difference is extremely significant. Every effort must be made to respect and maintain it.

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21. As the foregoing passages imply, if the Bank decides to adopt the proposed policies, it should do so gradually, case by case, as the need arises and appropriate country policies warrant. The Bank should adopt a reactive, ex post stance; therefore no public announcement of this policy could be made ex ante. Without disagreeing with this, some Task Force members felt that in order to exert a leadership position the Bank urgently needed to regain credibility. Given the attitudes, pronouncements and actions of commercial banks, we should no longer continue claiming that they will adequately finance adjustment programs through the provision of new money. It is also desirable to generate support for the Bank's own actions in the new situation, and to ensure that unilateral debtor actions do not take on a confrontational character. Given these considerations, *the explanation of the Bank's policies will take on particular importance.*

<u>Worldwide new proposals to deal with debt problems (*point c of your memorandum*)</u>

22. A variety of proposals for global schemes to deal with debt problems are summarized in the attachment prepared by the working group chaired by Alex Shakow. There has been little substantive change since the previous such summary was circulated. However, proposals to pass on to borrowers some of the reduction in loan values implied by the provisions constituted by banks have gathered some additional support *within* the banking community itself. There is a broad consensus within the Task Force that none of the existing proposals can be endorsed by the Bank in their present form, but that several of them contain elements which may become parts of a long-term solution if the situation evolves further. Clearly, no solution can be general, dealing uniformly with all debt and all indebted countries. In that sense, "global solutions" can be excluded. Nevertheless, there is a feeling within the Task Force that a deteriorating global environment, and the already clear inadequacy of new money flows may bring about a situation in which the present institutional framework may no longer be adequate for dealing with the situation. The Bank must therefore continue to keep under review both new schemes as they emerge, and changing requirements, and be prepared to be an active participant in a global institutional dialogue.

23. From time to time, proposals have been put forward for a controlled process of debt reorganization for sovereign debtors, using mechanisms similar to those existing under national laws. As the debt crisis worsens and existing techniques continue to prove inadequate, the time may come when central management of sovereign debt, on a country by country basis, may ultimately be necessary. For a number of countries, including at least the low-income countries of Africa, but possibly several others, there will be a need for an international mechanism presided over by a neutral body which will provide a framework for a systematic resolution of debt problems based on a well-formulated financing plan. This would realistically address the terms and conditions on which the debtor country could service its debt, including, as a last resort, such debt relief measures as might prove appropriate (excluding from their scope multilateral claims). Without such a mechanism the overhang of past debt would continue to prevent even borrowers that

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have adopted good policies and achieved good performance from ever returning to the market for new loans. Its role in determining the adequacy of the debt servicing efforts of countries in arrears may constitute the beginnings of the Bank's involvement in the creation of such a mechanism. There is no consensus within the Task Force as to how actively the Bank should pursue this line.

APPENDIX

Task force Members:

Jean Baneth, Chairman
David Bock
John Holsen
Vinod Dubey
Herbert Morais
D. C. Rao
Alex Shakow

Other active participants in the work of the Task Force and of its working groups:

David Goldberg
Ishrat Husain
Fred Jaspersen
Charles Larkum
Fred Levy
Paul Meo
C. Sanjivi Rajasingham
Andrew Steer

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cc. Members of the Policy Committee

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The World Bank

OFFICE OF THE PRESIDENT

November 30, 1987

Jennifer:

The attached is for Mr. Conable's meeting with Mr. Stan Fischer on Thursday, December 3 at 8:30 a.m.

Marianne

With the compliments of Stan Fischer

The World Bank
1818 H Street, N.W.
Washington, D.C. 20433, U.S.A.

10/30/87

This is mainly a review of options. The NBER does not permit its authors to take policy positions.
Please let me know if you'd like to talk about this.

Sharing the Burden of the International Debt Crisis

By STANLEY FISCHER*

Muddling through was the right strategy to handle the international debt crisis in 1982. Over the next four years, the debtor countries performed miracles on current account as they made massive interest payments amounting frequently to as much as 6 percent of GNP, with very little inflow of funds. But the price in terms of growth has been heavy, the debt problem continues to bedevil many of those countries, and the time for debt relief has arrived.[1]

The initial burden of the debt crisis was borne largely by the debtor countries. In addition, bank shareholders have paid the price of lower stock values for their assets. But because there has been no formal debt relief, debtor-country wage earners bear the burden of unnecessarily low real incomes. Formal debt relief will entail little further burden on bank shareholders, while substantially reducing the burden on wage earners in debtor countries. This should be possible without increasing burdens on taxpayers in the industrialized countries.

I. Background

There are two major debt crises—the crisis of Africa and that of Latin America and the Philippines. Although the African debt crisis is more serious in human terms, its implications for the financial system are less serious, and I do not discuss it further.

The debt crisis had three causes: imprudent macroeconomic management and borrowing by the debtor countries; imprudent lending by the commercial banks; and the increase in the *ex ante* real interest rate. The rise in the real interest rate to about 6 percent by 1982 increased the real interest burden on borrowers sixfold and completely changed the nature of the debt problem. With a real interest rate of 1 percent, growing out of a debt overhang was easy; with a 6 percent real interest rate, few countries could realistically hope that growth would easily reduce the debt burden without significant current account improvements.

It is unlikely that the possibility and effects of an interest rate shock of that magnitude were taken into account when the original loan agreements were entered into.[2] In the first instance, such an increase in the *ex ante* rate over a protracted period had not been seen previously. Second, it is likely that the significance of the shift from fixed to floating rate lending had not been absorbed. In past debt crises when loans were made at fixed interest, real interest rates would rise with deflation. But once the price level stabilized, the real interest burden would be higher only to the extent of the proportional decline in the price level. And it remained possible that inflation would reduce the burden in the future. In this crisis, the real interest rate has risen and stayed high for five years, and shows little sign of falling soon. Now inflation brings no automatic debt relief.

The initial response to the debt crisis in 1982 was to work out debt reschedulings with IMF approval certifying the debtors' macroeconomic policies. That was the appropriate strategy. Something—renewed world growth, a recovery of primary product prices, or a decline in the real interest

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[1]Rudiger Dornbusch (1986) and Paul Krugman (1986) both discuss the case for debt relief, as does Jeffrey Sachs (1986).

[2]The *Brookings Papers on Economic Activity* (*BPEA*), representative of thinking by well-informed economists, contains only three papers on the international debt between 1977 and 1982. Robert Solomon (1977) contains no suggestion that future interest rate developments might affect the stability of the debt. In the discussion following the paper, the real interest rate receives mention only in the last sentence. In papers in 1981, Solomon and Sachs mention that the debt problem could become serious if the real interest rate failed to come down—but place no emphasis on this possibility.

TABLE 1—DEBT DATA, DEVELOPING COUNTRIES, WESTERN HEMISPHERE

	1978	1982	1986
Total ($b)	155.8	333.0	382.5
Debt/Exports (%)	217.0	273.1	333.1
Debt Service /Exports (%)	38.2	50.6	46.0
Debt/GNP (%)	31.8	43.5	47.0

Source: World Economic Outlook, International Monetary Fund, October 1986.
Note: Total debt outstanding for all capital-importing developing countries was $399b. in 1978, $763b. in 1982, and $973b. in 1986.

rate—might turn up while the borrowers made much-needed changes in macroeconomic policy. With the rapid U.S. recovery in 1983–84 and the impressive turnarounds in trade account by the debtors, proponents found justification for their positions.[3] To be sure, the continued high real interest rate was a source of worry, but, in 1985, Gramm-Rudman-Hollings promised improvement on that front.

Developments in the debtor countries were less encouraging. There was indeed an extraordinary turnaround in trade account: in Brazil and Mexico an improvement of the order of 6–7 percent of GNP, compared with the worsening of the U.S. trade account of 3 percent of GNP that is proving so difficult to reverse. But the improvement in debtor country trade accounts was a result of import compression, through real devaluation and restrictive aggregate demand policies. Export volume had risen since 1980, but low dollar prices kept the dollar value of exports virtually unchanged. Investment fell by 5–7 percent of GNP between 1981 and 1985 for the major debtors.

Per capita real GNP was down, as much as 20 percent in some of the debtor countries.[4] The debt-to-exports ratio was not falling despite current account improvements and the rising volume of exports. More concretely, the burden of the debt took the form of transfers from the developing to the developed countries as capital inflows slowed. Whereas in 1981, Latin America and the Caribbean had a net inflow of resources of 2 percent of GNP, in 1984 and 1985 that area was transferring nearly 4 percent of GNP abroad.[5]

II. The Role of the Banks

By 1984 the commercial banks had become battle weary. Interest receipts from debtor countries exceeded new loans in 1984, 1985, and 1986. The U.S. banks actually reduced their exposure in Latin America in 1985. The banks, the main beneficiaries of the efforts of the IMF and the U.S. authorities' attempts to maintain continued debt servicing, participated in IMF packages with increasing reluctance. The Baker Plan in October 1985 spelled out the conditions for continuing cooperation among the U.S. government, the multilateral lending institutions, and the banks, but still did not succeed in bringing new commercial bank financing of even the modest proportions included in the plan into the developing countries.

Fear of financial collapse in the United States was one of the main motivations for the original approach to the debt crisis. In 1982, the nine large money center banks had over 250 percent of their capital in loans to LDCs; the proportion for all U.S. banks taken together was above 150 percent. By mid-1986, the nine money center banks had sufficient equity and reserves to withstand even the complete loss of Latin American assets (Table 2). The European and Japanese banks, which built up loan loss reserves more rapidly, were even better placed than U.S. banks to withstand losses on LDC debt.

Although banks have increased their loss provisions, they continue to carry LDC debt

[3] The best-known scenario is that of William Cline (1984).

[4] Argentina and Venezuela suffered the largest income declines.

[5] The net transfer is calculated as the current account deficit (representing net capital inflows) minus net investment income, both taken from *World Economic Outlook* (October 1986, p. 77).

TABLE 2—U.S. BANK EXPOSURE TO DEVELOPING COUNTRIES (June 1986)

	Nine Money Center Banks	All U.S. Banks
To LDCs:		
$b	73.9	112.1
% of Capital	167.2	101.3
% of Assets	11.7	7.3
To Latin America and Caribbean:		
$b	43.2	68.2
% of Capital	97.7	61.6
% of Assets	6.9	4.4

Source: Federal Reserve Board of Governors, Statistical Release E16 (126), October 17, 1986. "Capital" consists of equity, subordinated debentures, and reserves for loan losses.

TABLE 3—SECONDARY MARKET LDC DEBT PRICES, NOVEMBER 14, 1986 (Cents/$)

Country	Price	Country	Price
Argentina	65.7	Mexico	57.2
Bolivia	7.5	Philippines	73.0
Brazil	75.5	Turkey	98.3
Chile	68.0	Venezuela	74.5

Source: Salomon Brothers, Inc.
Note: Price is average of bid and offer prices.

at face value. The active market in such debt prices it at a significant discount. Sample prices are listed in Table 3. Equity values for the banks are consistent with the prices of debt in the secondary market.[6]

III. Proposed Solutions

Reform proposals can be distinguished according to whether they propose extending the effective maturity of the debt, changing the nature of claims on the LDCs, whether they offer genuine debt relief, and what sort of conditionality they impose (Paul Krugman).

The present strategy and the Baker Plan both deal with the debt crisis by extending the effective maturity of the debt. Interest capitalization would do the same. Any method that reduces the current flow of resources from the debtor countries will help them grow in the short run. But further lending promises little in the way of a lasting solution to the debt problem. So long as real interest rates remain around 6 percent, debtor countries will have great difficulty growing out of their debt problem.

Debt-equity swaps, increased direct investment, proposals to sell shares in the export earnings of the debtors, and indexation of payments to export prices, would all change the form of the debt. None necessarily changes the present value of the debt, though their risk characteristics may make these forms of debt more attractive to the debtors. The recent Mexican agreement takes the IMF part way down the road of providing cash flows that respond to the risks facing the developing countries.

The debt crisis has made it entirely clear that floating rate debt is a poor way of financing a country's development. Innovative methods of financing all give promise that international capital flows can resume without producing the danger of another debt crisis. However, they are being introduced too slowly to resolve the current crisis.

Conditionality is explicit in the Baker Plan and in the present strategy. As IMF conditionality has progressed over the past four years to the sophistication of the recent Mexican package, it has become a viable means of providing useful external constraints on domestic policymakers. Conditionality will be needed if debt relief is granted, both to ensure that the relief is not wasted, and to prevent relief being an entirely pleasant experience.

IV. Debt Relief

There are now two choices. Either the piecemeal approach continues, or there is some form of debt relief. The current approach is certainly more imaginative—provided the Mexican package is not the last of its kind—than that of 1982. But the banks are increasingly reluctant to participate.

The argument that the slow approach is the right one points to the successes of the

[6]In a study based on 1983 data, Sachs and Steven Kyle (1984) suggested Latin debt was then being carried at about 80 cents on the dollar.

last four years—there was no financial collapse in the United States, there has been no explicit debt default, Latin America is moving towards instead of away from democracy. Maybe something will still come up; perhaps a U.S. tax increase that takes the real interest rate down by 2–3 percent, perhaps an improvement in the trade climate, perhaps a growth recovery.

Perhaps liberalization of debtor economies will solve the debt problem, as increasing confidence draws flight capital home. High interest rates might attract flight capital home, just as they may entice other capital from abroad. But the interest rates needed to bring home flight capital will not restore investment. Indeed, the notion that flight capital should come home is not consistent with general liberalization, for it is very likely that optimally diversified portfolios for residents of developing countries contain more industrialized country assets than they do at present—even including flight capital. Liberalization is likely to lead to more, not less, capital flight.

The case for debt relief is not that the present evolution cannot continue, but that it should not continue. For four years, the debtor countries have paid the price of low GNP growth and significant falls in real wages as they have made transfers to service the debt. Protectionist pressures in the industrialized counties have made the transfer process more difficult. The transfers have been made at a real interest rate that was almost certainly not envisaged when the debt was incurred.

Economic theory has little to say about the appropriate procedures to follow when unanticipated events happen.[7] Formally, the loan contracts do not give the borrower the right to reopen negotiations, nor is there any procedure for establishing whether a particular set of circumstances might reasonably have been anticipated when the contracts were entered into.

Presumably any potentially Pareto-improving changes in debt contracts have already been made. What remains are changes that improve the lot of one party to the contract at the expense of the other. Thomas Walde notes that there is a strong legal presumption in favor of lenders, who gave up real resources in exchange for promises. The IMF and developed country governments have certainly taken the attitude that the debt contracts should continue to be honored, no matter what the burden on the borrowers.

One argument for maintaining current debt contracts is distributional—that the lenders deserve to receive the payments due them. That is a hard argument to support in the present crisis. The lenders had no reason to expect such payments, they too made mistakes, and they are not obviously more deserving than the borrowers. Further, the borrowers have paid a high price for whatever mistakes they made in the past.

The market, reflected in Table 3, has already concluded that the lenders will not receive their claims in full. Shareholders have taken their losses. But the lenders hang on to their claims in the hope of capital gains in the event the borrowers pay in full. Millions of residents of developing countries are being kept at low levels of income for the sake of possible capital gains for bank shareholders. There is no distributional case for the current debt strategy. There is a strong distributional case for debt relief.

Even so, there might be an efficiency argument against relief. It has been contended from the beginning of the debt crisis that only by maintaining existing debts can the existing international capital markets be maintained. It is impossible to be sure, but the evidence from history is strong that default or relief is not the end of the capital markets. Indeed, debt relief that promises to put an end to the uncertainty of the current situation would likely promote future capital flows—albeit, and to the good, in forms other than floating rate debt. It is difficult indeed to believe that international capital

[7] Thomas Walde (1986) discusses legal precedents in domestic and international agreements, including force majeure and change of circumstances. The most relevant cases appear to be the Westinghouse and Alcoa vs. Essex cases where price shocks resulted in courts excusing nonperformance.

will fail to flow to a country offering good rates of return.

Moral hazard is another argument against debt relief. Why grant relief to the badly behaved when the well-behaved, such as Turkey, have made a more serious and successful effort to adjust? Isn't this an invitation to countries in trouble in the future to default? The answers here are simple. No country will get debt relief in the future without going through a protracted period of uncertainty and adjustment. What borrower will in the future become overextended to have the privilege of following in the footsteps of an Argentina or Mexico or Brazil over the past four year? Further, the proposal is for debt relief administered from the center, not for default by the borrowers.

What form should relief take? Relief should only be available in the context of structural adjustment programs adopted by the countries in cooperation with the IMF and, depending on how rapidly it adapts, the World Bank. There would be no general forgiveness of debt, rather in each new negotiation interest and principal payments to commercial lenders would be reduced to 65 percent of the contractual value contingent on a structural adjustment program being agreed with the IMF. If the commercial lenders found such terms inappropriate, they would forego the help of the IMF and their governments in extracting resources from the debtors, and negotiate on their own.

The IMF agreements would be for comprehensive growth-oriented adjustment programs, encouraging investment in both government and private sectors. Other desirable structural adjustments, along the lines of freeing up markets and privatization of sectors that have no inherent government connection, such as nightclubs, hotels, and grocery chains, could be included. So too would the opening up of the economy to imports, and the removal of standard developing country distortions in the form of subsidies.

What would such a scheme cost? The total outstanding debt to financial institutions and other private creditors of all countries with recent debt-servicing difficulties was $336 billion in 1986. Interest payments on this amount appear to be about $28 billion.[8] The annual reduction in the interest bill would be close to $10 billion. For example, Brazil and Mexico would save about $2.5 billion annually, the Philippines and Chile about $600 million. The numbers are between 1 and 3 percent of GNP, enough to make a difference, but not enough to let the debtor countries off the hook entirely.

What would be the consequences for the banks? They would take a loss, but there should be no mass bankruptcies. The losses would be recorded gradually as countries negotiated agreements with the IMF, rather than on announcement of the plan.

Without debt relief, the debt crisis promises to drag on for decades, slowing growth in the developing countries, sapping the energies of policymakers, and tieing up the multilateral lending agencies in endless crisis negotiations. With sensible debt relief, countries and the multilateral institutions can begin to worry about growth-oriented development policies. If the debt relief does not come by agreement, then debtor countries would have to consider taking the first step.

[8]Based on data in *World Economic Outlook*, October 1986.

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RESOLVING THE
INTERNATIONAL DEBT CRISIS

Stanley Fischer

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Resolving the International Debt Crisis

ABSTRACT

Since August 1982 the international debt crisis has dominated economic policymaking in the developing countries, economic relations between the debtor and creditor countries, the attention of the multilateral institutions in their dealings with the debtor nations, and private sector decisions on lending to the developing countries.

The period since 1982 has seen some progress. Neither the commercial nor central banks have had to deal with formal large-scale debt defaults. Balance sheets of creditor banks have been strengthened. There is an active secondary market in developing country debt, and debt to equity swaps are a reality. For the debtors, real interest rates have fallen between 1982 and 1987. Net exports showed extraordinary growth. Budget deficits have been reduced despite falling incomes. In 1987 commodity prices have begun to recover. The period has seen a shift toward rather than away from democracy.

But five years after it began, the debt crisis is very much alive. None of the major Latin American countries has restored normal access to the international capital markets. At least one major debtor has been in trouble each year.

Three classes of solutions are described and evaluated. Least radical are proposals for procedural reform and changes in the nature of the claims on the existing debt. Some procedural reforms such as multiyear reschedulings and exit vehicles for smaller banks have already begun to be instituted. Others include changes in accounting rules, and U.S. information provision on foreign accounts held in the U.S. Changes in the nature of claims include debt-equity swaps, country funds, interest capitalization, and payment by the debtors in their own currency.

The second type of solution is the creation of a facility, or new institution to deal with the overhang of existing debt. The institution would buy the debt from the banks in exchange for claims on the institution, and in turn collect from the debtor countries. The prices at which debt is purchased, and the amounts to be collected from the debtors are the crucial issues. Finally, there are proposals for debt relief, either in direct negotiation between creditors and debtors and/or in conjunction with the creation of a facility.

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RESOLVING THE INTERNATIONAL DEBT CRISIS

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Since it was first recognized in August 1982, the international debt crisis has dominated economic policymaking in the developing countries, economic relations between the debtor and creditor countries, the attention of the multilateral institutions in their dealings with the debtor nations, and private sector decisions on lending to the developing countries.

Developments since 1980 are summarized in Table 1, which presents data for the Baker fifteen of heavily indebted countries. The

Table 1: ECONOMIC PERFORMANCE, FIFTEEN HEAVILY INDEBTED COUNTRIES.*

	1969-79	1980	1981	1982	1983	1984	1985	1986
Per capita real GDP growth	3.6	2.6	-1.6	-2.7	-5.5	-0.1	0.9	1.4
Current account ($ billion)		-29.5	-50.3	-50.6	-15.2	-0.6	-0.1	-11.8
Interest payments ($ bill)		25.1	37.0	45.5	41.5	46.0	44.0	38.2
Investment/ GDP (%)		24.7	24.5	22.3	18.2	17.4	16.5	16.8

Source: World Economic Outlook, April 1987, Statistical Appendix.
* Countries are: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, Yugoslavia.

most significant fact is that the heavily indebted countries suffered reductions in per capita real GDP averaging ten percent over the period

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1981 to 1984, which wiped out most of the gain that had taken place since the mid-seventies[2]. There was an extraordinary turnaround in the current account of the balance of payments which was in balance in 1985 as large trade surpluses were used to pay interest bills of about 5% of GDP. Improvement in the current account was matched by a decline in domestic investment[3] implying a fall in net capital formation to half its previous share of GNP.

Developments on the trade and debt fronts are described in Table 2. Net private capital inflows have virtually disappeared, and even total capital inflows have been much smaller since 1982 than interest payments abroad: The most remarkable feature of the debt strategy

Table 2: TRADE AND DEBT DATA, HEAVILY INDEBTED COUNTRIES.

	1969-79	1980	1981	1982	1983	1984	1985	1986
Total external debt ($ bill)		269.3	330.8	383.1	394.2	410.9	417.2	434.4
Net private borrowing[1] ($ bill)		43.2	57.3	30.7	-2.4	4.2	-2.7	-7.2
Debt/export ratio (%)		167.1	201.4	269.8	289.7	272.1	284.2	337.9
Terms-of-trade change (% p.a.)	4.4	13.4	-2.8	-4.1	-3.5	2.2	-1.9	-16.1
Non-oil commod. prices (% p.a.)	10.0	2.7	-14.1	-8.8	6.3	2.5	-10.8	1.5

Source: World Economic Outlook, April 1987, Statistical Appendix.
[1] Net external borrowing minus long-term borrowing from official creditors and reserve-related liabilities (short-term borrowing from foreign monetary authorities, and use of Fund credit).

[2] There are of course large differences among countries; for instance Argentina's per capita GDP fell almost 20% from 1981 to 1986, and was still 10% below its 1975 level, while Brazil's 1986 per capita GDP was above its 1981 level and 20% above the 1975 level.

[3] Total GDP for the fifteen heavy debtors is in the range $750-1000 billion.

followed since 1982 is that the heavily indebted developing countries have been transferring real resources of close to 5% of their income to the developed creditor countries. A solution of the debt crisis will either reverse the direction of this resource flow or at least significantly reduce it. Despite the virtual cessation of capital inflows, debt burden indicators, such as the debt to export ratio, have not improved[4]: the effects of the increased volume of exports and decreased volume of imports were offset by a worsening of the terms of trade.

The picture for the debtors is not entirely bleak. Real interest rates have fallen between 1982 and 1987. Net exports showed extraordinary growth. Budget deficits have been reduced despite falling incomes. In 1987 commodity prices have begun to recover. The period has seen a shift toward rather than away from democracy.

There has also been very real progress for the creditor banks and for the international financial system. Most important, neither the commercial nor central banks have had to deal with large-scale debt defaults. Balance sheets of creditor banks have been strengthened by additions to capital and loss reserves in the United States and Europe, by the weakening of the dollar for those foreign banks that lent in dollars, and by reductions in foreign exposure. There is an active secondary market in developing country debt, and debt to equity swaps are a reality. The optimist (for example, Feldstein, 1987) can take

[4]The debt to GNP ratio also increased over the period 1982-1986.

solace in the failure of the worst fears of 1982--that there would be a worldwide financial crisis--to eventuate. He can point also to some successes, such as Korea and other southeast Asian countries, and the earlier problem case of Turkey.

But the fact remains that five years after it began, the debt crisis is very much alive. None of the major Latin American countries has restored normal access to the international capital markets. Even a country like Colombia, which has rigorously met its payments, finds it difficult to roll over its debts. At least one major debtor has been in trouble each year. In 1987 it is Brazil, whose moratorium could mark the beginning of a new phase of the crisis.[5]

In its brief life the international debt crisis has generated an impressive variety of proposed initiatives and solutions.[6] Least radical are proposals for procedural reform and changes in the nature of the claims on the existing debt. There have been several suggestions for the creation of a facility, or new institution that would in specified ways deal with the overhang of existing debt. And finally, there are proposals for debt relief. I take up these possibilities in turn in Sections II through IV. Preliminary questions about the nature of the debt problem and solutions to it are discussed in Section I.

[5]However the banks quickly moved to limit the system-wide effects of any unilateral Brazilian decisions by reaching agreements with other major debtors.

[6]Dornbusch (1987), Feldstein et al (1987) and Krugman (1986) present useful surveys of alternative solutions; the classification of debt initiatives used here is taken from Krugman.

I. The Meaning of a Solution.

What would it mean for the debt crisis to be resolved? The simplest criterion is that the debt crisis will finally be over when the debtor countries have normal access to the international capital markets. Of course, normal access is itself difficult to define, both because it is quite normal that not all countries are able to raise funds on the same terms and that some of them may be credit rationed because lenders understand that raising interest rates to compensate for the risk of default may itself increase the probability of default.

More pragmatically, it will be clear that the debt crisis is moving towards a solution if the net outflow of resources from the developing debtor countries is significantly reduced, enabling most of them to run current account deficits. The resource inflows would finance investment to raise the growth rate and over time move living standards closer to those of the developed countries.

The assumption that a solution to the debt crisis would reduce resource flows from the debtors to the creditors is based in part on the view that investment opportunities in the debtor countries justify capital inflows. Although investment opportunities appear to warrant capital inflows in some debtors, such as Brazil, that may not be true of all debtor countries. Then the case for reducing their net resource outflows is fairness or the preservation of democracy or capitalism--and those are obviously both highly important and highly political issues.

Resolution of the debt crisis would enable developing country

policymakers to base policy decisions on longer-term considerations than their effects on the forthcoming debt negotiations, and it would free up for more important purposes policymakers who are now preoccupied with debt negotiations. The private sector would be able to make investment plans with less uncertainty about the long term, in particular the availability of foreign exchange and investment financing.

If the debt crisis were resolved, banks would no longer have to make loans to developing countries merely to preserve their existing investments. The banks would eventually be able to reduce their exposure to the levels they would prefer--and after the experience of the eighties, these might be very low.

Resolution of the debt crisis would likely also see a change in the form of international lending. Both lenders and borrowers can now see that floating rate financing is a risky way for a country to finance its long-term development. Very likely, a resolution of the debt crisis would end with the debtor countries financed through long-term capital--bonds, equity, direct investment, and perhaps some forms of long-term indexed debt--rather than floating rate liabilities whose terms can change overnight.

Resolution of the debt crisis would mean also that the international institutions, the IMF and the World Bank, would be able to get back to their respective goals of promoting international monetary stability and economic development rather than preventing debt default.

Efficient Solutions.

The debt crisis involves at least three parties: the debtor countries, the creditor countries, and the private banks and their stockholders. A more sophisticated view further distinguishes between the governments of debtor and creditor countries and their citizens, between the creditor governments and the international institutions, between workers in the debtor countries and portfolio holders who succeeded in moving their capital abroad, and between financial and manufacturing interests in the developed countries.

A solution to the debt crisis is efficient if it is not possible to make one of the parties better off without making another party worse off. There are many efficient solutions, involving tradeoffs among the interests of the different parties. Although the point is rarely explicitly recognized, there is no blinking the fact that alternative solutions imply different burdens for different groups involved in the crisis. Someone has to pay for past mistakes. It could be the bank stockholders, creditor country citizens, or citizens of debtor countries. Or the burden could be shared.

Up to 1987, most of the burden has been borne by wage earners in the debtor countries. Part has been borne by bank stockholders, who have seen the value of their shares rise less rapidly than the stock market as a whole. Some will be borne by the taxpayers of the creditor countries, as the banks record portfolio losses, lower profits, and lower taxes. The taxpayers of the creditor countries would pay more of the burden if their governments or the international institutions were to provide concessional aid to the debtors. It is of course entirely

possible that a longer view of the interests of the developed countries would see benefits rather than burdens for their citizens in the provision of aid to the debtors--just as it might be possible that the unconditional provision of aid to their governments would make the citizens of debtor countries worse off in the long run.

Although the relative burdens are rarely explicitly discussed, the problem is implicitly recognized by proponents of plans who claim they are in the best interests of everyone concerned. For instance, debtor countries are warned not to take unilateral action because future access to capital markets will be long delayed; or banks are urged to make concessions that will in the end enable them to collect more rather than less interest.

Why have the private markets not reached the optimal solution already? To start with, the underlying transactions were hardly private market loans in the first place. Many of the loans were made to governments, who, the lenders believed, simply would not default. Other loans were taken over from private firms by debtor governments on the view that default by a domestic firm would spill over to the credit terms for the country, or to protect domestic borrowers. Further, creditor governments and central banks were actively encouraging the recycling of petrodollars and, it might be expected, would support the banking system if any difficulties arose as a result of the large-scale foreign lending. Second, governments and governmental organizations--the IMF, the Fed, the U.S. Treasury and other governments--have been heavily involved since the crisis began.[7] Third, there is no single optimal solution. Solutions differ by who bears the burden.

[7] It has been argued, for instance by Lindert and Morton in the present volume, that the debt crisis would have been resolved far more rapidly without the government intervention.

But it is likely that improvements that could have been made by negotiation among the creditors and debtors have already been achieved. What remains to be discussed are changes that would shift the burden among the parties, and improvements that involve externalities, that is actions that benefit more than the individuals making the direct transaction.

It is conventional in discussing the debt problem to focus on the restoration of debtor country growth as the ultimate aim. However, the levels of income and consumption cannot be overlooked. If it can repress living standards enough, a country can probably put itself in a position to begin growing again. Figure 1 illustrates. The country has been growing at a certain rate up to time T, when the debt crisis strikes. The country has been living beyond its means, and has to reduce its living standards. By how much? By servicing the debt in full, it may move onto path A, cutting living standards sharply, suffering low growth for a while as the economy reallocates resources from production for domestic use to production for export and import competition, and then moving ahead. Alternatively the country may, perhaps through a moratorium, pay a lower price in terms of the initial reduction in the standard of living and move onto path B, starting at a higher level of income than on A, and as shown here, growing as fast.

If the growth rates on A and B are the same, and if income on B is higher by more than the interest on the additional debt on that path, the country gains from the moratorium. Corresponding to the lower standard of living on A is a larger transfer of resources to the

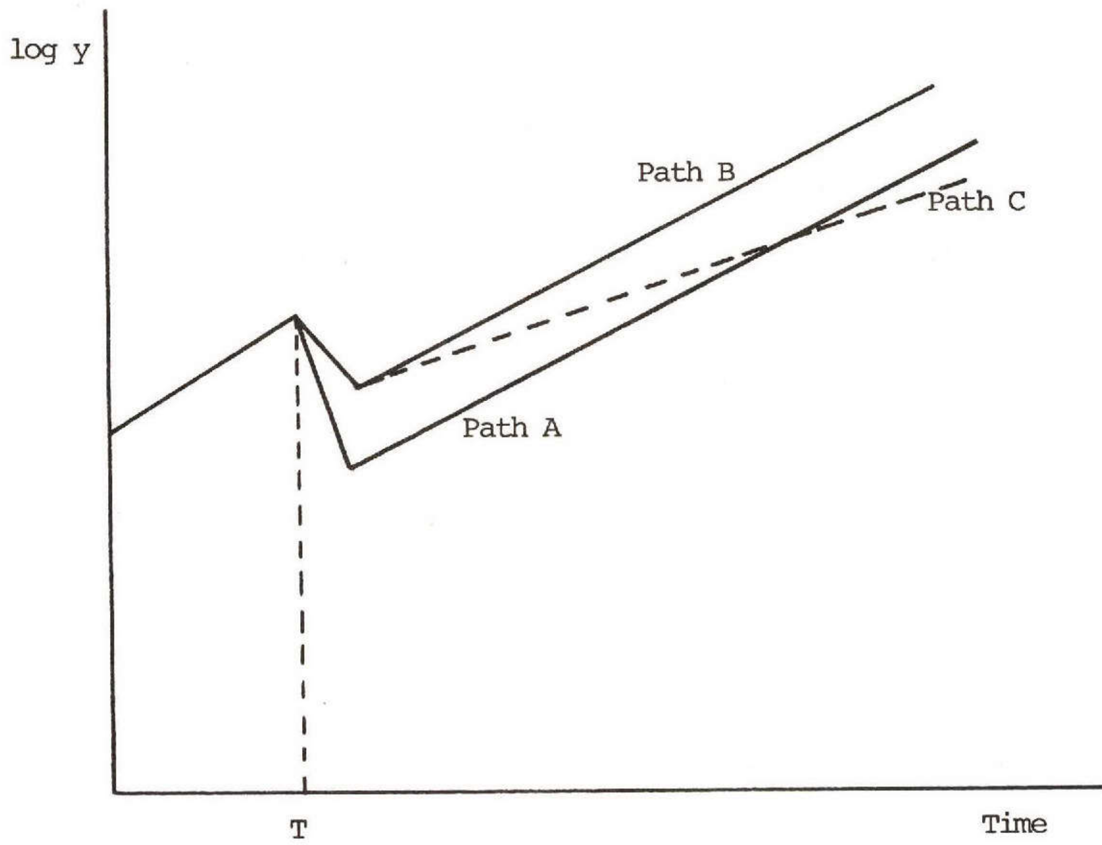

Figure 1.

creditor countries, ultimately to the stock-holders of the creditor banks. The burden of adjustment on path A is greater than that on B, although both eventually lead to a restoration of growth. Eventual return to growth does not imply the success of a debt strategy. Quite possibly there were alternatives that would have resulted in higher levels of income or consumption in the debtor countries throughout.[8] The failure of the fifteen heavily indebted countries to restore consistent growth since 1982 has to be weighed in the balance in evaluating the debt strategy followed so far.

A major issue that has to be discussed in evaluating different debt strategies is whether the growth rate of real GNP for the debtor countries is the same on paths with deeper adjustment such as A, and paths with less adjustment such as B. If a moratorium or any policy other than full debt servicing reduces market access, it could also slow growth. If so, the relevant choice in Figure 1 would not be between A and B, but between A and C, where C's low growth rate results from sanctions, explicit or implicit, that are imposed as a result of the failure to meet debt obligations in full, or by the incomplete adjustment of the economy to its new circumstances.

Before describing and evaluating plans to solve the debt problem, I make several stipulations about the nature of the problem and its solution.

[8]A simple criterion by which to judge alternative strategies from the viewpoint of the debtors is the present discounted value of their consumption.

. First, the debt crisis will have to be resolved in a way that differentiates among countries. Bolivia's problem is different from Brazil's, and both are different from Tanzania's.

. Second, from the viewpoint of the stability of the U.S. banking system, the debt problem is dominated by just a few countries--over half of total U.S. banks' liabilities, and the liabilities of the nine money center banks, are in Mexico, Brazil and Venezuela. The concentration on the Baker fifteen with its heavily Latin American flavor is a result of those countries' debts being predominantly to the private sector. Similarly, the concentration is this paper is on private sector capital flows and debts.

. Third, concentration on the Baker fifteen overlooks the debt and growth problems of sub-Saharan Africa, which will have to be taken into account in any discussion of aid.

. Fourth, just as the debt problem arrived unexpectedly as a result of changes in the international economy, it could quietly go away. Higher prices for commodity exports, and further reductions in real interest rates, would make the entire problem look manageable. It could also intensify quickly if the international trading system seizes up as a result of growing protectionism.

. Fifth, the interested parties, the banks and the debtors, each have little interest in revealing the dimensions of whatever compromises they might ultimately be willing to make.

Finally, there are important political constraints on solutions to the debt problem. There is no well-defined economic sense in which a Brazil, Mexico or Argentina is incapable of servicing and ultimately paying off its debt.[9] In none of these countries is the external debt to GNP ratio much more than 60%. Given long enough, and given a government powerful enough to reduce living standards sufficiently,[10] those countries would be capable of generating the trade surpluses that would enable them to regain normal access to the capital markets. However the new democratic governments in several of the heavily indebted countries are certainly too weak to achieve massive reductions in consumption. The question for both their own governments and the creditor governments is how far it is possible and politically wise to push their citizens to meet debt payments.

[9]See Feldstein (1986) for a detailed scenario.
[10]Of course it becomes harder for the debtors to meet their obligation if the creditor governments close markets to foreigners.

II. Procedural Reform and New Debt Instruments.

Some debt plans would leave the present value of claims on the debtors unchanged while changing their form. Others would reduce the present value of claims on the debtors. Many of the proposals for new debt instruments are intended to maintain the present value of claims on the debtors while making it easier for them to pay, by adapting repayments schedules to the likely patterns of debtor foreign exchange receipts.

In this section I take up both procedural and regulatory reforms that could improve the bargaining process by which debt deals are reached and reduce obstacles to capital inflows to the debtors, and suggestions for new debt instruments. In neither case is the change designed to reduce the value of claims on the debtors.

Procedural Reform.

Several procedural reforms are listed in Table 3. There has already been progress in the implementation of a number of these reforms, including the first. The frequency of complicated debt negotiations has been a significant burden on the economic management teams of debtor nations. Because macroeconomic management skills are in short suppply, reduction of the frequency of such negotatiations would

Table 3: PROCEDURAL REFORMS.

Change	Initiating agency.
1. Multiyear rescheduling.	Banks and debtors.

2. Reduced size of banking syndicates and exit option for small banks.	Banks and debtors.
3. Change accounting rules to allow partial writedowns and their gradual amortization.	Bank examiners and accounting standards.
4. U.S. information provision on foreign accounts.	Bank regulators and IRS.
5. U.S. taxation of foreign accounts.	Congress.

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help improve the overall quality of macroeconomic management. Although the creditor banks value the short leash that more frequent negotiations provide, they can retain some of that control by using IMF Article IV consultations as a framework of evaluation of the country's economic progress and as a condition for further disbursement of funds. Multiyear restructurings of the debt are becoming routine, for example for Mexico, Argentina and the Philippines, and there appears to be no objection in principle to such agreements on the part of the banks.

The size of the banking syndicates involved in the debt negotiations and the need for hundreds of banks to agree to packages that have already been negotiated are obstacles both to efficient negotiation and to the rapid mobilization of capital after an agreement

has been reached. After the September 1986 Mexican agreement it took nearly six months for all 500 banks to sign on. The desire of many of the small banks to leave the international debt business is well known. The exit vehicle may be either the interbank secondary markets or as in the 1987 Argentinian restructuring, special provisions to enable the small banks to leave the syndicates. For instance, it should be in the interests of both the large creditor banks and the debtor countries to agree to allow banks that collectively hold the last 3-5% of the debt to leave the syndicate. This could be achieved by the debtor selling them exit bonds that pay interest at a rate below the market rate, with an economic present value above the secondary market price of the country's debt but a face value equal to that of the original debt. Alternatively they might be allowed to leave the syndicate if they sell their claims in the secondary market.[11] In order to provide an exit vehicle for the smaller banks, it would also be necessary for the larger banks and the debtors to agree that sales of securities or purchases of long-term bonds of the debtors free the bank from the obligation to participate in future funding.

Two aspects of the accounting and tax treatment of sales of debt at less than face value have to be distinguished. First, it is unclear whether a bank selling part of its claims on a given country for less than book value has to write down its remaining claims to the same extent. That is a problem for those banks wishing to sell off part of their debts but not all, and presumably is not the main concern of the

[11]Obviously this would apply only to banks holding the last 3-5% of the country's debt as of a given exit date.

smaller banks that wish to leave the international debt business. Second, any bank taking a loss in a given period has to record that as a loss in current revenue and cannot amortize it over time.

To start with the second problem: it is not obvious that the value of a firm's stock is increased by amortizing a recognized loss over a prolonged period. Certainly markets responded well to the creation of large loss reserves by the leading banks in May and June of 1987, apparently placing a positive value on the explicit recognition of the possible loss. If nonetheless banks were convinced that amortization was preferable to a larger one-time loss, they could be allowed to write off the losses over a period of several years rather than immediately.

Uncertainty arises over the accounting treatment of debt whose market value is below face value when some of that debt is sold. One view is that banks have to write down the value of all the remaining debt of that type on their balance sheets. That would seem to be the rationale for banks' attempts to swap debt among themselves rather than buy and sell in the secondary market. However, some bankers believe that it is not necessary to write down all the debt of a given country if some of that debt is sold in the market--so long as a good case can be made that the bank is likely to collect on the remaining debt.[12] Certainly the creation of loss reserves against developing country debt has not forced the banks to carry the corresponding debt on their balance sheets at its market value.

[12]This was the position taken by a panel of the American Institute of CPA's in 1985 (See "The Outlook" column, Wall Street Journal, October 26 1986).

The basic source of the accounting difficulties, if they exist, stems from the fact that debt is carried at more than market value in the first place. If for some reason it is appropriate to carry that debt at market value so long as it has not been sold, then the regulators should not have any difficulty allowing those parts of the debt that have not been sold to continue to be carried on the same basis as before.

Although some capital flight can be regarded as a natural attempt by portfolio-holders in developing countries to diversify internationally, much of it is a form of tax evasion. Procedural reforms 4 and 5 would help the debtors deal with the tax-evasion aspects of capital flight. U.S. and foreign developed country banks that hold the accounts of citizens of other countries could be required to inform the tax authorities of those countries of the existence of the accounts. It is probably at present difficult to trace the home country of some depositors, but it should not be difficult to find a method of requiring those opening new accounts to give some proof of country of residence. This provision would have to be agreed with other countries, and thus would take time to implement.

The United States could more easily impose a uniform tax on all interest on bank accounts, and indeed on other income generated from securities holdings, that are not those of United States taxpayers. Once again the effectiveness of such measures would depend on cooperation in introducing similar measures in other countries. By taxing the accounts itself, the U.S. government would be reducing the

attraction of capital flight. An alternative would be for the taxes to be imposed by the country from which the capital fled, for which purpose the provision of better information about foreign-held bank accounts would assist the tax authorities in the debtor countries. Here too an international agreement would be needed if countries were not to compete for foreign capital by favorable tax treatment, as they do at present.

Changing the Nature of Claims.

Many of the suggestions for dealing with the debt crisis involve changes in the nature of the claims on the debtors. The driving force behind these suggestions is the conclusion that the structure of the debt in 1982 was partly responsible for the debt crisis. With virtually all payment flows linked to short term interest rates abroad, the debtors were vulnerable to a rise in real interest rates in the

Table 4: CHANGING THE NATURE OF CLAIMS.

Change	Initiating Agency.
1. Development of secondary and insurance markets.	Creditor financial institutions and official institutions
2. Indexed loans	Debtors and banks
3. Contingent lending obligations	Debtors, banks and offical lenders.
4. Longer maturity debts.	Debtors and banks
5. Debt-equity swaps	Debtors and banks
6. Servicing of debt in local currency.	Debtors and banks
7. Return of flight capital	Creditor and debtor governments, and banks.
8. Country funds.	Debtors and creditor financial intermediaries
9. Debt subordination.	Debtors, existing and new lenders.
10. Interest capitalization.	Debtors and banks, plus creditor governments.

developed countries, and had no protection against changes in the terms of trade. These suggestions are probably motivated also by the view that eventually the structure of debtor country liabilities should correspond more closely to the structure of underlying assets, and should have more long-term fixed interest debt, more equity, more direct investment, and less floating rate debt.[13] These arrangements would

[13]Lessard and Williamson (1985) provide a very useful review of alternative proposals for changing the form of finance of the debtor countries. See also World Development Report, 1985, and World Economic Outlook, April 1986.

provide for more risk-sharing between lenders and borrowers than floating rate debt was expected to produce.[14]

The term securitization is often used to describe a process in which existing debt is taken off the books of the banks and turned into securities, for instance through sale in the secondary market. The same term can be used to describe potential changes in future private sector financing of economic development, with the maturity and nature of the securities reflecting the underlying investments.

Secondary and insurance markets: It is often suggested that the development of secondary markets would help solve the debt crisis. Secondary markets have already developed to some extent, though trading in those markets is thin. Citibank's intention to use the secondary markets more intensively, announced in May 1987 in conjunction with the increase in its loss reserves, could increase the depth of those markets. Regulatory restrictions discouraging partial sales by the banks, or at least uncertainties about accounting and regulatory treatment of the sales, would have to be removed for these markets to develop.

The secondary market does little to solve the debt crisis other than to enable the banks--if they were to sell their claims--to reduce their vulnerability to default in particular countries. Banks have also engaged in debt swaps to strengthen their balance sheets, sometimes in conjunction with debt-equity swaps. The secondary market could eventually become the locus in which an international facility deals

[14] In the event, though, creditors have to some extent shared in the losses that higher interest rates imposed on borrowers.

with the debt. And, if the market became deeper, prices in it could serve as the basis for debt renegotiation.

Private insurance of the debt is not in principle different from the provision of a secondary market, except that it would enable banks tied into the debt to reduce their vulnerability to default.[15] Insurance rates could be deduced from the discounts on debt in the secondary market, and would be extremely high for many countries. The public sector in the form of the Fed has implicitly been providing insurance to the banking system since the start of the debt crisis, but because it is not obligated to come to the rescue of any particular bank, private insurance if it were available would remove uncertainty for creditor banks. Because the debt crisis and discounts on debt are so deep, it is difficult to see private insurance markets becoming large, or contributing significantly to a solution of the current debt crisis. But the emergence of such markets could facilitate future debt flows to developing countries.

There have also been proposals for public sector provision of insurance in the form of a MIGA (multilateral investment guarantee authority) perhaps spearheaded by the World Bank.[16] Such an authority could help mobilize new private capital, perhaps at lower cost than through private insurance because the World Bank and other multilateral agencies have developed expertise in evaluating loans to developing countries. The MIGA need not necessarily subsidize the insurance rates;

[15]In this paragraph I discuss insurance of existing debt obligations.
[16]National export credit agencies perform some of the same functions. The World Bank has provided some investment guarantees in co-financing of projects with commercial lenders.

if it were to do so, the organizing agency would have to decide if that was the most productive use of its subsidies rather than, for instance, providing them in the form of lower cost loans to the borrowers. The provision of 100% insurance by MIGA would create the type of moral hazard problem of inadequate monitoring of loans by lenders that contributed to the creation of the current debt crisis; MIGA would therefore probably insist on significant levels of co-insurance with the lenders.

Indexed loans: Any loan that ties payments from debtors to creditors to some objective criterion is an indexed loan. There are different motivations for such instruments. A proposal that countries should pay real interest on their debts, which would mean say 2-3% real, could imply a cash flow that starts out small and ends with a balloon payment at maturity when the inflation adjustment component is added to principal. But indexation of interest could also imply that the interest due in a given year is 2-3% plus that year's rate of inflation. The proposal to fix the real interest rate on the international debt was made with the aim of reducing short-term resource flows from the debtor countries, both by reducing the real rate below the extremely high levels implicit in then nominal rates, and in delaying some repayments until maturity. A reduction in the real rate would of course reduce the resource transfer from the developing countries. But given the possibility of supply shocks, debtors with real obligations could find themselves having to make high real transfers precisely when world trade and their export earnings are depressed. Of course, if the country is

the beneficiary of the supply shock--for instance the oil exporters during the first and second oil shocks--then the indexation helps it match its payments stream to its ability to pay. Similarly, if high inflation is caused by expansionary demand policies in the developed countries that raise commodity prices, indexation would create a closer match between the countries' liabilities and its ability to pay.

Exchange participation notes suggested by Bailey (1983) tie payments to export earnings.[17] In a crude way Peru has instituted such notes by paying interest only up to a certain percentage of its export earnings. However creditors have not relinquished their unmet claims on Peru, whereas agreed upon exchange earnings indexation could simply define the claim as a certain share of export earnings. In well-operating markets such claims could be priced and traded, and there is no difficulty in principle in envisaging their introduction.

Two objections to the indexation of interest payments to export earnings have emerged. First, if interest payments are indexed to export earnings--for instance that a country pays 20% of its foreign exchange earnings in interest--then that is like a tax on exports earnings, which discourages the country from exporting. Rather, it is argued, index the payments to a larger total, such as GNP, which would permit a lower "tax" rate and therefore a smaller disincentive effect. While the tax argument is correct (though its quantitative significance remains uncertain), it is not decisive: first, a country with export earnings has the foreign exchange to make payments to foreign creditors,

[17]Lessard and Williamson (1985) analyze this and related proposals which they call "quasi-equity" investments.

whereas a country whose GNP is growing while its exports are not may not; second, the indexation of interest payments provides an incentive for the creditor governments not to restrict imports from the debtors, for in so doing they reduce the interest earned by their own banks.

The second objection to indexation of interest is that the bank regulators would have great difficulty handling the valuation of these quasit-equity claims and might forbid the banks from holding them. Other financial intermediaries, such as pension funds, might be willing to hold exchange participation notes. Further, debtor countries could attempt to sell such instruments as bonds. Oil-price indexed bonds have already been sold by both Mexico and a private company[18] and are an obvious indexed instrument that the oil exporters would presumably be willing to supply and for which a hedging demand in the developed countries is likely to exist.

It is sometimes suggested that the debtors would be unhappy to allow the payments on indexed notes or bonds to rise very high in the event the country suffers a bout of good luck. There is again no problem in principle for the capital markets to price indexed instruments with ceilings on payments. Of course the sellers of the bond pay a price for imposing the ceiling, but it may be a price they are willing to pay.

Direct swaps of debt for claims on commodities which the recipient exports are another form of indexed instrument. By tieing the

[18]Both Mexico and Petro-Lewis suffered subsequent reverses, and the Mexican oil bonds are not regarded as a success; Petro-Lewis's problems appear unrelated to the issue of indexed bonds.

payoff of loans to a specific amount of the country's production, such agreements reduce the transfer problem.[19]

Contingent lending obligations: Contingent lending obligations are another variant of this type of proposal. Examples are the IMF's Compensatory Financing Facility and the 1986 agreement that Mexico will receive additional loans if oil prices fall. In all cases of contingent financing and interest payments the benefit for the recipient country is the assurance that it will automatically rather than after protracted negotiation receive financing in the event of need; the problem for the lender is the fear that good money may be thrown after bad. That can to some extent be compensated for by a higher interest rate, but higher interest rates increase the probability of default, which is the cause of rationing in credit markets.

Longer debt maturities: Moving on to item 4 in Table 4, debt maturities are already quite long, from six to as much as twenty years, in many debt agreements. The long maturities protect the borrowers from having to roll over the debt frequently, but because the loans are at floating rates still leave them vulnerable to interest rate shocks. From the viewpoint of the banks, the lengthening of maturities is a lengthening of the rein on which the debtor countries are held--as indeed are other proposals in Table 4 including indexed instruments--and therefore comes at a price.

[19] In conversation Pentti Kouri has argued that the fact that Finnish reparations to the Soviet Union after World War II were specified in physical terms made the transfer of resources less burdensome than it would otherwise have been.

Debt-equity swaps: Debt-equity swaps are the central element of most market-oriented debt restructurings, and they have also been implemented, for example in Mexico, Chile and Argentina. The essential transaction is simply that a debt claim on a country is swapped by that country's central bank for local currency claims that should be invested in local firms.

If the domestic equity markets were working well, if there were no constraints on purchases of foreign exchange or domestic assets, and if there were no subsidies involved, such transactions would not attract any attention. But they do. The greatest attraction for the creditors is that debt-equity swaps often carry an implicit subsidy of the equity investment. Swaps may involve the purchase of debt in the secondary market at a discount, and redemption at face value. With secondary market discounts that even for the major debtors may be as high as 50%, the subsidy element can be very large.

However there is no inherent reason the debtor country has to subsidize the transaction to the extent set by the New York market price of the debt. If it wants to subsidize the transaction, it can do so by setting a price at which debt can be redeemed prematurely, at a level between the New York price and face value. Another approach has been used by Chile, which auctions off the right to exchange dollar debt for peso assets.

Obviously debt-equity swaps replace interest payments by dividend payments, and are not a source of new money for the debtor country. In addition, they may merely be subsidies for investment flows

that would have taken place anyway. A further difficulty arises from the possibility of round-tripping, in which the debt-equity swapper succeeds in converting the purchased equity into foreign exchange at a rate close to the official rate. This is a result of the subsidy provided by carrying out the swap at a price for debt different from that in the secondary market, but can be mitigated by imposing minimum holding periods on the equity purchases.

None of these problems rules out debt-equity swaps as a useful supplement to handling the debt crisis. By swapping at a markup over the New York price, the debtor country in effect is able to buy back some of its debt for less than face value. The present value of the dividend outflow is probably similar to the expected present value of interest outflows on the debt, but does reduce the probability of debt default and does provide a payment stream that better matches the country's economic performance; for these reasons debt-equity swaps may be preferable from the viewpoint of the debtors to agreed direct purchases of their debt in the market at the same price as the swap is transacted. Argentina and other countries are attempting to ensure that the swaps produce new money by requiring swappers to demonstrate that they are in addition bringing in new funds.

Debt-equity swaps will to begin with play only a small part in solving the problem of the debt overhang. The amounts transacted have been small, perhaps approaching $4 billion in total, out of a debt of the countries involved of near $400 billion. Nonetheless over time an increasing share of foreign investment may take equity form. As in the

United States, the value of the equity will likely grow more from reinvestment of profits than as a result of fresh infusions of funds.[20] If the development of this form of financing also results in strengthening of the domestic equity markets that will be a bonus.

The substitution of domestic currency loans for foreign debt is part of the 1987 Philippines restructuring (Philippine Investment Notes). They may be used internally to buy equity. Unless the recipient can sell them directly for foreign currency, they appear to be a modified form of debt-equity swap.

Local currency servicing: Closely related to the notion of debt-equity swaps is the proposal from debtors that they be permitted to service their debt in local currency, with automatic reinvestment of the proceeds in the domestic economy. Part of the servicing might be made available to the government; the remainder would be relent to the private sector, in forms chosen by the creditors.

This proposal has the benefit for the debtors of reducing the need to generate foreign currency to service the debt. It has the advantage for creditors that their debt is serviced in full, but the disadvantage that they would be constrained from reducing their total exposure in any given country. The proposal is likely to receive consideration both as one means of automatically handling the transfer problem--the debtors' problem in transferring resources abroad--and because it establishes a simple formula by which all existing creditors provide continuing finance for a country.

[20]New equity issues usually account for only a small share of funds raised in U.S. capital markets; for instance in 1983, when equity issues were unusually large, they totalled $53 billion when total funds raised by private domestic nonfinancial business exceeded $400 billion.

Flight capital: The return of flight capital is another item that has received considerable attention. Here the amounts involved may be large, of the order of half the Argentinian and Mexican debts. Some debt-equity swaps probably represent the return of flight capital. Provided the subsidy element is kept small, this may be a useful vehicle for the return of flight capital. Similarly any measures the regulatory authorities in the developed countries are willing to take to enable countries to trace this capital would help the debtor governments tax it, and perhaps help bring it home.

The main advantage of flight capital over alternative sources of funding that might be available at lower rates is that it prevents the sale of the national patrimony to foreigners. (Meltzer, 1983) Flight capital might also be a preferable source of financing of domestic business because the local owners of flight capital have more specialized knowledge of local markets.

However it would be difficult to place flight capital as the centerpiece of any debt strategy. If it would come back for reasonable interest rates and small subsidization of debt-equity deals, it would not need any special attention. It is quite likely though that especially high rates of return would be needed, because the owners of flight capital would fear the imposition of ex post sanctions of some type.[21]

[21]The government of Turkey obtains funds from expatriate workers by borrowing in Germany at 3% above the Eurodollar rate. (See Rodrik (1987) for details). Presumably debtor countries could set up similar schemes in foreign countries for capital held there. It might however be difficult for the government to justify paying higher interest to citizens who had invested abroad than to those who had kept their funds at home.

Flight capital left some countries, such as Argentina, completely legally. It left others that had exchange controls illegally. The possibility exists of providing an amnesty for the return of flight capital to those countries it left illegally, though here as with other aspects of the debt crisis, the fear of setting precedents would affect policy decisions.

Mutual funds: Mutual fund investment in developing countries, the "Country X Fund" is a potential source of equity capital that would succeed in attracting some new capital, and help in the aim of changing the form of foreign investment in the debtor countries. The amounts involved here are however likely to be small initially. Such mutual funds would do more to encourage future capital flows to the developing countries than to deal with the existing debt problem.

Debt subordination: Another suggestion to encourage new capital inflows is that existing debt claims be subordinated so that new lenders go to the front of the repayment line. Subordination is presumably ruled out without the permission of the existing lenders. If it were likely that substantial new capital could be tapped through subordination, the existing lenders could see an increase in the probability of their being repaid, and might be willing to agree. However with no obvious sources of new capital available, they are unlikely to do so.

Interest capitalization: The last item in Table 4, interest capitalization, could change resource transfers to the debtors quite radically and rapidly. Capitalization simply limits the amount of interest that has to be paid in any one year, perhaps to a given nominal

interest rate on the debt, or to a given percentage of GNP, a given percentage of export earnings, or by some formula related to commodity prices. Whatever the criterion for the amount to be transferred in the given year, the remainder is capitalized and automatically added to the debt, to be paid off over a specified horizon.

Interest capitalization has the attraction of dealing very directly with the problem that current transfers from the debtors are so large as to inhibit growth. The obvious fear from the viewpoint of the creditors is that the process is unstable, that the amounts capitalized will grow too fast for the country ever to be able to pay all the interest without further capitalization. Whether that is a realistic fear depends entirely on the growth prospects of the country and the exact formula used for capitalization. But if every reasonable capitalization formula results in debt instability, then there is presumably no chance that current claims on the country can be collected in full. That is, interest capitalization is a simple substitute for rescheduling when the problem is liquidity, but not when it is solvency.

Table 5 presents calculations of the hypothetical path of the indebtedness of the fifteen heavily indebted countries under the assumption that interest capping began with the onset of the debt crisis in 1982 and continued to 1987. According to the real interest rate formula, the hypothetical payment from debtors to creditors each year was 3% plus the rate of inflation of the U.S. GNP deflator. According to the share of exports formula, the debtors made interest payments of 25% of their exports.[22] In each case it is assumed that the interest

[22]The 3% real interest rate and the 25% share of interest earnings were chosen to ensure that the hypothetical debt in 1987 was similar to the actual debt in 1987.

rate at which interest is accumulated is the average actual interest rate paid on the debt in that year. It is further assumed that the only capital inflows to the fifteen heavily indebted countries resulted from interest capping.

Table 5: RESULTS OF HYPOTHETICAL INTEREST CAPITALIZATION.

Formula	Outstanding Debt ($ bill)					
	1982	1983	1984	1985	1986	1987
Actual	383.1	394.2	410.9	417.2	434.2	464.9
3% real interest	383.1	392.6	409.8	427.3	443.9	451.5
25% of exports	383.1	400.7	414.4	429.6	443.8	457.4

Source: Underlying data are from World Economic Outlook, April 1987, Statistical Appendix.

The calculations in Table 5 show that interest capping based on a 3% real interest rate would have produced a very similar pattern of capital inflows to the actual pattern--but it would have been produced automatically without the constant negotiation that has marked the period since 1982. The main difference between the first two rows of the table occurs in 1985, when capital inflows would have been substantially larger with a 3% interest rate cap, and in 1987 (for which the "actual" is in any event hypothetical) when the inflow would have been reduced. Interest capping under a formula that fixed actual payments at 25% of exports would have produced a larger inflow of capital in 1983 at the start of the crisis.

The assumption in Table 5 is that exports and the interest rate at which interest is accumulated would have been the same under interest capping as actually occurred. It might be pointed out that with a 25% "tax" on earnings, exports would have been lower. That is possible, but note that actual interest is merely deferred by the capping, not forgiven. It is also possible that the dynamics of negotiation and thus the interest rate at which interest would have accrued would have been different under interest capping. However there is no presumption as to the direction of that effect.

The calculations presented in Table 5 may thus be taken as indicative of the pattern that would have been seen under interest capping. The most interesting result in the table is that capping at a 3% real interest rate would have had only a small effect on the pattern of debt accumulation, and is thus a less radical proposal than it sounds.

Interest capitalization has received more support in Europe than in the U.S. Capitalization maintains the banks' claims on the debtors, producing the prospect of eventual repayment, and would thus be preferred by the lenders to interest forgiveness. However it may suffer from accounting difficulties in the United States, with the issue being whether the debt has to be treated as non-performing when capitalization is triggered. Here U.S. regulators would have to change rules if capitalization were to become a practical option.

It has also been argued that capitalization is an unstable process because once introduced, it leads inevitably to the demand for more: if the first agreement is to capitalize 40% of interest, won't the debtor demand 60% next time, and so on. It is hard to see why the normal bargaining process is more unstable in this direction than in any other. Besides, agreements will almost certainly include an extra charge for the use of the capitalization feature.

As with the other types of change in the form of claims on the debtor countries, interest capitalization may be useful for some countries, in this case those clearly in temporary difficulties. The alternative of a rescheduling suffers the need to engage in a more complicated negotiation, which may bog down over the desire of the smaller banks to escape. But the reschedulings achieve some of the goals of interest capitalization in reducing immediate outward resource transfers from the debtors by providing a grace period before principal repayment is to resume.

Most of the proposals discussed in this section are for changes in the form of the debt, that--except to some extent in the discussion of debt-equity swaps--do not reduce the present value of debtor country obligations. Alternative proposals do typically include elements of debt relief.

III. New Institutions.

The overhang of the existing debt is the main obstacle to a renewal of resource inflows to the heavily indebted developing countries. Very early in the debt crisis both Kenen (1983) and Rohatyn (1983) proposed the formation of an international institution to buy

debt at a price below the face value and provide relief to the debtor countries. Similar proposals have been made later, most recently in the 1987 U.S. trade bill.

Kenen's 1983 proposal was for the governments of the creditor nations to set up an International Debt Discount Corporation (IDDC) to which they would contribute capital. The IDDC would issue long-term bonds to the banks in exchange for their developing country debts, at a discount. In 1983 Kenen suggested 90 cents on the dollar. It would in turn collect from the debtor countries, using some of the 10 cents to provide debt relief. If the IDDC misjudged and was unable to collect, the creditor governments would bear the losses.

The plan is elegantly simple in replacing developing country debt in banks' balance sheets with the liabilities of the IDDC, in effect requiring the banks to lend to the IDDC. Kenen proposed that the banks not be allowed to choose which debt they would sell, and that the debtor countries would have to agree that the IDDC was the successor debt holder. The IDDC could lengthen the maturity of the debt. He proposed only a modest discount, of about 10%, on the debt; given the persistence of high interest rates and low commodity prices since 1983, and the large discounts in the secondary market, he would presumably currently suggest a larger discount.

Rohatyn suggested the setting up of an institution that would obtain resources by borrowing in the market, and from the creditor governments. It would then buy debt from the banks, at a discount, and pass the discount on to the debtor nations. He envisaged sufficient

discounts to bring debt service burdens down to 25-30% of exports; they are currently 50% for the heavily indebted countries.

Weinert (1986-87) proposes that the World Bank and/or developed country governments buy the debt from the banks in exchange for low-interest loans. Suppose that the debt relief is organized through an IDDC. The IDDC passes the same low interest rate on to the debtors. The interest rate is calculated so that the market value of IDDC bonds exchanged for a given country's debt is equal to the secondary market value of that country's debts. But because the face value is the same as that on the debts bought from the banks, the banks can in effect amortize their capital loss through lower profits over the life of the bonds.

Weinert assumes the operation can be carried out without government funds. Some source of capital, presumably governmental, would be needed in any case. Whether the governments retrieve their capital depends on whether the debtors succeed in paying off their reduced obligations. Possibly the creditor governments or the World Bank might decide that aid could be injected to reduce the burden of the debt on the debtors even beyond that implied by the purchase of the debt at secondary market prices.

There are several questions about IDDC type schemes. First, why would the banks agree, and would they all have to agree? At the right price, the banks collectively might agree to a scheme of this sort on the grounds that it transforms uncertain debt into more certain or perhaps even government guaranteed debt.

The key operational issues in the setting up of an IDDC are the prices at which the IDDC buys debt from the banks, and the amount of relief it provides to the debtors. Unless the debt were auctioned off, it would be difficult to come up with the right price. Once the IDDC became a serious possibility, the secondary market price would reflect expectations about IDDC operations, and would not necessarily serve as an accurate indicator of value. But even though there appears at present to be little prospect of such an institution, the secondary market is thin and prices in it cannot be used as good indicators of the market value that would exist if the regulatory environment made it possible for the large banks to use that market freely.

How much debt would be offered by the banks? If the IDDC offered a high enough interest rate it would get all the banks to participate. At a sufficiently low interest rate no banks would take part. The IDDC could not force the banks to accept the offer unless perhaps it reached an agreement with the banking syndicate for each country. Unless there is some contribution of public money, the plan gets stuck if the banks will not buy debt at an interest rate that looks reasonable for the given country, or some other means is found of ensuring bank participation

Any IDDC type scheme creates a freerider problem. If the IDDC buys up much of the developing country debt and makes some form of debt relief possible, then the credit standing of the debtors improves. Those creditors who stayed out of the IDDC agreement have a capital gain. For that reason an IDDC would have to find some means of ensuring almost complete participation by the creditors.

If it does not use secondary market prices, how would the IDDC proceed? It would have to calculate for each country the interest rate it regards as right for that country, and then offer to exchange debt at that interest rate with the banks. There is no ready objective basis for calculating how much each country can afford to pay, or should pay. This will be an issue in all debt relief schemes, and will have to be settled on the basis of some combination of the country's per capita income level and the losses it has suffered in the debt crisis.[23]

Recently the Japanese commercial banks have, with government blessing, set up an intermediary to buy their holdings of developing country debt. The Japanese banks derive tax benefits from the sale of their assets at a discount. The U.S. tax laws appear not to afford the same advantages to U.S. banks taking discounts. The Japanese intermediary does not of course plan to forgive any of the developing country debt. But it does provide a precedent for half of the transaction an IDDC would undertake

The IDDC notion is at the least interesting; if it could be carried off with relatively small injections of public money it would also be important. The key questions about each such plan are how large a writedown the banks take, whether they would be willing, or could be made willing, to do so, and how much relief is provided to the debtors. If there is to be an overall solution to the debt problem it will almost

[23]Sachs (1986) suggests per capita income declines since the start of the debt crisis as the basis for relief. This could give large amounts of relief to the relatively rich borrowers. Since the provision of debt relief through public funds is in part a result of a sense of fairness, it is likely that relief would be based on the level of per capita income as well as (perhaps) debt-related indicators.

certainly involve an IDDC type institution. But since the procedures it sets up for pricing debt will determine the burdens borne by both banks and debtors, and the possible extent of creditor nation government support, its operating rules and management are bound to be the subject of protracted negotiations. It might be possible in such a negotiation to separate technical discussions on the terms and methods of buying debt from aid discussions that determine the concessions that are given to each country.

One way to move ahead systematically on the debt issue is for the creditor and debtor countries to agree to exploratory talks on the setting up of such an institution.

IV. Debt Relief.

Debt relief could be given in the context of an IDDC. The case for relief is that debtor countries will be unable to grow unless they can increase imports, that no solution currently in sight permits them to do that without reducing income levels to politically unacceptable levels, and that ultimately they will in any case not pay most of their debts. If debt relief were not necessary, the creditor banks and debtors would already have got together on a plan, such as interest capitalization, that permits the resumption of growth while promising that the debt will eventually be paid off.

The case against debt relief is that of precedent, and the view that contracts that were voluntarily entered into should not be abrogated. The question of the precedent that would be set by giving

debt relief is not simple. As Lindert and Morton (1987) point out, defaults have occurred quite regularly in the past, but that precedent has not made any of the major debtors default this time. Further, debt contracts involve both creditors and debtors, and the use of political authority to enforce the debts sets a precedent for creditors, whose incentives to exercise appropriate caution in lending are reduced.

Relief can come through direct negotiations between the creditor banks and each debtor country, or with the intervention of the international institutions and/or creditor governments. Or it may be imposed unilaterally by some of the debtor governments, either in the form of a moratorium which does not repudiate the debt, or in the form of unilateral action that leaves them to deal with the legal consequences of their actions. Or it could come in some combination of the above.

Negotiations between debtors and their creditor banks would not be direct unless the creditor governments and international institutions kept out. A negotiation in which a creditor government warns the debtor that any failure to pay 100% of the debt will affect political and aid relations is multilateral, not direct. In any direct negotiation the debtor nonetheless would have to weigh the legal and other consequences of not paying in full (Kaletsky, 1985). If it can meaningfully threaten that, it should be able to reach an agreement that provides some relief.

Presumably the largest debtors, such as Brazil and Mexico, would have the negotiating power to reach an actual agreement on relief. The smaller debtors are in a weaker position with regard to reaching an

agreement, although the case of Peru suggests the smaller countries may find it easier to set unilateral terms on which there is no formal agreement with the creditors. The most likely scenario in which smaller countries obtain agreed-upon relief in direct negotiations is that they reach agreements patterned on those of the larger debtors. Indeed, one of the fears of the creditor banks is that any concessions extended to one country will have automatically to be extended to others.

It might be possible for the major debtors to settle their own debt problems in direct negotiations. As in any real world bargaining situation, the outcome would be determined by the threats that each side could realistically make (Bulow and Shoven, 1986). Since neither debtors nor creditors can be sure of the consequences of default, the results of such bargaining are difficult to foresee. So long as the creditor countries permitted these negotiations to proceed without interference, and at critical stages were willing to help--for instance by changing banking regulations--agreement is quite possible. The agreement would likely be conditional on the country's economic policies, and could involve the international institutions in monitoring roles.

However the free rider problem among creditor banks is not trivial. If an overall agreement is reached in which creditor banks make concessions that help restore the debtor's growth, individual banks have the incentive to stay out to try to collect 100% of their debt. In the United States at least it appears to be extremely difficult to

prevent this type of action, even by law, since the rights of the banks may be constitutionally protected.

Proposals to require relief, for instance by interest rate capping, or by debt forgiveness imposed by law, would likely also run into legal obstacles in the United States if not elsewhere. It might be possible to make relief more attractive to the creditors by providing further aid for the debtors, most likely in an IDDC context.

V. Scenarios.

Three basic scenarios can be seen. The first is an evolution of the muddling through strategy that has been followed to date. The basic element in the strategy is the negotiation of agreements from time to time between each country and its private creditors, with interest rates being set on a floating rate basis at some markup over LIBOR. The evolution would take place as new assets (such as oil-price indexed bonds, and exit bonds) were introduced, as banks swapped claims with each other and with the debtors (debt-equity swaps for example), and as the margins and fees on the existing debt change through negotiation. This is the very much the mixture as before.

Its benefits were noted in the introduction: there has not been a world financial crisis, the banks have had time to improve their balance sheets, real interest rates have fallen, and possibly the world economic situation will become more favorable for the debtors. The difficulties with this strategy were also noted in the introduction: growth has been slow or negative in the debtor countries and the crisis

shows no signs of disappearing. If anything, debt negotiations appear to have become more rather than less difficult since 1982.

The second scenario would see a series of direct agreements between each debtor and its creditors, involving relief and substantial lengthening of the debt. The negotiations for such agreements would be protracted and possibly crisis-laden, and would likely involve the international institutions in monitoring roles. The benefit of such a solution is that it is a longer-term solution, which enables debtors to concentrate on domestic economic management, and gives creditors an opportunity to put their balance sheets in order. The chances of reaching such agreements may well have been enhanced by the creation of loss reserves by the creditor banks.

The third possibility is the setting up of a large international organization, the IDDC, to attempt to dispose of the debt problem. This too has the benefits of settling the crisis and enabling economic management teams to concentrate on policies for growth. It would also provide a longer-term solution for the banks. Such a scheme would likely require a net contribution of resources from creditor governments or the international institutions, and the political difficulties of reaching agreed upon formulae for debt relief would be formidable.

Of course, the scenarios are not mutually exclusive. The second and third possibilities could be combined, with the debt crisis eventally being resolved through a mixture of direct agreements between creditors and detbors with extra relief being provided for the most impoverished countries though an IDDC or the existing international

institutions. Elements of the first scenario would be seen in the evolution of international lending in the direction of more equity-like claims. In all cases the solutions would involve agreed upon policy reforms in the debtor countries to attempt to ensure that the debt problem does not soon recur.

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Correspondents / Participants
To : Mr. W. David Hopper
From : Ibrahim F. I. Shihata

Subject / Title
Towards Central Management of the Debt Problem on a Country-by-Country Basis

Exception No(s).

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THE WORLD BANK

From the
Vice President for Financial Policy and Risk Management

August 4, 1987

Mr. Qureshi
Mr. Wapenhans
Mr. Hopper

Debt Task Force - Interim Report

Mr. Stern thought you might be interested in seeing this.

Joe

Attachment

D. Joseph Wood

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: August 4, 1987

TO: Mr. E. Stern

FROM: Joe Wood

EXT: 72784

SUBJECT: Debt Task Force -- Interim Report

1. The Interim Report concludes that debt relief is needed by many middle-income debtors. This conclusion seems to rest on three distinct lines of argument:

#1 capital inflows required to finance growth-oriented scenarios will, in all likelihood, not be forthcoming.

#2 even if external capital in the required volumes could be mobilized, the workout scenarios would still not be viable because there would be insufficient improvement in key debt indicators (and hence no restoration of market access).

#3 the assumptions made by Regional staff with respect to domestic savings and efficiency of resource use are "over-optimistic", so that the incompatibility of growth and continued servicing of debt is even worse than it appears at first sight.

Each of these arguments deserves some comment.

New Money Availability

2. The pessimism with respect to availability of new money strikes me as being overdone. While the concerted lending process has certainly proven to be cumbersome and to take much longer than anyone would wish, packages have been put together for the great majority of the Baker countries. Moreover, the Argentine case suggests that the process can be modified so as to speed up implementation.

3. The fundamental case for commercial bank participation in new money arrangements is that the banks receive at least some interest payments (net of new financing) that way. The attached table shows that this basic self-interest will continue to be applicable in the great majority of cases in the future.

4. Thus it seems to me to be very premature to conclude that the required volumes of new money simply cannot be mobilized. Instead of dismissing the possibilities in this area, I would urge that the Task Force consider how the Bank can help make the process of putting together financing packages work more effectively. This, after all, is what FIS was set up to do.

Outlook for Debt Indicators

5. Even if external financing could be mobilized in the required volumes, the Interim Report suggests that the scenarios would still be unsustainable because there would be insufficient improvement in the key debt indicators to restore market access. The implicit assumption seems to be that a reasonably prompt restoration of market access is crucial in order to make the workout plan politically viable in the debtor countries.

6. The deterioration of key debt indicators over the past few years is discouraging, of course, but it is important that this deterioration be kept in perspective. Debt to GDP ratios have worsened partly because of exchange rate movements (i.e. devaluation has lowered the $ value of GDP; $ depreciation has increased the $ value of debt in non-dollar currencies). Debt to export ratios would have improved for some of the commmodity dependent countries had it not been for the major declines in commodity prices which have occurred in recent years. Since these factors are unlikely to exercise as much of a drag on the debt indicators in the future as in the last couple of years, one should not assume that recent experience is a good guide to the future.

7. Indeed, the projections for debt indicators presented in the Country Perspective attachment to the Interim Report do generally show an improving picture. The authors of the Report judge the pace of the improvement to be too slow. It is not obvious why. My own sense is that, given two or three years of improving debt indicators, the climate of opinion could improve a lot -even though the absolute level of the debt indicators remains high. It was, after all, not many months ago that creditors were talking about Brazil being able to mobilize limited amounts of new money on a voluntary basis.

Over-Optimism of Country Projections

8. The country projections in the attachment are viewed by the authors of the Interim Report as being "over-optimistic". Hence the incompatiblity of growth and continued servicing of existing debt is seen to be even greater than is implied by the projections themselves.

9. I accept the proposition that improvements in domestic economic performance will be uneven -that there will be occasional important lapses in country performance. To that extent, the "linear" projections we customarily use probably do have an optimistic bias. But the projections also underestimate the response elasticities when things are going well. There are plenty of examples of growth rates of manufactured exports that greatly exceed the sorts of figures we customarily use in country projections. In other words, the standard projections miss both the peaks and the valleys. The authors of the Report are much more sensitive to the latter than to the former.

10. The authors are particularly critical about the assumptions made with respect to domestic savings (para. 69). Not enough evidence is presented in the Report to permit an informed judgment to be made, but I would agree that this is an aspect of our country creditworthiness evaluation than needs to be given more attention.

Conclusions

11. When one separates out the various strands of argument presented in the Interim Report, the case for concluding that "debt relief is needed by many middle-income countries" is far from being established. At most, the Report demonstrates that the workout plans are high risk propositions, whose success is far from assured. That is nothing new.

cc: Mr. Baneth
Mr. Dubey
Mr. Bock
Mr. Steer

New Money Requirements in Selected Highly Indebted Countries

	1987	1988	1989	1990	1991	1992	1993	1994	1995
	<—			as % of GDP					—>
Colombia									
New Money	1.4	1.7	1.1	0.8	0.8	0.5	0.5	0.6	0.6
Interest Payments	4.1	4.3	4.3	4.2	4.1	3.9	3.7	3.5	3.3
New Money/Interest %	34.1	39.5	25.6	19.0	19.5	12.8	13.5	17.1	18.2
Brazil									
New Money	4.1	3.4	3.1	2.7	2.1	2.2	2.2	2.1	2.1
Interest Payments	6.5	5.8	5.7	5.7	5.3	5.2	5.1	5.0	4.8
New Money/Interest %	63.1	58.6	54.4	47.4	39.6	42.3	43.1	42.0	43.8
Chile									
New Money	-3.1	2.3	4.3	5.1	6.5	7.7	8.4	9.2	9.7
Interest Payments	9.2	8.9	8.6	8.4	8.8	9.0	8.3	8.5	8.7
New Money/Interest %	-33.7	25.8	50.0	60.7	73.9	85.6	101.2	108.2	111.5
Philippines									
New Money	2.8	5.5	5.7	5.2	4.9	4.9	4.0	3.3	3.8
Interest Payments	4.7	4.6	4.7	4.8	4.6	4.6	4.4	4.2	3.9
New Money/Interest %	59.6	119.6	121.3	108.3	106.5	106.5	90.9	78.6	97.4
Uruguay									
New Money	2.3	2.8	2.4	0.5	-0.1	-0.3	-0.5	-0.6	0.4
Interest Payments	6.1	5.7	5.7	5.5	5.3	4.8	4.6	4.3	4.1
New Money/Interest %	38.2	50.0	42.4	8.7	-2.5	-6.8	-11.8	-12.9	8.7
Argentina									
New Money	2.7	2.5	2.4	2.2	2.1	2.0	1.5	1.3	1.4
Interest Payments	5.9	5.6	5.6	5.6	5.2	4.8	4.4	4.0	3.9
New Money/Interest %	45.8	44.6	42.9	39.3	40.4	41.7	34.1	32.5	35.9
Nigeria									
New Money	1.5	1.6	2.6	3.5	3.5	3.2	3.0	2.9	2.9
Interest Payments	7.4	7.8	7.9	8.1	7.2	7.1	7.0	6.7	6.3
New Money/Interest %	20.3	20.5	32.9	43.2	48.6	45.1	42.9	43.3	46.0
Bolivia									
New Money	6.3	7.1	7.0	9.3	7.5	5.2	7.0	5.6	4.9
Interest Payments	6.8	6.9	6.8	6.9	6.8	7.4	7.8	8.2	8.6
New Money/Interest %	92.6	102.9	102.9	134.8	110.3	70.3	89.7	68.3	57.0

Source: Derived from projections presented in "Debt Problems of Middle Income Countries: Reappraisal II - The Country Perspective", except for Nigeria where interest payments are taken from the recent Country Strategy Paper.

FRS/CR
04-Aug-87

Sent under
cover note
PMBrary→BC
11/26/86

The Baker Plan.-- Notable Points.

1. The Baker Plan was unveiled in Seoul in late 1985 in response to the realization that austerity based adjustment programs -- launched with IMF support in late 1982 -- had reached the limits of sustainablity and acceptability in indebted developing countries.

2. These austerity programs, based essentially on the immediate need to bring egregious current account imbalances and public sector deficits under control, were successful in achieving the first objective but not the second.

3. The massive restraints on imports which these programs entailed, coupled with indiscriminate cutbacks in public outlays, affected both recurrent expenditures and investments somewhat indiscriminately. This inevitably resulted in economic shrinkage thus exacerbating the incapacity of debtor countries to service increased debt with lower output.

4. After three years of painful adjustment, both developed and developing countries realized that further adjustment through austerity was no longer a tenable approach. It was leading rapidly to economic implosion in most debtor countries and could have triggered widespread default by permanently impairing the capacity of these countries to repay.

5. What was needed was the restoration of growth through productive investment, especially in the trade sector, so that export earnings could be generated to cover external debt service obligations. At the same time, confidence needed to be restored in the economies of debtor countries in order to arrest, then reverse, capital flight -- a factor which had resulted from a lack of confidence in the future of these economies and had compounded the debt problem.

6. Confidence could only be restored if: (a) sound macro-economic policies (interest rate, exchange-rate, pricing, cost-recovery and fiscal balance) were embraced and vigorously pursued; and (b) incentives were provided for the private sector to exert investment and management initiative. However, both of these actions would need to be accompanied by infusions of new capital to finance the transitional costs of adjustment and new investment needed to spur growth.

7. In most indebted countries, it had become clearly apparent that the causes of the debt problem had much to do with indiscriminate external borrowing being used to finance: (a) subsidised consumption and (b) unproductive, mismanaged investment undertaken largely by public enterprises on an uncontrolled basis. It was essential, therefore, for these problems to be attacked at the very root. Consequently, one of the pillars of policy change was to reduce the role of an over-extended public sector and to

expand the role of an underutilized private sector especially in the management of production.

8. It was evident that for growth to be restored, export earnings enhanced and debt repaid, investment would need to be revived through new money flows. The paradox was that traditional commercial lenders were loath to lend any more money without demonstrable evidence that programs of adjustment with growth could be designed and would work.

9. Mindful of their own experience, commercial banks and industrial country governments began to realize that what was needed was the sustained participation, over the long-term, of credible partners with experience and expertise in development investment. The obvious choice of institutions for playing this unique role were the Multilateral Development Banks, and in particular the largest of these -- The World Bank. These institutions, working in partnership with: (a) indebted country governments; (b) international commercial banks; and (c) the private sector in both developed and developing countries; were the only viable alternatives available for helping to design and implement workable programs for adjustment with growth in heavily indebted countries.

10. Accordingly, the Baker Plan envisaged a tripartite compact between the MDBs, debtor countries and commercial banks which would provide new money packages (the aggregate amounts were to be $29 billion but that is not an important point) to debtor countries willing to undertake serious and sustained policy reform programs aimed at restructuring their economies to become internationally competitive and to encourage investment, production and exports.

11. The key assumptions underlying the anticipated success of the Baker Plan were that: (a) debtor countries would be willing to work with the World Bank and other MDBs to design and implement appropriate policy reform programs, which included specific emphasis on public sector rationalization, efficiency and privatization; (b) commercial banks would be willing to lend significant amounts of new money under such circumstances; (c) industrial country governments would provide backstopping support through their export credit agencies and would keep markets open with unrestrained access for debtor country exports; (d) with policy co-ordination, major countries would stabilize the world economy through lower interest rates, stable exchange rates, and domestic fiscal policies which engendered a steady and sustainable rate of significant real growth.

12. It is important to remember that there was also a list of grave concerns impelling the adoption of the Baker Plan: (a) the world financial system was particularly fragile and increased non-performance on LDC debt could precipitate a crisis; (b) there were pressures on adopting counterproductive protectionist policies in most industrial countries; (c) trade and fiscal imbalances in the industrial world threatened stability and increased the risk of financial upheaval; (d) the substantial cutback of imports by developing countries had resulted in substantial lost export

production, markets and jobs in the major countries. Interdependence was here to stay and the well-being of the industrial world also depended in large measure on the restoration of stability and growth in the developing world.

13. Moreover, it was felt that pursuing options such as debt-writeoffs and forgiveness were likely to be counterproductive. Apart from damaging the sanctity of contractual relationships, especially on the part of soveriegn governments, such measures would extinguish any willingness on the part of old or new private lenders to extend further credit for trade or investment. There was concern that such actions might also be construed as "an easy way out", rewarding recalcitrance on the part of borrowers and diminishing the prospects for achieving needed policy change.

14. It was also felt that even partial approaches in these directions -- in instances where they might seem clearly justified -- could result in an uncontrollable avalanche of requests for write-downs which would be impossible for the system to handle in a rational or equitable manner. The net result would have precipitated precisely the kind of financial crisis which both the system and authorities wanted to prevent.

15. Many debtor country governments themselves were concerned about measures which might been seen as reflecting a breakdown in lending and borrowing discipline. They felt that such measures might well redound to their detriment over the long-term even if they provided immediate relief. Consequently, they would affect their credibility and creditworthiness as reliable borrowers and would therefore delay indefinitely their returning to markets on a normal basis after the present crisis had past.

16. For all these reasons, and despite the crushing burdens of debt service which were acting as a significant drag on development, both creditor and debtor countries agreed to work on the basis of the Baker Plan. Many of them felt, even then, that the amounts of new money flows envisaged would not be sufficient to revive growth across the spectrum of debtor countries. All parties to the compact have nevertheless proceeded on the assumption that if a record of initial successes could be established, the system would find the amounts needed. It was futile, therefore, to focus debate on the adequacy of funding proposed under the Plan and to attempt acquiring pre-commitments on grandiose sums before there was evidence of success.

17. A year has passed since the Baker Plan was unveiled and many pundits pronounced it dead before it was properly born. Apart from concerns about the adequacy of new money flows envisaged in the blueprint, several observers have felt that the key underlying assumptons for success were unlikely to materialize. The experience of the World Bank did not suggest any real enthusiasm for debtors to formulate and execute, with urgency, sweeping policy reform programs. Nor was there much enthusiasm for large-scale privatization. The trading environment was shaping up in an ominous

way with the spectre of protectionism looming large.

18. And, above all, there was a growing realization that adding to the debt of already over-indebted countries was an odd way of solving the debt problem. Most indebted countries were already diverting too large a share of their export earning and of their GNPs to debt service. Moreover, in order to generate adequate export earnings, too large a portion of their investment programs were being diverted to the trade sector, thus depriving the domestic economy of needed funds. Incurring more debt simply to reinforce these basic trends was being a questionable strategy. After a six-year period of belt tightening, adjusting to reduced subsidies, tighter money, and recession, the limits of political tolerance were being tested for further policy reform in most debtor countries.

19. These considerations, taken together has led to serious questioning as to whether the Baker Plan is working or whether its time has run out. New approaches are being suggested as alternatives; approaches which would not require debtors to keep adding to their debt burdens to grow.

20. From the World Bank's perspective, the jury is still out on the Baker Plan and we think it needs more time to be given a fair chance. While we have not achieved spectacular policy reform successes in a sweeping way, we have made slow and steady progress in reforming policies, sector-by-sector. We have made impressive strides in Brazil, Colombia, Chile, Argentina and Morocco. And while no one can be excessively sanguine about other countries, we are hopeful that we will achieve the same methodical pace of progress. Brazil has shown, that with the right set of circumstances, it is possible for a Baker-type strategy to pay dividends even though the Brazilian program was largely a domestic effort. We think that with a bit more domestic stability the same type of approach might result in a relatively quick turnaround in the Philippines.

21. We think the commercial banks are being too gun-shy and less forthcoming than we would wish; but their position does deserve understanding as they themselves are engaged in a difficult effort to restructure their own balance sheets. We are concerned about the trading environment. Further trends towards protectionism will virtually guarantee the unravelling of the Baker strategy because the very capacity of debtor to earn a fair living and pay their debts will be undermined. And, we are convinced that unless the stability of interest and exchange rates in an environment of steady world growth is assured, the painstaking gains of the last two years could be very quickly undone.

22. These risks notwithstanding, we feel that the Baker Plan must be given more time and more effort on the part of all the players involved, including the direct participation of a fourth player -- namely the industrial country governments themselves. It is not enough that they provide a benign environment; the debtor countries need more active and material support on the trade and capital flow

fronts. An inability to provide new money packages where the willingness to undertake serious reform is evident would be self-defeating. An unwillingness to undertake serious reform in the face of circumstances of chronic indebtedness is equally damaging.

23. It is not yet completely clear that additional outstanding debt (and future debt service) burdens imposed under the Baker Plan will be of a magnitude which will be impossible for debtor countries to sustain. If we can achieve growth rates and increases in export earnings which significantly outpace the rate of increase in outstanding debt, the situation can be gradually unwound. Indeed, in most debtor countries the ratios of debt and debt service to exports and GNP look healthier than they did four years ago; but, they are nowhere in a desirable range of manageability yet.

24. If it does become clear that additional debt burdens are simply unsustainable then we will inevitably have to consider alternative means by which we can reduce debt burdens. But, before we leap to the conclusion that we must start writing down debt, we should try to exhaust other market-based options such as conversion of debt to equity; debt securitization and sale at appropriate discounts; temporary use of local currency for discharging fully or partially debt service obligations, with special features attendant to the use of such currency procedures by holders of foreign debt and so on.

25. It may well be that, in tandem with the implementation of the Baker Plan, we ought to be exerting the imagination and energy of the investment banking community in devising workable market based solutions to debt service. Such solutions would attempt to protect the nominal asset value of the debt but would reduce the annual debt service burdens through such features as commodity price or export earning linkages or tie it to some eventual benefit captured in a way which interest the attention of investors with different risk preferences and who are prepared to accept lower regular annual returns.

Debt Initiative

The World Bank/International Finance Corporation
O F F I C E   M E M O R A N D U M

DATE: 26-Nov-1986 03:10pm EST

TO: BARBER B CONABLE (PAPER MAIL)

FROM: Percy Mistry, SVPFI (PERCY MISTRY)

EXT.: 75464

SUBJECT: **Talking Points on the Baker Plan.**

Barber:

Judy Maguire had asked that I try to do a note with a number of talking points for you on The Baker Plan.

The attached represents a quick attempt. It was difficult for me because I happen to be of the school which believes that time is running out on us and we do need to consider other options, including some of the elements contained in Senator Bradley's proposal. I know you have expressed your reservations about the latter, but I feel that the proposal does bear further scrutiny.

Indeed, the Bank may well find itself, a year from now, combining the elements of Bradley and Baker. Besides, the Bank has put the wrong foot forward on the nature of the debt problem in the past, and I am cautious about incurring the risk of doing so again unless there are powerful reasons for doing so.

Some of my reasoning is reflected in two notes which I prepared for Moeen earlier this year. You may find them of interest if you have the time or the inclination to browse through them. It would be nice to have the opportunity to talk to you about this, and other matters, when you have the time.

CC: BILL STANTON (PAPER MAIL)
CC: JUDY MAGUIRE (PAPER MAIL)
CC: Vivek Talvadkar (VIVEK TALVADKAR)

THE BAKER PLAN & THE WORLD BANK

STATUS REPORT

1. Secretary Baker's Initiative for the Heavily Indebted Developing Countries was unveiled in Seoul at the Bank's Annual Meetings in October 1985. It called on The World Bank to play a central role in a joint tripartite enterprise between:

   (a) the indebted countries themselves;
   (b) the International Financial Institutions (viz. IBRD, IMF, and other MDBs; and
   (c) private commercial banks.

2. The aim of the Baker Plan was to restore creditworthiness and recovery through programs of "adjustment-with-growth" in fifteen selected countries. These programs, involving policy change and greater reliance on private sector resources, were expected to be developed jointly by the countries and IBRD/IMF. They were expected to be financed by the multilateral and commercial banks.

3. Over the last seven months, steady progress has been made by the Bank in developing Adjustment-Growth recovery programs in most of the countries identified although actual Bank lending for such programs has only occurred in about six of these countries so far. Moreover, in most instances Bank lending operations have fallen short of the sweeping programs of reform anticipated in the Baker Plan; they have, quite pragmatically, focussed on more limited measures in key sectors which could be operationally implemented relatively swiftly.

4. Skepticism persists, however, about the willingness of commercial banks -- particularly European ones -- to come forward in the same way as they did in the first round of the debt crisis when the IMF took a leading role in pressing ahead with its stabilization programs in 1982. After four years, the commercial banking system now has about 65% more in financial assets outstanding and at risk in these countries than it did four years ago. They are not easily persuaded about the viability of the Baker Plan or about prospects for its success.

5. Nor are developing countries too sanguine about their ability to handle the growing debt problems they now confront by adding to their debt. Indeed, their concerns are being echoed in the industrial world by influential observers such as, for instance, Senator Bill Bradley. There are, therefore, several questions which remain open at this juncture which will need to be more convincingly answered if real and sustainable progress on this initiative is to be made.

PROBLEMS AND ISSUES

6. THE FIRST AND FOREMOST QUESTION RAISED BY COMMERCIAL BANKS AND DEBTOR COUNTRIES CONCERNS THE CREDIBILITY OF THE ADJUSTMENT WITH GROWTH (AG) APPROACH AND OF THE BANK'S ABILITY TO PROVIDE "DELIVERANCE." In 1982, the world at large and commercial banks in particular, were told by the Bank and Fund that the debt problem was basically a question of liquidity and not solvency. Along with the IMF, the commercial banks provided the liquidity, albeit reluctantly, to finance stabilization. They are now told that the problem is indeed structural. Leaving aside their obvious concerns about the probity and wisdom of the earlier Bank/Fund conviction about the nature of the debt crisis, and the resulting approach to solving it, they are now asking - "What is it that the Bank is going to do, which the Fund didn't/couldn't do, that will turn the situation around and indeed increase the prospects of improved repayment performance"? The Bank has not come up with a decisive or convincing answer. Indeed it is not entirely clear to the financial community exactly what a Bank AG program in an indebted country will entail. By contrast, they know exactly what Fund stabilization programs involve and can therefore assess their prospects for implementation and their impact.

7. THE SECOND QUESTION CONCERNS THE WILLINGNESS AND ABILITY OF THE INDEBTED COUNTRIES TO UNDERTAKE AND IMPLEMENT FURTHER POLICY REFORM MEASURES. Looking at the last four years from a dispassionate viewpoint, these countries have already undertaken very harsh adjustment measures for which they have not been given full credit. The results that they were led to anticipate, if they undertook stabilization through fiscal constriction and export expansion programs, have not materialized -- except in one or two isolated cases. They have imposed on their populations austerity measures which are now testing the limits of social and political tolerance; measures which go well beyond anything that could have been attempted in more developed economies. They have lost a decade of growth and seen per capita incomes plummet throughout this decade.

8. While some progress has been achieved in a few countries, there have also been some debilitating setbacks in others. Mexico, for example, which ushered the debt crisis onto the world stage in 1982, seemed by 1984 to offer the greatest hope for surmounting its difficulties. The progress being made was sharply reversed in 1985 by rapid oil price declines followed by a succession of earthquakes. Now, after nearly five years of austerity, Mexico's debt has nearly

doubled and the arithmetic raises serious questions about whether the problem is tractable at all if approached by adding more debt to existing unserviceable burdens. At the same time, the government's ability and willingness to consider imposing further austerity are being severely tested.

9. THE THIRD QUESTION CONCERNS THE PARTICIPATION OF INDUSTRIAL COUNTRY GOVERNMENTS THEMSELVES AS THE FOURTH PARTNER IN A QUADRILATERAL RATHER THAN TRIPARTITE EXERCISE. IT CONCERNS THEIR WILLINGNESS TO FUND -- BOTH DIRECTLY THROUGH BILATERAL PROGRAMS AND INDIRECTLY THROUGH INCREASING THE CAPITAL BASE OF MULTILATERAL AGENCIES -- THIS INITIATIVE ADEQUATELY. While the governments and central banks of industrial countries, led by the United States, have been jawboning commercial banks and indebted countries to embrace the Baker Initiative with greater enthusiasm there is a disconcerting absence of symmetry between word and action. Footdragging over a capital increase for the World Bank and Inter-American Development Bank is in marked contrast with efforts to get these institutions moving. European bankers, in particular, often point to the absence of explicit mention in the Baker Plan of the responsibilities of industrial countries as the "missing link" in the joint enterprise.

10. Even more worrying is the apparent inability of the multilateral banks, which are supposed to be providing the bulk of the additional net new resources, to increase their lending and net resource transfers to indebted countries at a pace commensurate with the rhetoric. In the case of the World Bank alone, net transfers have fallen from an average level of $2.5 billion in 1984-5 to a negative $0.3 billion in 1986 and are likely to remain negative through 1988-9. Moreover, bilateral aid and export credit support programs appear to be either stagnant or diminishing. And, there is a general lack of clear decisive effort behind the rescheduling of official bilateral debt.

11. THE FOURTH ISSUE CONCERNS THE REAL COMMITMENT UNDERLYING THE RHETORIC OF INDUSTRIAL COUNTRIES' POLICY ON FOSTERING FREE TRADE AND OPEN MARKETS. There is general consensus that indebted countries cannot begin to address their serious debt servicing problems if they are denied the ability to expand rapidly their exports to "hard currency" markets. Indeed, in the Bank's AG programs, considerable reliance is placed on gearing their trade and exchange rate policies to substantial export expansion coupled with a degree of import liberalization. Yet, the actual experience of indebted countries which have attempted to adjust in this direction has, with the probable exception of Brazil, been dismal.

12. Markets in developed countries are becoming more, not less restrictive. In the U.S. and the EEC major barriers are being erected to prevent agricultural exports from entering their markets, which debilitates the ability of countries like Argentina to earn foreign currency. Similar restraints are being applied to textiles, garments, footwear, light manufactures, steel and the list keeps growing. Under these circumstances, the resolve of indebted developing countries to follow through on policy reform in the areas of tariff and exchange rate policy is weakening substantially.

13. Indeed, doubts about the credibility of the Bank-Fund strategic approach to alleviating the debt problem -- which depends heavily on both expanding world trade and the share of indebted country exports to industrial markets in such expanded trade -- are now being openly aired in both debtor and creditor countries alike. IN DEBTOR COUNTRIES the main concern is about being compelled, through conditionality and domestic belt-tightening, to gear their economies for export production when markets are disappearing. The sheer magnitude of resources that need to be diverted to the trade sector, in order to earn enough to repay foreign debt, raises a major political issue in terms of how far governments can go in depriving their populations to meet external obligations. IN INDUSTRIAL COUNTRIES, the concern is whether the Bank-Fund approach to the debt problem will result in intolerable burdens in the form of exacerbated unemployment and accelerated industrial demise in politically sensitive sectors with no adequate lead time for adjustment.

THE STANCE OF THE WORLD BANK

14. In the face of these questions and growing doubts about whether the Baker Initiative will work -- or whether it will only result in throwing more good money after bad, thereby increasing the risks to commercial lenders and putting in jeopardy the preferred creditor status of the multilateral banks -- it is clear that the World Bank must act, and must be seen to be acting, with greater certitude and resolve. The Bank faces a stark choice, the impact of which does not quite seem to have been appreciated within the institution. The Bank cannot afford to fail. It must either succeed or risk immediate relegation to the ranks of the irrelevant. If it tries and does not succeed the financial consequences for the Bank and the international community could be extremely serious. WHAT MUST IT DO TO SUCCEED OR, AT LEAST, INCREASE THE CHANCES OF SUCCESS? Regrettably, there are no simple sets of action which will guarantee success. It would be excessively ambitious to attempt providing a comprehensive, exhaustive list of presriptions. But, there are a few noteworthy actions which, left untaken, will almost certainly pre-destine failure.

15. FIRST, THE BANK MUST RESTORE THE BASIC ELEMENT OF TRUST IN ITS RELATIONSHIPS WITH BORROWERS, both heavily indebted ones and those not yet so afflicted. This quality of trust seems to have been continuously eroded over the past few years. The Bank, in explaining the difficulties it constantly confronts in persuading developing country governments to undertake difficult policy reform measures, seems to be protesting too much. The Bank and industrial governments pressing for policy reform should not presume that they have a greater stake in the future of indebted borrowers than they themselves do. If the Bank faces the difficulties it claims, it should be prepared to recognize that the underlying problem may not be a lack of understanding or decisiveness or the willingness to take political risks on the part of client governments.

16. The problem may, instead, be that the Bank is no longer regarded as the trusted, impartial and extremely competent source of advice that it once seemed to be. The Bank, in continuing to see itself as a "Mission Infallible" has not yet come to accept that this might conceivably even be a problem. Its bureacratic processes have served to obscure the reality of this problem at senior levels of management. Conversely, staff at the operating level attribute their difficulties in relating effectively with their clients to the behavior of senior management. In the face of this critical problem the Bank, paradoxically, has sounded even more emphatic about its infallibility even as it becomes less certain as to exactly what its mission is or how it might best be carried out.

17. In restoring trust, it is essential that the Bank pay more attention to: the quality of its analysis, the competence of its advice, the realism of its prescriptions and the time-frame within which they can be implemented. It is equally important for the major shareholders to realise that their rhetoric in shaping the policies of the Bank must be blunted and muted if their well-intentioned attempts to reform the institution are not to prove counterproductive by impairing the quality of relationships with its borrowers. The Bank simply cannot function effectively and credibly in developing countries if it is portrayed as a mere tool for imposing on them the diktats and ideological preferences of the industrial nations.

18. The Bank must demonstrate, with greater humility, an ability to read and understand the political and social constraints to, and consequences of, abrupt changes in economic parameters in each of its client countries. That ability, which is clearly lacking right now, must at least be equal to the Bank's ability to analyse economic issues. Most of all, the Bank must strive to restore the confidence of its clients in the belief that the traditional impartiality, pragmatism and absence of ideology in approach, which had previously characterised its analysis has not been irretrievably compromised. There has been concern, in the reactions of many clients, that the Bank appears more and more to be pushing the policy line of its largest shareholder rather than tempering its approach with a recognition of the realities prevailing in borrowing countries. That concern must be actively dispelled.

19. SECOND, THE BANK MUST COME ACROSS WITH A CLEAR AND SIMPLE MESSAGE, WHICH CAN BE COMPREHENDED EASILY BY TECHNOCRATS AND POLITICIANS, AS TO WHAT ITS "ADJUSTMENT-WITH-GROWTH" PROGRAMS ARE GOING TO COMPRISE. In contrast to the Fund, the Bank's message and approach are not at all clear or convincing in terms of the content of its programs or in terms of its ability to get them implemented and follow through on them. Adjustment-with-growth is an attractive slogan which has captured public attention. But, at present, it is a pretty empty one. The Bank's policy rhetoric fuels the perception that it essentially has the same policy agenda as the Fund, only the time frame for achieving results is different. The "uniqueness" of the Bank's role is not fully appreciated -- not even in the Bank itself. Exactly what the Bank can do that the Fund cannot, which makes the Bank central in this phase of the debt crisis, has never been made quite clear. Nor is it clear that the Bank really does possess the capacity to do what needs to be done.

20. If the Baker Plan is seen essentially as revolving around programs developed jointly by the Bank and Fund, the Bank's central role should shift from stressing Fund type policy issues (such as interest and exchange rates, trade and tariff policy and subsidy issues) except insofar as they relate to distortions in key sectors and prices in the economy. The Bank should leave these issues to the Fund not because they are less important or significant but because the Fund is better equipped to deal with them. The Bank's perspective on these issues can refine and temper the Fund's positions but the Bank should not invest a great amount of its own resources in duplicating and second-guessing the Fund's capabilities.

21. Conversely, the Bank should lead on structural adjustment issues through focussing on the crucial importance of reshaping public expenditure and investment programs. It is clear now, that in all heavily indebted countries, stabilization through corrections in the macro-aggregates is likely to be short-lived in impact if it is not followed through by enduring structural change. Such change can only be brought about and reinforced by changes in fiscal measures; first, by correcting major imbalances between recurrent and "development investment" expenditures in indebted country budgets and second, by re-orienting both public and private investment priorities across and within key sectors of economic activity.

22. The major policy issue here for the Bank to grapple with effectively, is to bring about a shift in investment and operating efficiency burdens from the public to the private sector wherever possible. Equally important is the urgency of ensuring that public resources are concentrated on optimal and essential infrastructural and social investments. In most developing countries this shift can only be brought about through a gradual, pragmatic approach which stresses that particular country's realities.

23. It is in achieving these changes that the Bank has a unique advantage and capacity which must be brought to the fore. No other institution, private or public, has the knowledge, the richness of experience, the familiarity with the economic, technical and financial issues, or the ability to deal with the key institutional development problems which the Bank has. These skills have been developed and honed, over forty years, in the context of specific investments. They need to be broadened and enhanced if the Bank is to work effectively when the COUNTRY itself becomes THE PROJECT.

24. THIRD, IN A RELATED CONTEXT, THE BANK MUST COME TO TERMS WITH THE PRESENT CONFUSED MANNER IN WHICH IT APPROACHES AND DEALS WITH THE PRIVATE SECTOR AND THE INTERFACE BETWEEN PUBLIC AND PRIVATE SECTORS. IT MUST EMPHASIZE LENDING AIMED AT PRIVATIZATION AND INDUSTRIAL RESTRUCTURING OF LARGE-SCALE PUBLIC ENTERPRISES IN PRODUCTIVE SECTORS AND IN SERVICE SECTORS, WHERE PRIVATE CAPACITY TO TAKE OVER EXISTS. IN DOING SO IT MUST WEAVE INTO ITS OPERATIONS THE CAPACITIES AND FUNDING ABILITIES OF THE PRIVATE, INTERNATIONAL INVESTMENT BANKING COMMUNITY AND OF MAJOR MULTINATIONAL ENTERPRISES.

25. Ever since the establishment of IFC in the mid-1950's the Bank Group has been bedevilled by not quite knowing: (a) how to deal effectively with the private sector in developing countries; and (b) how to influence the behavior of developing country governments toward the private sector. Nor has the Bank Group developed a well-established and close set of working relationships with the international business community in the same way that it has with governments in both industrial and developing countries.

26. The present unhappy arrangement has resulted in the Bank being able to provide appropriate macro-level policy advice and IFC continuing to be able to execute individual deals. There remains a large vacuum in between these two levels of operation. Neither institution works particularly well with the other. Neither can do the job on its own. And neither has had the kind of impact on influencing not just government policy (in which there have been some notable successes) but actually changing the behavior and mind-set of government bureaucracies in dealing with the private sector. Interestingly, the Bank's main interventions in assisting private enterprise in developing countries has been through domestic financial intermediaries (often publicly owned) which are often regarded by IFC as competitor's for its own business.

27. The Bank must address this issue simultaneously on both of two fronts: (a) cleaning up organizational and working arrangements within and between the Bank and IFC; and (b) acquiring staff skills which understand and know how to deal effectively with private business. Present working arrangements and the division of labor between Bank Regional staff in the Industry & Finance Divisions; in the central Energy & Industry Staff and IFC departments need to be carefully re-examined.

28. There is a case for the wholesale transfer of ALL staff in these areas to IFC, with IFC acting as a major sub-contractor to the Bank. Given IFC's presently limited management resources and abilities, as well as its precarious financial position, this may not be immediately feasible. The more workable, if less satisfactory, immediate alternative may be to regionalize within the Bank all EIS staff in the operating divisions and to incoporate within Operations Policy Staff, the remainder who focus on policy.

29. The present unsatisfactory state of affairs is highlighted by the Bank and IFC's apparent inability to move quickly and decisively on the "privatization" front. If the Baker Plan is to work, the Bank will need to put some weight behind a systematic effort to assist in moving a large number of public enterprises into the private sector in virtually all the countries on the Baker list and in others such as Pakistan, India etc. as well. It will need to do so in a carefully planned manner which attempts to achieve multiple objectives: reversal of capital flight; reduction of the public budget burden; improved management and financial performance; achievement of international competitiveness; attraction of foreign investment and technology; adoption of appropriate labor and wage policies; promotion of domestic private investment; and improving the capacity of the local capital market to handle the securities aspects of privatization to broaden ownership and participation.

30. At present, the Bank and IFC are gingerly attempting to scratch the surface of this massive effort with a few tentative forays into the field. Neither institution has geared up for this effort through adequate preparation. Neither has seriously engaged developing country governments in an intensive dialogue on the issue which can be translated into lending and investment programs within which the Bank and IFC can mobilize the necessary equity and debt resources, both foreign and domestic, to address this problem on a global scale. Neither has built up the relationships with private intermediaries and investment/merchant banks to tackle the massive and complex issues/problems that will inevitably be associated with such an endeavour. There is much to be done. Both institutions need to organize themselves more effectively. They must be prepared to commit the staff and budget resources that will be needed for the privatization initiative. In neither case is there a need to add to organizational budgets for this purpose, what is needed is an imaginative redeployment of existing resources aimed at putting them to more effective use.

31. FOURTH, THE BANK SHOULD URGENTLY TACKLE THE TASK OF RE-ORGANIZING THE OPERATIONS COMPLEX IN A MANNER WHICH REMOULDS THE STRUCTURE TO MEET CURRENT RATHER THAN PAST NEEDS. At present, the organization structure of Operations induces diffusion and opacity of responsibility and authority making effective managerial delegation down the line, to achieve COUNTRY ASSISTANCE goals, a near impossible task. The extant structure was designed to facilitate the production and quality control of PROJECTS. It is ill-suited to focussing on country assistance. Macro-economic analysis and Sector Analysis skills need to be organized within a DEPARTMENTAL context, with Operations Departments being Country-Focussed, and with analytical skills/staff at the micro-project level being centralized. [A separate paper with detailed suggestions on this issue has been prepared.]

32. FIFTH, IN DEALING WITH THE HEAVILY INDEBTED COUNTRIES, THE BANK SHOULD MAKE MUCH MORE EFFECTIVE USE OF STAFF RESOURCES AND SKILLS WHICH ARE AVAILABLE OUTSIDE THE OPERATIONS COMPLEX, PARTICULARLY IN FINANCE, THAN IT IS PRESENTLY DOING. With the unveiling of the Baker Plan there has been a tendency to confine all activities relating to these countries within the ambit and control of Operations management. While there can be no quarrel with the propriety of maintaining clear division of responsibility between the major organizational units in the Bank, the very nature of the task of dealing with the indebted countries successfully requires a multidisciplinary approach which combines the efforts of the best talent available in the Bank, wherever it might be located. That unfortunately is not the case today. Bureaucratic concerns are intruding on and obstructing the effective participation of staff with appropriate skills in financial engineering and the use of market techniques and instruments in debt management.

33. There is also some confusion and dissembling on the part of the Bank in its dealings with the commercial and investment banking communities on the indebted countries. The Bank has not organized itself very effectively; various managers have taken an ad hoc independent approach in expressing the Bank's general views on the debt crisis and even in expressing opinions in individual country cases. The "visibility" of this exercise has triggered an unhealthy reaction on the part of many managers attempting to attract the spotlight.

34. For these reasons, the Bank has not yet managed to command the same degree of respect and the same reputation for professionalism in the private financial community as the Fund managed to do in the first phase of the debt crisis. It is

imperative that this situation is quickly corrected. Given the responsibility that the Finance Complex has in dealing with global financial markets and commercial banks on a daily basis and with the authorities of the principal creditor (industrialized) countries, there is merit in considering a shift in the locus of responsibility for the "financial engineering" and "debt management" aspects of the Baker Plan to Finance. For the same reasons, consideration should also be given to relocating the Co-Financing Program in Finance in keeping with the main responsibility which that Complex has for resource mobilization. This shift in the allocation of organizational responsibility would also facilitate a more effective working relationship between Finance and Operations at staff and management levels.

CONCLUSION

35. If the World Bank is to fulfill its mandate as the central hub around which the key elements of the Baker Plan must work, it needs to take swift action on several fronts. It needs to work more effectively with the Fund and with its developing country clients in developing credible and effective programs of adjustment with growth. It needs to work intensively with industrial country governments in co-opting their efforts, and improving their understanding of the unfolding situation, on both the financial and trade fronts. It must develop quickly the capacity to work with and mobilize the energies of the private sector, foreign and domestic, to revive the process of productive investment and promote the efficient management of resources. Simultaneous action on all of these fronts is essential to quell doubts and restore confidence in the viability of the Baker Plan. For the Bank to do any of these things successfully it must, first, put its own house in order.

Topic V. Debt & Development.

Since this topic is one with which you are by now overly familiar it seems a little silly to attempt imparting further wit and wisdom. The following is therefore confined to answering the questions which have been framed for this Topic. [Incidentally the readings offered here, after the rich diet enjoyed by us over the last four years, are rather pitiful].

Q1 The debt crisis remains extremely serious - as is the complacency which has set in simply because we have been lurching from one day to the next avoiding disaster by increasingly thinner margins.

The thing is that the debt crisis today is MORE serious for the debtors than it has been over the last four years and, somewhat assymmetrically, it is a bit LESS serious for the commercial bank creditors.

The reason for this assymetry is simple. Concerned with a financial collapse in the first phase of the debt crisis, global authorities took actions based on the assumption that additional liquidity infusions accompanied by austerity based stabilization would turn the situation around.

It did for the commercial banks who were promptly paid debt service (at least interest) from the additional liquidity as a result of which their income statements were protected and their reserves against losses steadily built up. It did not for the debtor countries whose economies kept contracting while their debt kept piling up.

The upshot is that after four years of a prolonged debt crisis the commercial banks are better placed than ever to withstand a hit on their balance sheets and protect capital. The debtors on the other hand have increased their overall outstanding debt burden by about 40% over 1982 levels. None of this increase has added to their capacity to repay debt. It has simply enabled them to keep barely current with interest and survive. Their capacity to repay, with perhaps the exception of Brazil, has been weakened. They face the paradox of servicing a debt burden which is 40% higher with economies that are perhaps 10% smaller than in 1982. In the case of the indebted oil-exporters (Mexico, Nigeria, Ecuador, Peru etc.) their capacity to repay has been weakened by far more than this relatively simple arithmetic would indicate.

Put in this context, the Baker Plan is not on schedule. It would be excessively sanguine to pretend that one can now see the light at the end of the tunnel for any of the major debtor countries. Indeed one doesn't quite know how long the tunnel is or precisely at what point we are located in it.

In a more limited sense, the Baker Plan is being implemented slowly but surely. The World Bank has attempted to get organized with fast-disbursing policy based lending in most of the 15 Baker countries. But, most of what has been done so far involves a focus on reform at the sector level. There have been relatively few large scale structural adjustment lending operations embracing the kind of economy wide reform envisaged under the Plan. Also, the commercial banks have not quite come along for the ride despite their expressions of support.

Again the reasons are relatively simple. Neither the debtor countries, nor the commercial banks are fully confident that the economic prescriptions being written out for reform will work. After a dose of strong medicine administered by the Fund over the last four years -- which has not worked in the way anticipated -- the debtors are understandably skeptical about these prescriptions. Especially so when they carry an ideological flavor contrary to their traditions. It is not at all clear to the debtor countries (nor to their creditor banks) that they can sustain further resource shifts into the trade sector when world trade is stagnating and protectionist pressures in major markets are mounting. They are running out of domestic political rope to keep diverting resources away from the domestic economy to pay debt service for the indefinite future.

Nor is it clear to the financial community -- after four years of following the prescription -- that the way to solve the debt problem is by ADDING ON MORE DEBT on the backs of countries with a demonstrated INCAPACITY to bear further increases in their debt servicing burden. That approach works only when debt servicing is constrained by liquidity rather than by structural problems. It is by now clear that the debt problem is NOT a liquidity problem.

Recent declines in oil prices have benefitted some debtors to the serious detriment of others -- it has probably worsened the picture as a whole as far as the debt problem is concerned -- Mexico came close to bringing the system crashing down once again! Declines in interest rates have certainly helped all debtors. But, those benign factors are being offset by a much more sluggish global economy than had been hoped for, with the consequent stagnation of trade flows -- a pillar on which the debt strategy is critically dependent. The decline in the dollar has not helped to improve the situation much -- it may even have increased the burden for some debtors who earlier translated dollar debt into lower nominal cost currencies.

With this backdrop it is difficult to be optimistic about the revival of commercial bank flows to levels anywhere near adequate to reverse the negative net transfers currently taking place. Even if such commercial flows were taking place, their desirability would be doubtful. They would almost certainly result in continued rapid escalation of debt burdens beyond already unsustainable levels. Under present circumstances, without further reductions of global

interest rates and a revival of solid medium term global growth it is unlikely that either export earnings or capital flows will be at levels sufficient for the debt strategy to work. It may be possible to revive growth in these countries by emphasising the domestic sector more -- but that is not the kind of growth which permits external debt service to be managed.

The somber conclusion of this logic is that negative net transfers have to be reduced somehow -- and eliminated if possible -- but it is increasingly apparent that it would be more productive to try and achieve that through a reduction in existing debt service burdens rather than through additions to debt. This means several things. It means considering proposals like the Bradley proposal much more carefully without dismissing it as a debt-relief or write-off scheme. It means implementing simultaneously many of the innovative financial re-engineering proposals which have been put forward for: debt-equity swaps (the market for which could be substantially expanded through aggressive privatization of many state-owned enterprises in debtor countries); securitization of debt which would shift the burden away from commercial banks to independent risk takers; export revenue linked debt-servicing schemes; structuring organized markets for long-term rate caps and currency/interest rate swaps and so on.

In the past many of these schemes have been evaluated by criteria aimed to determine whether they offer general panaceas to the global debt problem. Those criteria are probably the wrong ones to use. The time has come to develop and implement a wide variety of these schemes combined differently in various packages as individual debtor country circumstances warrant.

The prime objective of these schemes should be to prevent the erosion of nominal asset value (from the viewpoint of the creditor) and to reduce the annual debt service burden associated with these assets - or at least link the burden to actual export earning capacity in some suitable way. A secondary objective should be to restructure the asset characteristics of the extant outstanding debt in ways which makes it more amenable to financial market preferences and which makes the return from these assets more dependent upon longer term rather than immediate performance .

Q2. Political or economic disturbances which compelled one or two large debtors to declare unilaterally that they would only pay what they could afford regardless of debt service owed could precipitate a major crisis. In other words a major crisis would be triggered were Mexico and Brazil, individually or together, to declare that the debt strategy was not working for them and they could no longer make the political choices necessary to protect the interests of foreign creditors above those of their citizens (i.e. do a Peru). Or it could be triggered by three or four smaller debtors (the Philippines, Argentina, Chile, Colombia for example) doing the same thing.

The consequence for the international financial system would be an immediate loss of depositor confidence in the major money-center banks followed by a run on banks of the Continental Illinois type. The US credit system no longer has the safety-net capacity to cope with such an outcome short of emergency legislation to cover a run. The FDIC is overextended with the CONILL rescue and with over a thousand smaller regional banks; the savings bank safety net is overextended as is the farm credit system.

Such a run could, therefore, extend into a panic over the quality and value of financial securities and instruments in general, particularly those issued by multilateral development banks or by any agencies dealing with developing countries. It would affect the market value of stocks of corporations doing business in these countries. It would immediately disrupt all trade financing arrangements with hardships falling equally on exporters in the industrial world as on the defaulting debtors.

In short, while the global system may have the capacity to take an annual hit of about $20-30 billion a year in a $1000 billion LDC debt portfolio, it certainly does not have the capacity to take a sudden hit of even $200 billion being written off or provided for in one shot. Hence the need for financing arrangements which will gradually begin to reflect the "market value" of this debt rather than its book value. Nor can the major industrial governments -- overextended as they are in their own credit markets -- finance even a significant fraction of this burden and take it off the back of the commercial banks. It is imperatve therefore, that the size of this total burden be gradually reduced.

Q3. As is implicit in the foregoing, the answer to Question 3 is resoundingly in the affirmative. Whether governments can or should promote an international program to limit debts is doubtful. What they should do is declare a preparedness to consider various options within a "general framework" for re-engineering the debt burdens of individual countries in ways suitable to their circumstances.

These options should, as noted above, have the objective of substantially reducing annual debt service burdens to a level of almost eliminating negative net transfers in some countries for at least the next 5 years.

The Bradley proposal had scorn poured all over it because of an ostensible aversion to writing down principal on the basis of upholding contractual sanctity. This is a bit peculiar to understand. It is also a double standard because commercial banks do it all the time in the case of corporate clients . If one can accept that corporations can go bankrupt, and may need to be restructured, it does not take a great intellectual leap to realize that countries can too. If commercial banks are prepared to write down corporate debt because of bad credit judgements, what is so different about country debt? Why should commercial banks not be subject to the same discipline for exercising bad judgement in these

cases?

In fact, many commercial banks have indeed been effectively writing down the principal of their LDC debt portfolio by stripping off and selling their LDC loans in the open market for between 30-70 cents on the dollar -- often resulting in speculative yields of over 30% to some risk-takers. In this transaction, although the commercial bank has effectively taken a write-down, the benefits do not accrue to the debtor who is still obliged to service interest -- on the full face value of the principal amount -- to the commercial bank as lender of record. Why not devise schemes which at least "split-the-difference" between the speculative beneficiaries of creditors willing to sell loans and debtors who are hard pressed to service them?

Taking all this into account, YES new policy approaches on the part of industrial country governments are needed. They need to show a great deal more flexibility in acknowledging that adding to the egregious burdens of debtor countries does not make sense. They need to moderate their "case-by-case" rhetoric in not using that phrase as a mantra to prevent the application of imaginative schemes on a cross country scale. For instance, some debt securitization schemes may work quite well if the basic asset consisted of a "pool" of LDC loans -- thus spreading the risk -- than simply a single LDC loan. They need to accept that they may need to take action to bolster the capital bases of smaller banks which are exposed (by putting up low-interest, long duration subordinated notes in the form of quasi-equity in these banks) till they have restored their capital values over time. And, they need to be far more forthcoming in expanding the capital bases of the MDBs for these institutions to take on a greater proportion of any incremental outstanding debt on considerably extended terms.

Q4. A package has just been structured for Mexico which attempts to meet its immediate financing needs -- it is not yet certain that the commercial banks will take up their full amount. The package represents an extraordinary compromise and does not entail features which necessarily prejudice the dialogue on debt with other debtors. It does however concede the inevitability of tailoring debt service to accommodate export revenues particularly in the case of dependence on critical, yet highly volatile, oil prices. It seems likely, that this principle will become an increasingly prominent feature in future debt rescheduling and refinancing packages.

But, the lowering of interest rates has led to a discomforting sanguinity. Neither debtors nor creditors are pursuing, as aggressively as they should, options to convert floating rate debt into fixed rate and to stabilize their debt service payouts through various market techniques. Nor are they pursuing options to match the cash flows of their export earnings and debt service payments in ways which minimize their exposures to exchange risks. These financial engineering arrangements should be receiving far greater attention especially at a time when financial costs are declining.

Q5. It would be unrealistic to expect the kinds of increases in private capital flows - expecially equity flows whether direct or portfolio - either from foreigners or from residents repatriating flight capital anytime soon. The simple expedient of swift policy changes will not accomplish that result except over time when investors -- who have been badly burnt all too often -- begin to realize that these changes are durable and likely to be permanent. The political situation in most of these countries is too fluid to encourage risk taking and no amount of insurance coverage against that sort of risk will really turn the situation around. Moreover, foreign investors and flight capital holders need to be convinced that the economic problems caused by intolerable debt burdens are likely to be solved. There is at present no assurance of that. It would also be remiss of anyone to underestimate the discouraging impact on foreign investment of inadequate infrastructure, poor telecommunications and transport facilities, the absence of service infrastructure (i.e. adequate legal, banking, accounting/auditing, market expertise, and business consulting support) and the prospect of dealing with excessive government bureaucracy. The gap between developed and developing countries in foreigners' willingness to put up with these petty irritations (and the resulting large costs in money and time) has grown considerably and has a far greater effect on impeding foreign investment than policy makers generally recognize.

And, special arrangements such as investment incentives in select industries have now outlived their usefulness as the competition in offereing these incentives has negated their effects. Businessmen would much rather have open regimes, free of bureucratic intervention, than special privileges which can be removed anytime. Nonetheless there are some successful schemes for attracting external capital which deserve further consideration. India, in particular, has devised a scheme for non-resident Indians to keep foreign currency accounts in India and to operate associated domestic currency accounts with a great degree of freedom. There are also tax exemptions and full convertibility/repatriation rights on capital gains or dividend distributions arising from either direct or portfolio investment made through these accounts. These arrangements have resulted in a steady flow of around $2 billion partly accounted for by returning flight capital. Schemes such as these, combined with privatization of successfully operating state-owned companies, do offer worthwhile options for reducing overall debt burdens, especially for example i countries such as the Philippines.

Measures such as tax amnesties for returning flight capital, however, tend to have fairly serious detrimental effects over the long term in rewarding illegal actions. They are poor substitutes for an overhaul of the general policy regime in a direction which makes it hospitable to holders and earners of wealth.

Q6. Obviously! What an incredibly silly question.

Q7. The kinds of policy changes needed in developing countries to improve growth prospects are all too familiar to you to require further elaboration here. They can always be made politically possible if leaders are willing to lead and providing populations can see that these measures, unpalatable though they may be, will improve their lot -- or failing that, the lot of their children -- at some time in the foreseeable future. It is when leaders are unwilling and people are unconvinced that these changes will result in improvements that the politics become impediments to progress. Unquestionably, and most particularly in Africa, there is a serious issue raised by policy reform in that it affects the interests of the urban elites -- who generally keep rulers in power in relatively fragile societies -- in favor of rural producers. Even so, it is clear that change is possible once leaders are convinced that their policies have failed and they have no other choice.

Q8. Yes. India and China should be gradually weaned from concesional aid. The process had already begun in the early 1980s. It was, however, extremely unfortunate that it was triggered in such a nasty and unhelpful way. Both countries are reaching the point where they are beginning to see the negative aspects of keeping the "begging bowl" extended as they begin to deal with industrial countries on equal (if not stronger) political terms. Being "dependents" diminishes their stature in ways which these countries themselves are beginning to see quite clearly and they are uncomfortable with prolonging that situation.

A balance needs to be struck, with the consent of India and China, in formulating a weaning process which does not suddenly endanger their own debt situation. The world can do without India and China becoming the Mexicos and Brazils of the next decade. The Bank itself -- which provides the largest amount of concessional assistance to these countries -- has been moving in that direction through the blend process. The pressures applied in the context of IDA7 were more disruptive and counterproductive rather than helpful in pursuing that course smoothly.

The point is often lost that it is the foundation of comfort provided by concessional flows that have enabled these countries, India more so than China, to become strong creditworthy borrowers. A continued, if gradually diminishing, flow of concessional resources actually enables these countries to borrow greater amounts commercially than they could otherwise comfortably do. And they need all the external capital they can get just for their infrastructural investment programs which offer substantial export and employment opportunities for the industrial countries.

Taking everything into account, it would not be unreasonable for the donors and these two large recipients of concessional aid to agree that IDA flows (i.e. commitments, not disbursements) to them should be phased out by 1995 i.e. during IDA 10 -- assuming that IDA keeps being replenished as before. This could be achieved by continuing the present process of gradually reducing the combined

share of India/China (it was under 40% in IDA7) to about 27% in IDA 8; 20% in IDA 9; and 15% in IDA 10, with total phaseout thereafter.

However, this phaseout should be paralleled by increased access on the part of these two countries to the hard window resources of the IBRD, AsDB and the OECD export credit agencies. It should also be accompanied by preferential access to developed country markets. Such measures would make it far easier to reach mutual agreement that concessional flows should be phased out over a definite time span in a well-thought out manner.

Q9. The relatively greater "trade deficit burden" which the US bears with developing countries vis-a-vis Europe and Japan has already been discussed earlier in Topic IV.

While noteworthy, there is something peculiar about introducing the notion of "fair burden sharing" in the trade field as well -- as if developed countries were again doing the developing countries an immense favor by trading with them. That goes against the grain of what free markets are all about. The process of trade is a business process in which both buyer and seller see a common advantage -- if they did not, trade would not occur. To free a market for access to the cheaper and more efficient seller is not doing anyone a favor, even if in this insanely configured world it may seem so.

The burden sharing issue is crazy enough in the aid debate and has been carried to the point of making virtually no sense; it only provides a crutch for donors to avoid doing what they can. It is therefore dangerous to introduce this kind of element into the trade debate -- because it is always tempting to carry it too far. Also, the US should not be developing yet another excuse for its pathetic peformance on the aid front.

Nonetheless, regardless of the burdensharing question, the point should be taken that Europe and Japan are not trading as much as they should be with developing countries (of course, such trade may directly compete with US exporters for instance in agriculture in these markets). What should be done about it? Precisely what should be done by Europe and Japan in opening up their walled-in markets generally. There may be a case for preferential access for African exports to Europe and "poor-Asian" exports into Japan with Europe and Japan actually providing direct help to these areas in penetrating their markets. This would involve direct action by the large Japanese trading companies in particular.

THE WORLD BANK
Washington, D.C. 20433
U.S.A.

BARBER B. CONABLE
President

August 25, 1986

Mr. William R. Rhodes
Chairman, Restructuring Committee
Citibank N. A.
399 Park Avenue
New York, New York 10022

Dear Bill:

Thank you very much for your letter of August 5th with its attachment. As I told you, I am committed to a strong role for the World Bank in trying to resolve the problems of growth and debt in highly indebted middle income countries. The World Bank has been playing a greatly enlarged role in helping to formulate acceptable medium-term growth oriented adjustment programs and in financing them and I expect that we will further expand our efforts. In this we have been collaborating closely with the International Monetary Fund, the official sources of bilateral finance, and the commercial banking community, and we will continue to do that. We are very appreciative of your own efforts to strenghten our collaboration with the commercial banks to make sure that, together, we provide the most effective support to the highly indebted middle-income countries in dealing with their current economic difficulties.

You raised in our conversation and in your letter a number of issues, specifically in the context of the current Mexican situation. Although these issues are of general relevance let me comment on them using Mexico as an example.

As you know, in the case of Mexico we will contribute to the 1986-87 program by substantially increasing commitment and disbursements. The latter are estimated to be $2.3 billion which will constitute a very large increase in our exposure in Mexico. We have also, as you are aware, been working actively with the Government of Mexico for the past two years to help them formulate the structural adjustment program which we will support over the next 18 months with individual operations. In the course of our work we had frequent contacts with you and your colleagues on the nature of the problem and on the program objectives that the Mexican government was developing. Some of these objectives, such as those in the trade area and interest rate structure, have already been incorporated in agreements with the Bank. In other areas of the program, such as debt/equity swaps and the accelerated treatment of foreign investment applications, both of great concern to the international investment community, significant progress also has been made. I believe therefore that the first two objectives -- increased World Bank lending and adequate consultation -- have been amply met in the case of Mexico.

In other country discussions, which are now ongoing or which have taken place in the past year, such as those on Nigeria, the Ivory Coast, Colombia, and Chile, I believe that our collaboration also has been

satisfactory. There has been ample opportunity to exchange views both on the terms and composition of the financing packages as well as on the substance of the programs which are to be financed.

However, you also raise other aspects which relate to the collaboration between the commercial banks and the World Bank, i.e., sharing of payments and cross-defaults. While we need to collaborate effectively in each of these highly indebted middle-income countries to try and resolve their problems we also must recognize that the nature of the various financial institutions involved is different and hence their contributions will be different. The International Monetary Fund, the World Bank, the export credit agencies all operate under different mandates, have different objectives and different legislative frameworks. And these differ from the operating frameworks of the commercial banks. I do not believe it will be helpful to our discussions to ignore these differences. These matters have been discussed at length with you and your colleagues on previous occasions and I do not wish to go into great detail. But, let me make three points.

First, the Bank will be a much more effective partner, and will be able to enforce its conditions more effectively, if it is seen by its borrowers as a development institution rather than another commercial bank. We must retain the flexibility to decide for ourselves when defaults and performance failures warrant suspension of disbursements and we must be able to decide what other remedial actions might be appropriate. To take the other course, i.e., to link our actions formally and mechanically to the decisions of others, would seriously undermine our relationship with all our member countries. This would not be in the interest of the World Bank or of the commercial banks. It would make it impossible for us to work with countries to remedy performance problems and to take additional measures when necessary. And it is precisely this that is essential if adjustment programs are to be effectively implemented.

Cross-default provisions will be <u>a less effective</u> not a more effective way of getting countries to implement the difficult programs of adjustment which lie ahead. Our key role, which will benefit the borrowers and the financial institutions involved is, together with the Fund, to convince countries about the need for growth-oriented adjustment programs, to help shape the content of the programs in light of available domestic and external resources, and to help monitor implementation. To play this role effectively the Bank must have the trust of the borrowers as a development institution proferring independent professional advice. While we need to be firm about the need for change neither we nor you can afford to be inflexible and mechanistic about assessing performance. There are too many uncertainties, as our experience with previously negotiated adjustment programs shows, to place undue confidence in our ability to be precise about developments in any country over a four-year period. That means that we must be ready to participate with the country, and with the financiers, to adjust programs as domestic and external circumstances evolve. The Bank and the IMF will monitor compliance carefully and we will of course refuse to disburse on tranches of adjustment loans if the borrower is not in compliance.

Second, the World Bank is increasing its net outstanding rapidly in all the highly indebted countries with effective adjustment programs. And I expect that this will continue if these countries continue to make progress. In the financing packages which have been agreed to to-date for such countries, including the Mexican one now under discussion, there is, I believe, a reasonable relationship between the increase in our net exposure, and that of the commercial banks and other sources of finance. Having agreed on our relative contributions it would not be appropriate for us to then agree to take further share of the risk of commercial bank contribution. We believe there is a common interest in making sure that the highly indebted countries can resume growth, to service their outstanding debt and begin to reduce the debt service burdens. It is in the careful implementation of agreed growth oriented adjustment programs that the security for the commercial bank lies rather than in any formal "protection" that the World Bank could offer through cost-sharing or cross-default arrangements. Because the total outstanding commercial bank debt is a multiple of World Bank exposure any such linkage would, if difficulties arose, only result in forcing the World Bank into rescheduling operations. This will not increase the resources available for payment to the commercial banks significantly. But it will mean that the World Bank would not be able to continue to operate as an effective financial institution at lending levels, and hence with the influence, that the current situation demands and that the commercial banks are seeking. I therefore believe that these kinds of linkages, while they may appear attractive on the surface by offering security, serve in fact no useful purpose; indeed, they will reduce the probability that effective growth-oriented structural adjustment programs will be agreed to and implemented.

Third, I want to stress that it is important to retain flexibility in the system because of the unpredictable nature of future events. This is a view which is strongly shared by the Managing Director. There must be sufficient coordination between the various sources of financing to ensure the country adequate support for agreed growth-oriented adjustment programs and to provide each one of us an opportunity to carefully consider the implications of changed circumstances, whether due to non-compliance with an agreed adjustment program or to external circumstances beyond the control of the country. But it would be seriously disruptive of the system, which has worked so well, to design linkages which will make all financial flows come automatically to a halt in case of unforeseen difficulties. This can only lead to highly undesirable disruptions in the borrowing country and to the kind of confrontations which none of us wish. Should we have such a rigid system it would put extraordinary pressure for reaching decisions not only on the borrower but also on the financial institutions. There will be no time to consider remedial actions carefully and to assess which actions can be implemented most readily in the political and parliamentary framework of the borrower. That is not to suggest that the Bank, and the Fund, should not be firm on insisting that the program will be implemented as agreed. We have been and will continue to be, because effective implementation is in the best interest of the country and its creditors.

But I understand the interest of some banks to be associated directly with specific aspects of the adjustment programs. We welcome this interest since these structural changes are indeed central to Mexico's

medium-term prospects. As you know, we have therefore suggested, subject to discussion with the Government, that the commercial banks consider associating their financing with specific World Bank operations which will incorporate the core of the adjustment measures which the Government of Mexico has decided to undertake. In joining in the financing of these operations the banks would know the destination of their funds, the support they are providing to specific policy changes and that the operation has been carefully designed by the World Bank and would be monitored regularly.

Mexico's agreement with the Fund, the agreement on the policy changes to be undertaken in the course of the next several years as announced by the Government of Mexico and to be supported by the World Bank, the financing arrangements involving all sources of credit, the monitoring which both the Fund and the Bank will do, and the commitment of the Government of Mexico provides a framework for resolving Mexico's problems in the medium-term with ample opportunity to assess the progress which is necessary if Mexico is to achieve its objectives and to maintain and enhance the confidence of external lenders. This seems to me to be the appropriate way of having the Bank and the Fund collaborate with the commercial banks and the bilateral sources of finance in helping the highly indebted middle-income countries deal with their medium-term problems.

As you know, in countries other than the highly indebted countries we continue to welcome cofinancing opportunities and are pursuing them vigorously. In those circumstances we continue to be prepared to join in syndicated loan operations with the commercial banks which provide a closer degree of association than is feasible or desirable in the context of specific adjustment programs. We also stand ready, of course, on a case-by-case basis to use our guarantee authority selectively as we have done most recently in the case of Uruguay.

Best regards.

Sincerely,

Barber B. Conable
President

cc: Mr. E. Gerald Corrigan, President
Federal Reserve Bank of New York

Mr. John F. McGillicuddy, Chairman & CEO
Manufacturers Hanover Trust Company, N.Y.

Mr. David C. Mulford, Assistant Secretary
International Affairs
Department of the Treasury, Washington, D.C.

Mr. John S. Reed, Chairman
Citibank, New York

Mr. Paul Volcker, Chairman
Federal Reserve Systems Board, Washington, D.C.

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Should this be circulated – at least to Ernie & Moeen?

B

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THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

212

DATE: August 22, 1986

TO: Mr. Barber Conable

FROM: Jose Botafogo G.

EXTENSION: 7-2466

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SUBJECT: Commercial Banks and the External Debt in Latin America. Role of the World Bank.

During my recent trip to Brazil and Argentina I saw a number of people in both the public and private sectors in Rio, Brasilia, S. Paulo and Buenos Aires.

Although the purpose of my visit was to get support for MIGA in these two countries, I arrived there in the aftermath of the political and economic agreements signed between Brazil and Argentina, and Brazil and Uruguay.

2. General discussions naturally focussed on the future implications of these accords and the possible short-term consequences of the political coordination between the Heads of State of those countries in the negotiation of the external debt of Latin America.

3. I was struck by the resurgence of talk about unilateral actions which debtor countries in Latin America might take in their dealings with commercial banks, and the opportunity to do it now because first the Presidents of those three countries are working together so well, and second because, according to this line of thinking, there are no other viable alternatives to cope with the heavy debt service issue.

4. What struck me more were the comments made by those who oppose any idea of unilateral action on the debt front. They feel that the chances that Presidents would further politicise the debt issue are increasing dangerously as a method to compensate for the troubles they are facing internally with the implementation of the Austral and Cruzado Plans. They said that cooler heads and responsible advice from senior economic officials may prevail but they feel that time is running out and that the politicians in the Cabinet may win if the issue comes up for discussion.

5. For those who support unilateral action against foreign creditors the theory runs as follows:

- the restoration of a creditworthiness approach by debtor countries is still the most valid theoretical one as the resurrection of a voluntary lending

market by private sources would provide the necessary capital flows to support sustainable growth;

- however, while some of the elements of this approach are being worked out by debtor countries, especially in the field of economic policy reforms and structural adjustments, other elements to be developed by external players are showing an unacceptable lack of progress;

- the missing elements of a comprehensive successful strategy are a resurgence of growth in the world economy, support from commercial banks and world trade expansion;

- even with the most optimistic assumption for successful MTNs, the effects of them in actual trade expansion will take many years to materialize. More realistically, industrial countries are not seriously committing themselves to any reasonable program of stand-still or a roll back of protectionism. Worse, some recent initiatives by the U.S. (subsidized wheat sales to the Soviet Union) will further aggravate the situation of commodities exports by Latin American countries in an already very depressed market. In addition growth in the industrial countries is slowing down;

- commercial banks, while paying lip service to the Baker initiative, are not prepared to increase their exposure to the highly indebted countries. They may reluctantly agree to participate in some important and crucial "rescue" operations, like the recent Mexico package, but voluntary lending, even inside the framework of the Bank's supported policy based loans (like the power sector loan to Brazil) is not foreseeable in this century according to bankers;

- in other words, if additional borrowing is not a workable solution, the only way left is the reduction of debt service, or more precisely the reduction of payments on the interest account;

- from a conceptual point of view, a reduction in the interest account would be beneficial both to debtor countries and commercial bank creditors. For LDCs

more resources would be available for productive investments. And for the banks, they would be relieved of the obligation to disburse new money;

- the remaining question is: who is going to take initiatives in this field? Governments of industrial countries have already said they do not want to twist the arms of commercial banks, or to be seen as baling them out. Commercial bankers themselves are constrained either by regulations or by their own boards or shareholders. So it remains up to the debtors to take the initiative and provoke a "de facto" situation that after all will benefit everybody.

6. As for the role of the World Bank in this process, there are now two basic schools of thought in Latin America. Both agree that the Bank has been very helpful in the recent past in providing resources for development, and is today and will be in the near future the only institution capable of recycling new money from the private capital market to their economies.

7. These two schools of thought differ, however, in their view of the scope of the Bank's role in dealing with the debt problem. One group of people is reluctant to see the Bank playing a central role in it. They believe the Bank's involvement in macro-economic issues is reaching saturation point, which would make it politically difficult for Latin American governments to effectively sell structural reforms internally. The other group see the lack of an adequate level of capital flows as a major obstacle to development. As a consequence, the Bank should play a catalytic role in providing the international financial world with new initiatives or mechanisms capable of restoring the adequate flow of capital to the developing world, especially from private capital markets. The underlying assumption is that there is liquidity in this market and a basic willingness to recycle this liquidity to LDCs. But, given the bad experience of the seventies, these resources have to be channelled through a universally accepted international organization, like the World Bank, in order to make sure that the new money would be available to match the implementation of growth-oriented strategies defined by the LDCs and supported by the Bank. Macro-economic conditionalities are not an issue, according to this school of thought. On the contrary, they are welcome as the countries need to implement structural reforms anyway, irrespective of the Bank's support. Certainly, one has to make sure that conditionalities are not seen as being imposed by an outside partner, but freely adopted by the government concerned. The role of the

outside partner is to help the government to implement the policy changes through technical advice and financial assistance.

8. In informing you about these perceptions in South America, I want to suggest to you that perhaps the Bank should revisit the issue of relationships with commercial banks. The fundamental question which we would seek to answer in this exercise is the following: will the Bank reaffirm its current policy in dealing with commercial banks only within the framework of specific country lending programs, or shall we in addition isolate this issue and treat it as an important development problem and promote discussions, formulate new initiatives and organize a technical task force composed of insiders and outsiders to look at them?

9. I remember that you raised precisely this same question in one of the first lunches you had with members of the Managing Committee. Since then, the concerns expressed by highly indebted countries on this problem have not ceased to increase. I expect that corresponding noises will be made by the Governors of highly indebted countries in the next Development Committee Meeting and at the Annual Meetings. The Bank should be prepared to handle them.

JBotafogo:sf

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Correspondents / Participants
To : Mr. F. Van Dam, Executive Director
From : Barber B. Conable

Subject / Title
Implementing Secretary Baker's Proposal

Exception No(s).

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399 Park Avenue
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William R. Rhodes
Chairman
Restructuring Committee

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ES

August 5, 1986

Mr. Barber Conable, President
International Bank for Reconstruction
and Development
1818 8th Street, N. W.
Washington, D.C. 20433

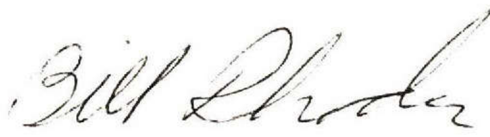
Dear Mr. Conable:

As a follow-up to the discussion John McGillicuddy and I had with you the other night at the Mexico presentation, I enclose for your information a brief memorandum prepared by the Baker Initiative Committee and distributed to Mr. Stern of your bank in December of 1985. As you know, the Baker Initiative Committee is composed of 16 of the largest banks in the United States, Canada, England, France, Germany, Switzerland and Japan. The memorandum reflects the views of that Committee with respect to the enhanced participation by the World Bank in cooperation with the IMF and the commercial banks. The memorandum has also been reviewed with the major U. S. regional banks and received their full support. The memorandum has been discussed with Mr. Stern and with members of the Department of the Treasury, the Federal Reserve and other agencies of the U. S. Government.

We consider the matter raised by this memorandum to be of the utmost importance particularly in the Mexican situation where the commercial banks will be asked to provide a substantial amount of new funds and where new and different facilities will be necessary to attract full participation by all commercial banks.

I would hope that you will have time to review this memorandum with me and the other people who will be instrumental in the Mexican and other debt packages. I will call you within the next few days to set up an appointment at a time which is convenient for you.

Very truly yours,



cc: Messrs. Corrigan
McGillicuddy
Mulford
Reed
Volcker

IBRD PARTICIPATION IN THE BAKER INITIATIVE

IN CONNECTION WITH THE BAKER INITIATIVE, IT IS ANTICIPATED THAT FOR AT LEAST SOME LARGE DEBTOR COUNTRIES ADDITIONAL LARGE SYNDICATED LOANS TO THE DEBTOR COUNTRY ITSELF (THE CENTRAL BANK OR OTHER OBLIGORS UNDER THE REPUBLIC GUARANTEE) WILL BE REQUIRED. THE BANKS BELIEVE THAT, CONSISTENT WITH SECRETARY BAKER'S SPEECH, A CENTERPIECE IN THESE PACKAGES, IN ADDITION TO THE IMF, WOULD BE A SUBSTANTIAL INCREASE IN THE ROLE OF THE IBRD AND A CHANGE TO SOME EXTENT IN ITS RELATIONSHIP WITH THE COMMERCIAL BANKS. IN EFFECT THE BANKS ARE LOOKING TO BUILD A NEW AND ENHANCED PARTNERSHIP WITH THE WORLD BANK.

WHILE WE UNDERSTAND SPECIFIC ISSUES WILL BE HANDLED ON A CASE-BY-CASE BASIS, WE WILL ALL BE WORKING UNDER SEVERE TIME CONSTRAINTS. THUS THE BANKS BELIEVE THAT IT IS IMPORTANT TO ADDRESS AS MANY OF THE ISSUES AS SOON AS POSSIBLE. THE BANKS BELIEVE THAT THE FOLLOWING REPRESENTS ESSENTIAL NEW ELEMENTS OF THE IBRD PARTICIPATION.

1. IBRD WOULD SUBSTANTIALLY INCREASE THE RATE AND MAGNITUDE OF ITS DISBURSEMENTS (INCLUDING DISBURSEMENTS TO THE COUNTRIES COVERED BY THE BAKER INITIATIVE).

2. A COMPREHENSIVE IBRD STRUCTURAL ADJUSTMENT/POLICY PROGRAM SHOULD BE DEVELOPED FOR EACH SUCH DEBTOR COUNTRY WHICH WOULD BE CONSISTENT WITH THE RELEVANT IMF PROGRAM AND INCLUDE INPUT FROM THE COMMERCIAL BANKS WITH RESPECT TO SUCH PROGRAM'S GOALS AND OBJECTIVES. IT IS ANTICIPATED THAT THE COMMERCIAL BANK VIEWS WOULD BE OBTAINED THROUGH CONSULTATIONS BY THE IBRD WITH THE RELEVANT COUNTRY ADVISORY COMMITTEE FROM AN EARLY POINT IN THE DEVELOPMENT OF THE IBRD PROGRAM AND THROUGHOUT ITS REVIEW AND APPROVAL PROCESS.

3. THE CO-FINANCING PROGRAMS SHOULD BE EXPANDED. IBRD STRUCTURAL ADJUSTMENT LOANS, POLICY LOANS, SECTORAL LOANS, TRADE LOANS, ETC. OUGHT TO BE ELIGIBLE FOR INCLUSION IN CO-FINANCINGS.

4. TO THE EXTENT THAT IBRD GUARANTEES ARE TO BE UTILIZED, SUCH GUARANTEES SHOULD BE MADE MORE COMPARABLE TO A CUSTOMERY COMMERCIAL BANK GUARANTEE. IN ADDITION, THE IBRD WOULD NOT BE SUBROGATED TO THE RIGHTS OF THE BANKS UNTIL THE BANKS HAVE BEEN FULLY REPAID PRINCIPAL AND INTEREST ON THE GUARANTEED LOAN, THE CO-FINANCING LOAN AND/OR ANY ADDITIONAL COMMERCIAL BANK LOAN TO THE BORROWER UNDER THE PROGRAM WITH OR WITHOUT IBRD PROTECTION.

5. THE DEFAULT PROVISIONS OF THE IBRD LOAN (SAL, POLICY LOAN, ETC.) SHOULD CONTAIN CROSS-DEFAULTS TO THE COMMERCIAL BANK LOANS IN THE PROGRAM (INCLUDING ANY GUARANTEED LOAN, CO-FINANCING LOAN AND ANY ADDITIONAL COMMERCIAL BANK LOAN TO THE BORROWER UNDER THE PROGRAM WITH OR WITHOUT IBRD PROTECTION). THE PROVISIONS OF THE IBRD STRUCTURAL ADJUSTMENT POLICY LOAN AND THE COMMERCIAL BANK CO-FINANCING LOAN SHOULD PROVIDE FOR SHARING OF PRINCIPAL AND INTEREST PAYMENTS ON A PRO-RATA BASIS.

THERE ARE ALSO PROVISIONS IN EXISTING IBRD AND COMMERCIAL BANK LOANS, SUCH AS CROSS-CONDITIONALITY OF DRAWDOWNS, WHICH WILL CONTINUE TO BE OF GREAT IMPORTANCE TO BANKS AS REGARDS FUTURE FINANCING BY COMMERCIAL BANKS. IT MAY ALSO BE WORTHWHILE TO CONSIDER NEW VEHICLES TO FACILITATE INCREASED COOPERATION BETWEEN THE IBRD AND THE INTERNATIONAL BANKING COMMUNITY. OBVIOUSLY, THE INTER-RELATIONSHIP OF THE PARTS OF A PARTICULAR TRANSACTION WILL BE EXTREMELY IMPORTANT TO THE OVERALL STRUCTURE OF ANY SPECIFIC COUNTRY FINANCING PLAN.

DECEMBER 23, 1985

Record Removal Notice

The World Bank Group **Archives** & Records Management

File Title	Barcode No.
Financial Files - Debt initiative - Correspondence - Volume 2	1782430

Document Date	Document Type
Jul 28, 1986	Memorandum

Correspondents / Participants
To : Mr. B. B. Conable, President, Executive Directors, Mr. E. Stern, SVPOP
From : Ferdinand van Dam, Executive Director

Subject / Title
Implementing Secretary Baker's Proposals

Exception No(s).

☐ 1 ☐ 2 ☐ 3 ☐ 4 ☐ 5 ☐ 6 ☐ 7 ☐ 8 ☐ 9 ☐ 10 A-C ☐ 10 D ☐ Prerogative to Restrict

Reason for Removal

Additional Comments
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Chandra Kumar	Aug 11, 2014

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July 14, 1986

Mr. Conable

Barber -

Senator Bradley's proposal has many flaws in it. You are right in not taking it on directly, but you will, of course, be asked your views, since you are to organize the conference.

In responding, you may want to draw on the following:

(1) You should start with your point of principle. These borrowings were legitimate contracts. In the middle-income countries there are capable administrators, and they decided explicitly to borrow for investments and policies. The external environment changed, but that is not a reason to allow people, or countries, to deny their legitimate obligations. We also ought to recognize what such denial would mean for future capital flows from these sources.

(2) It is simply not true that there is no feasible work-out program. The Bradley proposal takes the special problems of Mexico, and applies them to all highly-indebted middle-income countries. There is no doubt that the adjustment task in the oil exporters has been made much more difficult. But, on the other side, the task of the others has been made easier. Brazil, Colombia, and Chile are doing well---in terms of growth of their economies, and exports have grown much more rapidly than debt. There can be no doubt about the feasibility of a growth-oriented investment program for Argentina. Even for other oil exporters, such as Nigeria, a work-out program, based on growth-oriented adjustment, has been prepared and is clearly manageable.

(3) The incentives of the program seem wrong. Countries with an effective adjustment program will have their debt written down. But, how about the others who have large debts but managed their economies well enough to avoid this debt restructuring? Their debt burden may, nonetheless, be as high as that of some of the "highly-indebted middle-income countries". What justifies telling Korea, Turkey, Malaysia, or Indonesia that they must service their debt while those who misused their resources will get a discount? Lowering their debt will also accelerate growth and benefit poor people.

(4) The incentives are wrong in another way. If a country does not have a satisfactory adjustment program, there would be no debt write-off. But, these are precisely the countries which do not pay anyway---like Peru. The proposal focuses on the commercial banks. They are hardly the only creditors. If governments wish to take action, why not have <u>them</u> write-off the debt of the export credit agencies and other official sources? That would have budgetary implications. A few financial institutions, and their shareholders, are being asked to fund a public objective. Sound though the objective of restoring growth in the highly-indebted countries is, this is not an appropriate way of achieving it.

(5) Growth-oriented adjustment policies in all these countries are feasible. They are also difficult. The process will not, in the medium-term, be made any easier by debt forgiveness. On the contrary, these programs require new capital. It is <u>not</u> essential that total debt decline in the near term, what <u>is</u> essential is that the <u>debt service burden</u> must decline. That will happen as the economy expands and exports grow more rapidly than the debt and its interest charges. If debt is written-off, particularly if the process is forced, new capital will not be available to these countries for a long time.

(6) Finally, the proposal would be extraordinarily complicated. It would take a long time to negotiate. It involves different regulatory consequences in various countries. There is no incentive for the banks to formally write-down the debt, and no way to force them. Meanwhile, capital flows to <u>all</u> developing countries will come to a halt. All these are consequences of the simple fact that the solution to the debt crisis does <u>not</u> lie in more government intervention. This is true in the domestic economies of the highly-indebted counties, and it is true of the debt itself. These countries will be best served by getting them back to independent access to the capital market as soon as possible.

Ernest Stern

P.S. As Joe Wood mentioned this morning, we are of course in agreement on the need to maintain a liberal trading regime. And some reduction in spreads can be useful, though that doesn't help a lot.

June 5, 1986

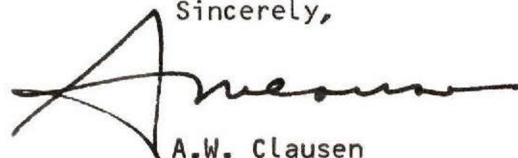
Dear Mr. Arendt:

I am very pleased to learn from your letter of May 22 that the Board of the Banking Federation of the European Communities has discussed and agreed with the basic principles embodied by the "Baker Initiative". As you know, the World Bank, together with the IMF, has endorsed the basic plan put forward by Secretary Baker at the last Bank/Fund Annual Meetings in Seoul, Korea. We believe that the concerted effort described by Secretary Baker is indeed essential to restore growth and creditworthiness among the heavily-indebted developing countries.

I was also interested to read about the several concerns that your Federation members have expressed with respect to the Baker Initiative. My colleagues and I at the World Bank are in basic agreement with the points you have raised. In particular, we also feel that active involvement is required on the part of the industrialized countries' governments not only to implement policies conducive to economic growth and trade liberalization but also to restore flows of official credit and encourage commercial credits consistent with prudent regulatory controls. We also accept the point that the fall in oil prices will require a special effort to assist those countries whose external financing needs have increased as a result. Finally, we wholeheartedly agree that developing countries must take appropriate measures to prevent capital flight which threatens to drain away new resources which may be provided.

Once again, thank you for your letter and for your interest in international cooperation to assist the heavily-indebted developing countries.

Sincerely,



A.W. Clausen
President

Mr. Georges Arendt
Secretary General
Federation Bancaire de la Ce
168, Avenue de Tervueren
B-1150 Bruxelles

cc: Messrs. Stern
Botafogo

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THE WORLD BANK

ROUTING SLIP	Date June 3, 1986

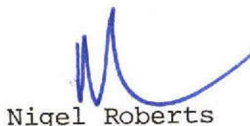
OFFICE OF THE PRESIDENT

Name	Room No.
Mr. Qureshi ✓	E-1241
cc: Mr. Stern	
Mr. Botafogo (for Paris Office)	

	To Handle		Note and File
	Appropriate Disposition	XX	Prepare Reply
	Approval		Per Our Conversation
	Information		Recommendation

Remarks

Would be grateful if your office prepares a reply for Mr. Clausen's signature by June 6.



Nigel Roberts

From

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FÉDÉRATION BANCAIRE
DE LA COMMUNAUTÉ EUROPÉENNE

Le Président

Luxembourg, May 22nd, 1986

Mr A.W. Clausen
President
International Bank for
Reconstruction and Development
1818 H. Street N.W.
WASHINGTON, D.C. 20433

Dear Sir,

The Banking Federation of the European Communities represent the banking associations of the 12 member countries: as a whole, about 1,700 commercial banks with deposits of 1,600 billion dollars and credits of 1,300 billion dollars.

At a meeting held on April, 18th in Dublin, our board discussed the "Baker initiative" and found itself in agreement with the basic principles therein. It also agreed upon the following conclusions which I am submitting to your attention. They are more reflections than requests, but I am confident that they will be of interest to you since they reflect matters of common concern among our member associations.

First of all, it seems that Mr Baker is seeking a great deal of involvement on the part of debtor countries, international organisations and commercial banks. However, the role of industrial countries' governments appears to be rather vaguely defined except that they are expected to implement economic policies conducive to growth and trade liberalisation.

Commercial banks are aware of their role in the process of supporting the economies of debtor countries, but consider that too little emphasis has been given to the contribution of governments, which should be asked to facilitate the financing by means, for instance, of more favourable fiscal treatment of outstanding credit and by resuming export credit cover through official agencies.

Secondly, due consideration should be given to a new factor, or rather to a factor the importance of which has increased since october 1985: the fall of oil prices which has worsened the position of certain debtor countries. It is difficult to see how - and to what extent - the measures envisaged by the Baker initiative could meet the additional needs of these countries.

Finally, governments of the debtor countries should be asked to consider more seriously the problem of capital outflows: unless effective measures are taken, their balance of payments will deteriorate in parallel with the new financing, as a consequence of additional capital being transferred abroad. On this issue, commercial banks would recommend firm pressure on the governments of the debtor countries as a pre-condition for further lending.

Yours sincerely,

Georges Arendt

correspondence to:

Secrétaire Général
FEDERATION BANCAIRE DE LA CE

168, avenue de Tervueren
B-1150 BRUXELLES

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