Folder Title:	Financial Files - Debt - Correspondence - Volume 2
Folder ID:	1782434
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Dates:	01/26/1989 - 04/13/1989
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Debt [2 of 2]

D E B T

Barber B. Conable

2

EXECUTIVE DIRECTORS

MH

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 89/04/13 DUE DATE : 00/00/00
LOG NUMBER : 890413012 FROM : Helen Ploix
SUBJECT : IBRD Role in Financial Intermediation Services: Expanded Co-Financing Operations Rescheduling of Item 1, Doc. A89-18/1
OFFICE ASSIGNED TO FOR ACTION : Mr. B. Conable (E-1227)

ACTION:

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THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 13, 1989

TO: Mr. Conable

FROM: Hélène Ploix HP

EXTENSION: 623-6505

SUBJECT: IBRD Role in Financial Intermediation Services: Expanded Co-Financing Operations Rescheduling of Item 1, Document A89-18/1

HP/pk
89- 127

The Development Committee communiqué clearly states that several proposals have been made by France, Japan and, more recently, the U.S.

I would appreciate your considering all of these proposals when you mention developments in the debt strategy. It goes without saying that all of the proposals deserve similar analyses.

cc: The Vice President and Secretary

P-1866

Record Removal Notice

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File Title	Barcode No.
Financial Files - Debt - Correspondence - Volume 2	1782434

Document Date	Document Type
Apr 13, 1989	Memorandum

Correspondents / Participants
To : Mr. Brian Crowa, Assistant to the US Exec. Director
From : Marianne Haug, EXC

Subject / Title
Public Disclosure of Information - Secretary Brady's testimony to changes

Exception No(s).

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

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WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 89/04/21 DUE DATE : 00/00/00
LOG NUMBER : 890421013 FROM : Stanley Fischer
SUBJECT : Analytic Issues in Debt Reduction: Board Memorandum.

OFFICE ASSIGNED TO FOR ACTION : Mr. B. Conable (E-1227)

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COMMENTS :for discussion on debt 4.21.89

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 21, 1989

TO: Mr. Barber B. Conable

FROM: Stanley Fischer SF

EXTENSION: 33774

SUBJECT: Analytic Issues in Debt Reduction: Board Memorandum

The attached paper has been revised in the light of comments received at the President's Council.

Attachment/-

DRAFT
DECVP
4/21/89

Analytic Issues in Debt Reduction
Board Memorandum

I. Introduction and Summary

1. The first 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 allow debtor countries to raise investment and resume growth. The adjustment programs supported by the Bank and the Fund should provide the 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 tax 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 DSR that uses 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. A second question is: "Why is the intervention of IFIs necessary to facilitate DSR?" The argument for official intervention rests on several bases. First, the free rider problem prevents debtors and creditors from reaching agreements that could make them all better off than they are currently: creditors who do not contribute to a debt reduction scheme find

the value of their claims enhanced by the contributions of other creditors. Official intervention may therefore assist in reaching agreements that could not otherwise have been reached. Second, because the debt strategy has, since 1982, been based on official intervention, it would be difficult for official agencies to remove themselves from the problem now. Third, the contribution of official resources from the IFIs and other official creditors is likely to make larger debt reductions possible; and without accelerated debt reduction, adjustment is likely to falter in a number of debtor countries.

6. The remainder of this paper examines 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 Brady or other proposed initiatives. The paper notes ways in which the initiatives could be strengthened to provide larger benefits to the debtor countries. In particular, the impact of officially supported debt reduction schemes depends heavily on the tax regulations and accounting rules in place in the creditor countries.

7. Given the differing rules now in place in the creditor countries it would not be possible to specify, a priori, a single set of instruments or techniques that would be generally preferred over others. The choice of DSR techniques 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?

8. Debt and debt service reduction (DSR) financed by borrowing is not necessarily beneficial to all debtors under all circumstances. DSR can be viewed as an investment, with a rate of return to the debtor country. It is beneficial when the rate of return is higher than that on alternative uses of the funds: investments in physical and human asset creation in the debtor country. DSR at a significant discount has a high rate of return, if the alternative is full service of the debt. The Brady countries do not have access to voluntary credit 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 something less than full debt service, implying care has to be taken in evaluating the rate of return. If a country's willingness to undertake and sustain a strong adjustment program is triggered by its ability to reduce debt substantially, then DSR carried out as an adjunct to an adjustment program that improves the allocative efficiency of the economy would yield a higher rate of return relative to DSR without adjustment.

9. 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. The debt overhang accentuates the uncertainty surrounding economic reform in the debtor countries and acts as a tax on current and future incomes, because a large share of improvements in economic performance accrues to the creditors. DSR would reduce both the uncertainty and the implicit tax, and thereby encourage economic growth.

(ii) The availability of additional IFI funds 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.

(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. These new forms of debt can provide overall gains that, in the context of DSR, can be split between debtors and creditors. Examples are bonds indexed to commodity prices, bonds that capitalize part of interest payments in periods of high interest rates, and explicit new money on a contingent basis.

10. If DSR is market-based and voluntary, creditors have to gain, not only relative to their situation before DSR was introduced, but also relative to the option of not participating in DSR. This is the free rider problem, which could limit the gains from DSR for the debtors. This issue is examined in Section III.

11. Preliminary calculations indicate that the benefits of DSR in many highly indebted countries are likely to exceed the cost but, in the existing tax and regulatory environment, rates of return may not be extremely high. Tax and regulatory reforms could increase the rates of return. As discussed in the next section, debt reduction may be less attractive than debt service reduction under some. (The effect of DSR operations on the new money process is also an important consideration. New money issues are discussed below.)

Issue 2: Will DSR encourage good performers to pursue less responsible policies?

12. Any indebted country or individual would, <u>other things equal</u>, always favor a reduction of debt or debt service. However, all countries that are likely to receive DSR under the current debt initiatives have grown very slowly this decade, and all of them still face very difficult adjustments to be undertaken in the context of strong conditionality agreed to with international financial institutions. Further, it is uncertain when they will return to creditworthiness.

13. Countries without debt service problems and with good economic policies have generally grown at reasonable rates over the past decade. These countries have access to international capital markets. Their more rapid growth more than compensates for any benefits eligible countries will receive from DSR. The pursuit by a country's officials of less responsible policies

in order to obtain debt reduction would--by reducing growth, access to international capital markets, and economic stability--be extremely costly to their people.

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. On a very general level, abstracting from issues such as seniority and tax treatment, and for a given level of official entanglement, buybacks and collateralized and guaranteed debt exchanges are exactly equivalent in terms of net debt <u>and</u> debt service reduction, for a given amount of available resources. (As a simple example, consider $1 million borrowed and used for a cash buyback compared with $1 million used to purchase a zero coupon bond to collateralize a payment in 20 years and compared with $1 million to collateralize next year's interest payment--with no "special features." All three reduce interest payments by $150 thousand at an interest rate of 10 percent and a secondary market price of 40 cents on the dollar. They are equivalent because the trades involve an exchange of old debt for a new instrument that combines features of 1) old debt, with no change in its value, and 2) an assured asset with a present value of $1 million. The only difference is the rate of exchange of the new asset--bonds or cash--for the old claims.)

16. In actual practice the costs and benefits of alternative forms of DSR will differ in the following ways:

(i) <u>Seniority of new claims:</u> if the new bond is senior to the old debt, 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 the senior 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 affected the seniority of their claims, unless the perceived benefits (the increase in the size of the pie) from DSR were so large that the value of the junior claims would also rise.

(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 and regulatory treatment: Bank staff work indicates that, for banks seeking tax advantages, current rules favor buybacks 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. The ideal, from the point of view of maximizing tax and regulatory benefits to share with debtor countries, would be rules that maximized both the tax advantage and the accounting advantage: tax relief up front with accounting losses amortized over the life of the loan, with rules that differentiated between new claims and claims not offered for exchange. For example, reserves against old claims could be excluded from regulatory capital and could be offered smaller tax benefits. (A reversal of tax benefits on old claims might be considered in countries where these benefits have already been realized.)

(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. The reduction would be more likely to be forgiven if the lower interest payments were credit enhanced. (Conceptually, a loan or bond with an interest rate step-up can be expressed in terms of its two components: a buyback or forgiveness component, and an interest capitalization component.) 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 greatly 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, with the support of the IFIs, 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 have, in most cases, all the advantages of buybacks, while providing the potential for added gains. The most important gain is

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

that the amount of debt relief can be linked directly to economic performance and policy conditionality, which is not always possible with buybacks. Other gains would come through the potential seniority of the new instruments and through the possibility of incorporating a new money component. 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, there may be political advantages to the fact that buybacks unambiguously reduce the outstanding debt stock.

Issue 4: What is the role of waivers of sharing clauses in reaching DSR agreements?

19. The granting of waivers of sharing clauses is important to reduce or eliminate the free rider problems that currently discourage voluntary agreements of potential benefit to both creditors and debtors. Agreement on waivers, where they do not exist as part of previous rescheduling agreements or where they are too weak, will have to be sought as part of the negotiation process.

20. Waivers may be important in the achievement of a more comprehensive solution. The more general the waivers the wider the scope for negotiated DSR. Experience has shown that waiver negotiations are likely to be protracted, but that agreement is possible. The waiver negotiated by Chile, allowing it to buy back a fixed amount of debt out of windfall gains from increases in the price of copper, is an example.

IV. Official Coordination and the Pricing of Debt Buybacks

Issue 5: To what extent will IFIs and creditor governments play a role in determining that the benefits of the use of official funds for DSR accrue to the debtor countries?

21. Official action, or inaction, may be important to ensure that the benefits of the use of official funds in support of DSR pass, for the most part, to the intended beneficiaries, the debtor countries. The IFIs and creditor governments may have to consider the degree to which they monitor negotiations between a debtor country and its creditors, and they may also have to consider setting a range of parameters within which the negotiations take place. The IFIs must consider the degree to which they tie additional lending to DSR or to a preset menu of DSR operations.

Issue 6: Should the Bank relate its support of DSR to the pricing of debt buybacks and exchanges?

22. IFI support should be limited to transactions that represent a substantial gain to the country and where the discounts offered by banks represent an appropriate sharing of the burden. While the prevailing secondary market price can be taken as a rough benchmark, efficient bidding procedures and guidelines that help to establish the price at which the debtor can buy back or exchange new debt for its existing obligations need to be established, especially for operations involving the use of IFI resources and

guarantees. Prices may tend to rise as new resources are devoted to buybacks and as banks less willing to part with their claims must be induced to sell; 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 the Brady Initiative was made public, indicating that commercial banks expect to benefit from official support for DSR.)

23. Negotiated prices may not be as high as the market appears to anticipate. If the increase in senior debt (including the increase in preferred creditor claims of the IFIs) as a result of the debt reduction program is significant, the remaining subordinate debt may rise very little in value. The debtor country itself may not be able to establish credibly the seniority of new bonds. Actions by official agencies could enhance the standing of these new claims relative to old debt.

24. 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.

V. New Money Issues

Issue 7: What effect will DSR have on the availability of new money?

25. DSR must be examined in the context of its overall impact on a country's external cash flow. The cash flow balance could deteriorate if debt service gains are more than offset by a decline in the availability of new funds. If debt and debt service reduction is large enough, new money from IFIs, bilateral official and other nonconcerted lending sources will be adequate. While this result may be expected some countries, it is unlikely to be the case in many larger debtor countries. Debt reduction is not likely to be large enough to offset the need for new money in the larger countries, for the following reasons:

(i) Funds available for debt relief are not that large; further, they are in the form of loans that, in part, add to the gap by reducing external financing of imports.

(ii) Voluntary debt reduction may mean that the creditors will not be required to give up much; as indicated in the previous section, the gains to the debtors may well be small.

(iii) Large debt reductions are not required in the most creditworthy of the countries; new money was always a major part of the solution.

26. New money needs, expressed as a percentage of commercial bank interest 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) Some of the IFI funds were gapfill finance before the introduction of the debt and debt service reduction exercise. The redeployment of these resources adds to the short-run gap.

27. There are potentially offsetting effects on the willingness of commercial banks to enter into new money agreements. 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 have shifted, to some extent, in the favor of debtor countries. Since the IFIs will lend before the financing package is in place, countries will be under less pressure to reach agreements.

28. Both of these effects suggest that the bargaining over new money and DSR is likely to involve a period in which debtors are in arrears to commercial banks. The IFI Boards will want to consider to what extent they are willing to tolerate these arrears. It may not be necessary for them to take a general position on this issue, but they could proceed on a case-by-case basis.

29. A possible method of reducing new money needs would be to incorporate new money into the bonds offered in exchange for old debt. The bonds, as discussed above, could combine debt reduction features with interest capitalization features. However, such bonds would not likely provide sufficient new money to the larger debtors, given the marginal nature of the contemplated debt and debt service reduction.

30. Over time the concerted lending process will disappear in countries that 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 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.

VI. Capital Flight

Issue 8: Will the return of capital flight play a large role in ending the debt crisis in countries eligible for IFI-supported DSR?

31. DSR that is beneficial to the debtor countries reduces the debt overhang and reduces that incentive for private capital outflows (the avoidance of taxes connected with government debt service). If DSR removes much of the uncertainty surrounding external support for adjustment, it will lower the inducement for capital flight. Increased conditionality also will reduce the incentive for capital flight, in part because overvalued exchange rates would be less likely. Outflows of private capital may be reduced or even reversed.

32. However, unless the debt reduction effects are very large, optimistic assumptions about the return of a large share of the outstanding stock of flight capital--enough to fill much of the financing gap--should be avoided. Special programs to attract flight capital may be counterproductive if they involve costly subsidies that outweigh the benefits.

VII. Possible Limitations of the Market Approach

Issue 9: Will the recent initiatives definitively end the debt crisis?

33. The forms and amounts of DSR considered here are not likely to end the debt crisis quickly. The impact on individual countries will vary, depending on the extent of the gains discussed above. Our preliminary analysis indicates that, overall, these gains will be modest. Countries that have a good track record of economic policies, are committed to strong adjustment programs, and have a large debt overhang can realize positive gains, consistent with rates of return required on Bank projects, provided the transactions are carefully structured. But in most countries, the DSR envisioned is not likely to lead to a quick return to creditworthiness.

34. Preliminary analysis undertaken by Bank staff indicates that debt reduction and debt service reduction, as outlined in the current version of the Brady Initiative, will not meet, by itself, the external financing needs of the target countries. On the assumption that approximately $20 billion of IBRD and IMF funds would be used to finance or guarantee debt reduction in highly indebted middle income countries (HICs)--half diverted from currently planned operations (and adding to the financing gap) and half from new operations--the initiative would generate about $4 billion to $5 billion per year in net interest savings over the next three years, about three percent of HIC annual exports and one half of one percent of GDP. The contribution to the closing of the HIC financing gap, now estimated at more than $10 billion per year, would be less because some of the IFI funds to support DSR would be diverted from other uses. The effective net reduction in debt (calculated as the change in the present discounted value of future scheduled debt service payments) of roughly $45 billion, is about 9 percent of the current total debt of these countries. The gross reduction in commercial bank claims (calculated on the same basis) of roughly $65 billion would represent about 22 percent of current commercial bank claims on these countries (including short term claims). This magnitude of debt reduction would leave debt/export ratios of most of the HICs well above maximum levels associated with creditworthiness. (The average HIC debt/export ratio, where debt is measured as the present discounted value of future scheduled payments, would decline from 325 to about 300 in the short run, on the basis of this preliminary calculation.)

35. There is an inherent contradiction in the market process assumed in the above analysis. The more successful the buybacks potentially, the more the price rises, and the less the country can buy with the funds available for DSR.

36. The DSR process can be strengthened in three directions: a more supportive tax and regulatory environment, additional official funds, and official support for the bargaining position of countries with strong adjustment programs that make well structured offers to creditors. The first two would provide greater inducement to creditor participation but could be very costly to IFIs and creditor governments.

37. 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. Entanglement is an

untested concept in the market. Caution should be used in the calculation of the effect of entanglement on DSR operations.

38. The success of this initiative will depend on the process through which the bargains between debtor countries and creditors are reached. Official agencies can provide assurances that the funds made available to debtors as a result of the DSR will be used efficiently by the debtor countries, increasing the value of new claims. In addition, the attitude of IFIs and creditor governments toward the accumulation of arrears--to creditors that stay outside of the bargaining framework--in debtor countries with strong adjustment programs and credible bargaining positions will play a role in determining the magnitude of debtor country benefits from officially supported DSR.

39. The major benefit for debtors of official support for DSR would be an assurance of smaller net transfers over the program 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.

VIII. Summary of Issues for Consideration by Directors

40. The preceding sections highlighted and discussed issues of analytical relevance with regard to IBRD support for debt and debt service reduction. Staff conclusions regarding those issues are summarized here as a guide to the discussion.

41. DSR, financed by borrowing, is not necessarily beneficial to all countries under all circumstances. DSR must be beneficial to both creditors and debtors and thus must create a gain to be shared among creditors and the debtor country. These 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. Debtor countries are likely to gain, but the gains may not be large under current tax and regulatory rules. If DSR is market-based and voluntary, it will have to offer gains to creditors, relative to the option of not participating. The implicit free rider problem limits the gains from DSR.

42. The availability of IFI funds in support of DSR should not encourage current good performers to pursue destabilizing economic policies in order to attain access to DSR. The costs, in terms of reduced growth, increased economic instability, and the loss of access to international capital markets, would be far higher than the likely benefits

43. It is impossible to say in advance and for all countries 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. However,

buybacks may have political advantages because the face value of the debt is immediately reduced.

44. Waivers of sharing clauses appear to be important in reaching DSR agreements. These waivers are necessary to reduce or eliminate the free rider problem that has plagued the new money process in recent years. The more general the waivers the better the chance that debtor countries will benefit, but creditors are likely to resist agreeing to very general waivers.

45. IFIs and creditor governments must determine to what extent they will play a role in determining that the benefits of the use of official funds for debt and debt service reduction accrue to the debtor countries. Official action, or inaction, can increase the possibility of agreements in which the major share of benefits are passed on to debtor countries.

46. More specifically, the IFIs should consider the relationship between their support of debt and debt service reduction and the pricing of debt buybacks and exchanges. IFI support should be limited to those agreements in which the price at which old debt trades for new claims or for cash reflects a reasonable return to the debtor country, where the alternative for comparison is something less than full debt service in countries whose debt is selling at a deep discount.

47. DSR operations will have an impact on the need for and the availability of new money. Unless DSR agreements are very comprehensive, the need for new money, as a share of the remaining creditor base, is likely to increase, rather than decrease in the short run.

48. The return of capital flight is likely to depend on the comprehensiveness of the DSR. If DSR is very comprehensive, reducing the debt overhang that--in part--fuels the capital flight, private capital reflows could be extensive. Marginal DSR operations are likely to reduce or reverse the rate of private capital outflows but are not likely to result in a major inward movement of the outstanding stock of flight capital.

49. The recently announced initiatives, once in place, should not be expected to end the debt crisis in all participating countries. 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 not be adequate to move them quickly out of the concerted lending process. The DSR process can be strengthened in two directions: a more supportive tax and regulatory environment, more official funds, and official support for well structured bargaining positions of debtor countries with strong adjustment programs.

By itself not enough —
Private lenders

EFFECTS OF ALTERNATIVE DEBT SERVICE AND DEBT REDUCTION INSTRUMENTS

		DEBTOR	CREDITOR /a	IFI
GENERIC	Debt Service and Debt Reduction (DSR)	Benefits: Lower total debt service obligations; better incentive to adjust; reduced debt overhang. Costs : If IFI resources are dedicated for DSR, then negative liquidity effects may exist; reduced base for new money.	Benefits: Value of remaining debt might increase; reduced obligation to provide new money. Costs : Value of remaining debt might decrease due to reduced status of remaining claims.	Benefits: Financial viability of adjustment programs enhanced. Costs : Increased relative exposure in each DSR country; increased absolute and relative exposure in case of additional funds in each DSR country; increased share of high risk countries in IFI portfolios; less flexible burden sharing in future workouts.
SPECIFIC TO INSTRUMENT	Buy Backs	Benefits: High debt stock reduction. Costs : Loss of liquidity if non-additional; low cash flow relief early.	Benefits: Up front tax benefits. Costs : Up front accounting losses; might need to replenish capital.	Benefits: No entanglement.
	Debt Exchanged to an instrument with lower principal but same interest rate	Benefits: Average cash flow and debt stock reduction; implicit enhancement can increase DSR relative to amount of resources. Costs : When guarantee/escrow is set aside from lending program, liquidity is reduced.	Benefits: Up front tax benefits for realized losses. Costs : Up front accounting loss; might need to replenish capital.	Benefits: No entanglement of loan in case of escrow account; entanglement with guarantees can leverage resources; entanglement can be time bound. Costs : Entanglement and guarantees can increase risks.
	Debt Exchanged to an instrument of same face value but lower interest rate	Benefits: High cash flow relief until maturity; implicit enhancement can increase DSR relative to amount of resources. Costs : No debt stock reduction; when guarantee/escrow is set aside from lending program, liquidity is reduced.	Benefits: Spread out tax benefits; can prevent up front loss; spread out accounting loss. Costs : Might need to replenish capital.	Benefits: No entanglement of loan in case of escrow account; entanglement with guarantees can leverage resources; entanglement can be time bound. Costs : Entanglement and guarantees can increase risk; delays debt stock reduction.
	Debt Exchange to an instrument with temporary large reduction of interest with same face value (interest either forgiven or capitalized)	Benefits: Highest cash flow relief; implicit enhancement can increase DSR relative to amount of resources. Costs : Low debt stock reduction; when guarantee/escrow is set aside, liquidity is reduced.	Benefits: Spread out tax benefits; can prevent up front loss; spread out accounting loss. Costs : Might need to replenish capital.	Benefits: No entanglement of loan in case of escrow account; entanglement with guarantees can leverage resources; entanglement can be time bound. Costs : Entanglement and guarantees can increase risk; delays debt stock reduction.
	Debt Exchange to Equity /b	Benefits: Repayments may be better matched to income; domestic financial markets enhanced; better transfer of managerial and technological skills; may enhance privatization program. Costs : Budget cost of implicit subsidy to foreign investment; possibly non-additionality; may discriminate against resident investors.	Benefits: Share in upside potential of debtor; debtor may have better incentives to perform; may lead to more enforceable contracts. Costs : Commercial risk; risk of expropriation; transfer risk (future); restrictions on remittances; might need to replenish capital.	Risks : Affects ranking of claims; monetary effect may have adverse impact on stabilization and structural adjustment.
	Debt Exchange to an Indexed Instrument (e.g., commodity bond)	Benefits: Repayments better matched to ability to pay; possible reduction of capital flight. Costs : Countries share upside potential.	Benefits: Enhances risk management; reduces risk of default. Costs : Exposure to new sources of risk.	Benefits: Increases likelihood of success of adjustment programs; reduces risk of default.

In each case, reduction of interest or principal involves an apparent cost to the cors.

/b Public debt for private equity swap.

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 89/04/18 DUE DATE : 00/00/00
LOG NUMBER : 890419001 FROM : S. Fischer
SUBJECT : Analytic Issues in Debt Reduction.

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 ______
- ______ PLEASE PREPARE RESPONSE FOR ______ SIGNATURE
- ______ AS WE DISCUSSED
- ______ RETURN TO ______

COMMENTS :Note: Hand-delivered by Mr. Fischer on 4/19 - 7:56 am.

cc: BBC (original), M. Haug, J. Stanton (For discussion at 11:00 am (4/19)).

URGENT

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 18 1989

TO: Mr. Barber Conable

FROM: Stanley Fischer SF

PHONE: 33774

SUBJECT: Analytic Isssues in Debt Reduction.

1. The attached draft paper examines analytic issues arising from recent debt reduction proposals. Comments on an earlier draft have been received from Messrs Scott, Shilling and Wood.

2. As in the case of the draft paper submitted earlier tonight by David Bock, we are forwarding this draft to you for discussion after PC tomorrow, on the understanding that it will be reviewed and revised before circulation to the Board at the end of the week.

cc: M/M Hopper (o/r), Qureshi, Stern, Shihata, Wood, Bock, Dubey, Holsen, Shakow, Haug, Husain, Shilling.

DRAFT
DECVP
4/18/89

Analytic Issues in Debt Reduction
Board Memorandum

I. Introduction and Summary

1. The first 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 allow debtor countries to accelerate investment and resume growth. The adjustment programs supported by the Bank and the Fund should provide the 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 tax 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 DSR that uses 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 observation reinforces the argument for a case-by-case approach to DSR.

5. A second question is: "Why is the intervention of IFIs necessary to facilitate DSR?" The argument for official intervention rests on several bases. First, the free rider problem prevents debtors and creditors from reaching agreements that could make them all better off than they are currently: creditors who do not contribute to a debt reduction scheme find

the value of their claims enhanced by the contributions of other creditors. Official intervention may therefore assist in reaching agreements that could not otherwise have been reached. Second, because the debt strategy has, since 1982, been based on official intervention, it would be difficult for official agencies to remove themselves from the problem now. Third, the contribution of official resources from the IFIs and other official creditors is likely to make larger debt reductions possible; and without accelerated debt reduction, adjustment is likely to falter.

6. The remainder of this paper examines 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 Brady or other proposed initiatives. It is conceptually important to distinguish between comprehensive or global solutions on the one hand, and marginalist measures on the other. The former, which would attempt to sharply reduce the debt of all eligible countries to a sustainable level, could involve the creation of new institutions or new facilities; and, unless these were carefully designed, the potential cost to creditor governments could be very large. The latter term spans a wide range of approaches that would deploy official resources in a way intended to accelerate the return of the debtors to creditworthiness, on a country-by-country basis, and without necessarily promising to solve an individual country's debt problem or the overall debt problem immediately. While the global approach is appealing in its sweep, and has potential benefits as well as costs, we assume a marginalist approach in the remainder of this paper. The paper notes ways in which the marginalist approach could be strengthened to provide larger benefits to the debtor countries.

7. In particular, the impact of officially supported debt reduction schemes depends heavily on the tax regulation and accounting rules in place in the creditor countries. Given the differing rules now in place in the creditor countries it would not be possible to specify, a priori, a single set of instruments or techniques that would be preferred over others. The choice of DSR techniques 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?

8. DSR can be viewed as in investment, with a rate of return to the debtor country. It is beneficial when the rate of return is higher than that on alternative uses of the funds: investments in the debtor country. DSR at a significant discount has a high rate of return, if the alternative is full service of the debt. The Brady countries do not have access to voluntary credit and their debt is selling at a discount because creditors do not expect the current high levels of debt to be serviced in full. Therefore, the alternative for comparison must be something less than full debt service, implying care has to be taken in evaluating the rate of return. Voluntary DSR

mean that there must be a benefit to the creditor, also.

9. The last two points imply that, for DSR to be beneficial to the country, it must provide the debtor and the creditor with a bigger pie to divide. The increased pie could come from:

(i) Increased incentives for the debtor country to adjust and for local investment as a result of the reduction in the debt overhang. DSR can give a country more incentive to undertake activities that increase the efficiency of the economy at the expense of current consumption. The external debt currently acts as a tax on current and future income and puts in doubt the sustainability of current adjustment efforts. If a country improves its economic performance, a large share of the benefits goes to its creditors. DSR encourages adjustment and investment because, in both cases, less has potentially to be shared with creditors.

(ii) Risk sharing features that could be built into new claims that reduce the risk to the debtor country without significant adverse effects on the creditors. These new forms of debt can provide overall gains that can be split between debtors and creditors. Examples are bonds indexed to commodity prices and bonds that capitalize part of interest payments in periods of high interest rates. Explicit new money could also be incorporated on a contingent basis.

(iii) The availability of additional IFI funds for DSR--which allows the creditors and debtors to gain, but potentially at some risk to the IFIs. The risk depends, in part, on the seniority that the debtor accords to IFI loans. Increased disbursements of IFI loans for debt reduction now would affect the time profile of net lending to IFI borrowers and thereby affect the risk to the IFIs. Precedents in IFI relations with countries with debt overhangs and in which IFIs are not making positive net new loans give some cause for concern about the risk aspects of IFI lending in support of DSR.

(iv) Tax and regulatory advantages that enhance the value of the new claims to the creditors, with some of the gain shared with debtors.

10. Preliminary calculations indicate that the benefits of DSR in many highly indebted countries are likely to exceed the cost but, in the existing tax and regulatory environment, rates of return may not be extremely high. Tax and regulatory reforms could increase the rates of return.

III. Forms of Debt and Debt Service Reduction

Issue 2: From the country's point of view, which forms of DSR are most beneficial (bearing in mind the potential benefits outlined above)?

11. 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.

12. On a very general level, abstracting from issues such as seniority and tax treatment, and for a minimum level of official entanglement, buybacks and collateralized and guaranteed debt exchanges are exactly equivalent in terms of net debt and debt service reduction. (As a simple example, consider $1 million borrowed and used for buybacks compared with $1 million used to purchase a zero coupon bond to collateralize a payment in 20 years and compared with $1 million to collateralize next year's interest payment--with no "special features." All three reduce interest payments by $150 thousand at an interest rate of 10 percent and a secondary market price of 40 cents on the dollar. They are equivalent because the trades involve an exchange of old debt for a new instrument that combines features of 1) old debt, with no change in its value, and 2) an assured asset with a present value of $1 million. The only difference is the rate of exchange of the new asset--bonds or cash--for the old claims.)

13. In actual practice the costs and benefits of alternative forms of DSR will differ in the following ways:

(i) Seniority of new claims: if the new bond is senior to the old debt, 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 the senior 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 affected the seniority of 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 and regulatory treatment: Bank staff work indicates that, for banks seeking tax advantages, current rules favor buybacks in the United States and Japan; par exchanges with reduced interest rates would be favored by U.S. banks seeking accounting advantages. Banks in most European countries have little incentive to sell their claims, because their current reserves are tax deductible. The ideal would be rules that maximized both the tax advantage and the accounting advantage: tax relief up front with accounting losses amortized over the life of the loan, with rules that differentiated between new claims and claims not offered for exchange. For example, reserves against old claims could be excluded from regulatory capital and could be offered smaller tax benefits.

(iv) Liquidity effect: to the extent that needed new money can be incorporated into the debt reduction, the debtor is more assured of adequate financing. One way of incorporating new money or of increasing the liquidity benefits is to exchange old debt for a new bond with a lower initial interest rate and a higher rate after the program period. Conversely, debtors must be careful to avoid a situation in which a large reduction in current debt service coupled with a steep rise at the end of the program period leads to renewed debt difficulties in the future. The terms of IFI support also should be considered in light of its possible contribution to a future debt service bulge.

14. The benefits and costs of each instrument will vary across creditors and debtors (the debtor can offer different instruments designed to appeal to creditors in different countries, based on tax and regulatory rules, for example). The Bank will need to do a case by case analysis. A matrix that identifies the attributes of alternative instruments is attached.

15. A general point that emerges from staff analysis is that debt exchange offers have, in most cases, all the advantages of buybacks, while providing the potential for added gains through seniority and through greater compatibility with policy conditionality.

Issue 3: Are waivers of sharing clauses important in reaching DSR agreements?

16. Waivers of sharing clauses are important to reduce or eliminate the free rider problems that currently discourage voluntary agreements of potential benefit to both creditors and debtors. Agreement on waivers, where they do not exist as part of previous rescheduling agreements or where they are too weak, should be sought as part of the negotiation process.

17. Waivers may be important in the achievement of a more comprehensive solution. The more general the waivers the wider the scope for negotiated DSR. Experience has shown that waiver negotiations are likely to be protracted, but that agreement is possible. The waiver negotiated by Chile, allowing it to buy back a fixed amount debt out of windfall gains from increases in the price of copper is an example.

18. General waivers of sharing clauses have a potential drawback. Without sharing clauses, unhappy creditors have a greater incentive to try to attach assets of the debtor country. The value of any assets attached do not have to be shared with other creditors.

IV. Official Coordination

Issue 4: To what extent will IFIs and creditor governments play a role in determining that the benefits of the use of official funds for DSR accrue to the debtor countries?

19. Official action, or inaction, may be important to ensure that the benefits of the use of official funds in support of DSR pass, for the most part, to the intended beneficiaries, the debtor countries. The IFIs should consider the degree to which they monitor negotiations between a debtor country and its creditors. The IFIs should also consider the setting of a

range of parameters within which the negotiations take place.

20. The IFIs must also consider the degree to which they tie additional lending to DSR or to a preset menu of DSR operations.

V. Pricing Issues

Issue 5: Should the Bank relate its support of DSR to the pricing of debt buybacks and exchanges?

21. Bank support should be limited to transactions that represent a substantial gain to the country and where the discounts offered by banks represent an appropriate sharing of the burden. While the prevailing secondary market price can be taken as a rough benchmark, efficient bidding procedures and guidelines that help to establish the price at which the debtor can buy back or exchange new debt for its existing obligations need to be established, especially for operations involving the use of Bank resources and guarantees. Prices may tend to rise as new resources are devoted to buybacks and as banks less willing to part with their claims must be induced to sell; and commercial banks may tend to benefit disproportionately. (Secondary market prices of the debt of likely beneficiary countries has risen as much as 20 percent since the Brady Initiative was made public, indicating that commercial banks expect to benefit from official support for DSR.)

22. Prices may not rise as much as the market appears to anticipate. If the increase in preferred creditor debt as a result of the debt reduction program is significant, the remaining subordinate debt may rise very little in value.

23. 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.

VI. New Money Issues

Issue 6: What effect will DSR have on the availability of new money?

24. If debt and debt service reduction is large enough, new money from IFIs, bilateral official sources will be adequate. While this result may be expected in a few small countries, it is unlikely to be the case in many larger debtor countries. Debt reduction is not likely to be large enough to offset the need for new money in most countries, for the following reasons:

(i) Funds available for debt relief are not that large; further, they are in the form of loans that, in part, add to the gap by reducing financing available for investment.

(ii) Voluntary debt reduction means that the creditors will not be required to give up much; as shown in the previous section, the gains to the debtors tend to be small.

(iii) Large debt reductions are not required in the most creditworthy of the countries; new money was always a large part of the solution.

25. New money needs, expressed as a percentage of commercial bank interest 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) Some of the IFI funds were gapfill finance before the introduction of the debt and debt service reduction exercise. The redeployment of these resources adds to the short-run gap.

26. There are potentially offsetting effects on the willingness of commercial banks to enter into new money agreements. 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 have shifted, to some extent, in the favor of debtor countries, since the IFIs will lend before the financing package is in place; countries will be under less pressure to reach agreements.

27. Both of these effects suggest that the bargaining over new money is likely to involve a period in which debtors are in arrears to commercial banks. The IFI Boards will want to consider to what extent they are willing to tolerate these arrears. It may not be necessary for them to take a general position on this issue, but they could proceed on a case-by-case basis, as the Fund Board has in the case of Mexico.

28. A possible method of reducing new money needs would be to incorporate new money into the bonds offered in exchange for old debt. The bonds, as discussed above, could incorporate debt reduction features with interest capitalization features. However, these bonds would not likely be the total answer, given the marginal nature of the contemplated debt and debt service reduction.

VII. Capital Flight

Issue 7: Will the return of capital flight play a large role in ending the debt crisis in countries eligible for IFI-supported DSR?

29. DSR that is beneficial to the debtor countries reduces the debt overhang and reduces that incentive for private capital outflows (the avoidance of taxes connected with government debt service). Increased conditionality also will reduce the incentive for capital flight, in part because overvalued exchange rates would be less likely. Outflows of private capital are likely to be reduced or even reversed.

30. However, unless the debt reduction effects are very large, optimistic assumptions about the return of a large share of the outstanding stock of flight capital--large enough to fill much of the financing gap--should be avoided. Special programs to attract flight capital may be counterproductive if they involve costly subsidies that outweigh the benefits.

VIII. Possible Limitations of the Market Approach

Issue 8: Will the recent initiatives definitively end the debt crisis?

31. The impact on individual countries will vary, depending on the extent of the gains discussed above. Our preliminary analysis indicates that, overall, these gains will be modest. Most countries can realize positive gains, consistent with rates of return required on Bank projects, provided the transactions are carefully structured.

32. But in most countries, the DSR envisioned is not likely to lead to a quick return to creditworthiness. There is an inherent contradiction in the market process: the more successful the buybacks potentially, the more the price rises, and the less the country can buy with the funds available for DSR.

33. Preliminary analysis undertaken by Bank staff indicates that debt reduction and debt service reduction, as outlined in the current version of the Brady Initiative, will not meet, by itself, the external financing needs of the target countries. On the assumption that approximately $20 billion of IBRD and IMF funds would be used to finance or guarantee debt reduction in highly indebted middle income countries (HICs)--half diverted from currently planned operations (and adding to the financing gap) and half from new operations--the Initiative would generate about $3 billion per year in net savings on external resource payments, less than one third of the annual financing gap estimated for these countries over the next three years and about two percent of the annual exports of these countries. The effective reduction in debt (calculated as the change in the present discounted value of future scheduled debt service payments) of roughly $50 billion, is about 10 percent of the current total debt of these countries. The gross reduction in commercial bank claims of roughly $70 billion would represent almost 25 percent of current commercial bank claims on these countries (including short term claims). This magnitude of debt reduction would leave debt/export ratios of most of the HICs well above maximum levels associated with creditworthiness. (The average HIC debt/export ratio would decline from 325 to about 310 in the short run, on the basis of this preliminary calculation.)

34. Increased leverage through entanglement, discussed under forms of debt service reduction, could increase the amount of DSR and reduce the financing gap. Entanglement is an untested concept in the market. Caution should be used in the calculation of the effect of entanglement on DSR operations.

35. The DSR process can be strengthened in two directions: a more supportive tax and regulatory environment and additional funds. To some extent there is a tradeoff between the two. The second would minimize the need for the first as an inducement for creditor participation.

36. A more ambitious initiative could combine incentives for both creditors and debtors. Positive incentives for creditors might include access to collateral or guarantees for exchanged claims and assurance that new funds and DSR provided would be used for investment and adjustment. Negative incentives for creditors could include tax and regulatory treatment of old and new claims that provided strong incentives for choosing new claims at a price different from that which would currently be reached in a voluntary exchange.

37. The major positive incentive for debtors would be an assurance of smaller net transfers over the program 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.

IX. Summary of Issues for Consideration by Directors

38. The preceding sections highlighted and discussed issues of analytical relevance with regard to IBRD support for debt and debt service reduction. These issues are summarized here as a guide to the discussion:

- Under what circumstances is debt and debt service reduction beneficial to a debtor country?
- From a debtor country's point of view, which forms of debt and debt service reduction are likely to be most beneficial?
- Are waivers of sharing clauses important in reaching debt and debt service reduction agreements?
- To what extent will IFIs and creditor governments play a role in determining that the benefits of the use of official funds for debt and debt service reduction accrue to the debtor countries?
- More specifically, should the IBRD relate its support of debt and debt service reduction to the pricing of debt buybacks and exchanges?
- What effect is IFI-supported debt and debt service reduction likely to have on the availability of new money to debtor countries?
- Will the return of capital flight play a large role in ending the debt crisis in the countries eligible for IBRD-supported debt and debt service reduction?
- Will the recently announced initiatives, once in place, definitively end the debt crisis?

Guidance from Directors is sought on each of these issues.

EFFECTS OF ALTERNATIVE SERVICE AND DEBT REDUCTION INSTRUMENTS

		DEBTOR	CREDITOR /a	IFI
GENERIC	Debt Service and Debt Reduction (DSR)	Benefits: Lower total debt service obligations; better incentive to adjust; reduced debt overhang. Costs : If IFI resources are dedicated for DSR, then negative liquidity effects may exist.	Benefits: Value of remaining debt might increase; reduced obligation to provide new money. Costs : Value of remaining debt might decrease due to reduced status of remaining claims.	Benefits: Financial viability of adjustment programs enhanced; better burden sharing in future workouts. Costs : Increased relative exposure in each DSR country; increased absolute and relative exposure in case of additional funds in each DSR country; increased share of high risk countries in IFI portfolios.
SPECIFIC TO INSTRUMENT	Buy Backs	Benefits: High debt stock reduction. Costs : Loss of liquidity if non-additional; low cash flow relief until maturity.	Benefits: Up front tax benefits. Costs : Up front accounting losses; might need to replenish capital.	Benefits: No entanglement.
	Debt Exchanged to an instrument with lower principal but same interest rate	Benefits: Average cash flow and debt stock reduction; implicit enhancement can increase DSR relative to amount of resources. Costs : When guarantee/escrow is set aside from lending program, liquidity is reduced.	Benefits: Up front tax benefits for realized losses. Costs : Up front accounting loss; might need to replenish capital.	Benefits: No entanglement of loan in case of escrow account. Entanglement with guarantees can leverage resources. Costs : Entanglement and guarantees can increase risk.
	Debt Exchanged to an instrument of same face value but lower interest rate	Benefits: High cash flow relief until maturity; implicit enhancement can increase DSR relative to amount of resources. Costs : No debt stock reduction; when guarantee/escrow is set aside from lending program, liquidity is reduced.	Benefits: Spread out tax benefits; can prevent up front loss; spread out accounting loss. Costs : Might need to replenish capital.	Benefits: No entanglement of loan in case of escrow account. Entanglement with guarantees can leverage resources. Costs : Entanglement and guarantees can increase risk.
	Debt Exchange to an instrument with temporary large reduction of interest with same face value (interest either forgiven or capitalized)	Benefits: Highest cash flow relief; implicit enhancement can increase DSR relative to amount of resources. Costs : Low debt stock reduction; when guarantee/escrow is set aside, liquidity is reduced.	Benefits: Spread out tax benefits, can prevent up front loss; spread out accounting loss. Costs : Might need to replenish capital.	Benefits: No entanglement of loan in case of escrow account. Entanglement with guarantees can leverage resources. Costs : Entanglement and guarantees can increase risk; delays debt stock reduction.
	Debt Exchange to Equity /b	Benefits: Repayments may be better matched to income; domestic financial markets enhanced; better transfer of managerial and technological skills; may enhance privatization program. Costs : Budget cost of implicit subsidy to foreign investment subsidy (fiscal or monetary); possibly negative additionality; may discriminate against resident investors.	Benefits: Share in upside potential of debtor; debtor may have better incentives to perform; may lead to more enforceable contracts. Costs : Commercial risk; risk of expropriation; transfer risk (future); restrictions on remittances; might need to replenish capital.	Risks : Affects ranking of claims; monetary effect may have adverse impact on stabilization and structural adjustment.
	Debt Exchange to an Indexed Instrument (e.g., commodity bond)	Benefits: Repayments better matched to ability to pay; possible reduction of capital flight. Costs : Countries share upside potential.	Benefits: Enhances risk management; reduces risk of default. Costs : Exposure to new sources of risk.	Benefits: Increases likelihood of success of adjustment programs; reduces risk of default.

/a In each case we assume the apparent loss the creditor takes by explicitly reducing interest or principal.
/b Public debt for private equity swap.

①~~MH~~

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 89/04/14 DUE DATE : 00/00/00
LOG NUMBER : 890417016 FROM : Stanley Fischer
SUBJECT : Debt Work Program - Second Weekly Progress Report.

OFFICE ASSIGNED TO FOR ACTION : ② Mr. B. Conable (E-1227)

ACTION:

______	APPROVED
✓	PLEASE HANDLE
______	FOR YOUR INFORMATION
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______	PLEASE DISCUSS WITH ______________
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______	RETURN TO ______________

COMMENTS :

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 14, 1989

TO: Mr. Conable, EXC

FROM: Stanley Fischer, DECVP SF

EXT: 33774

SUBJECT: Debt Work Program: Second Weekly Progress Report

Here is our overview of the progress during this week in Bank work on the Brady initiative.

1. Two Board papers are in preparation. The first, under the direction of David Bock, is expected to be presented to senior management by next Monday for an informal Board discussion later that week. The paper would present issues and points of discussions for the EDs regarding World Bank Support for Debt Reduction. The paper would cover issues and discussion points regarding country eligibility criteria, allocations approaches and associated impacts on Bank exposure, guidelines for the useage of Bank resources, and tranching and assurances. The second, under my direction, should be presented to senior management later in the week. It would cover the economics of debt reduction from the country's point of view and the consequences of making do with the resources suggested under the Brady initiative.

2. Individual country analyses have begun for those countries most likely to be considered for debt reduction in the near future. Operations Divisions responsible for these countries will provide the necessary information and are working in cooperation with DFS on the impact of different debt reduction scenarios.

3. We have had several meetings this week with various groups from the Fund. A group met to discuss a joint paper on the economics of debt reduction from a country's point of view and some joint work is expected over the next weeks. Other meetings covered the coordination between the Bank and the Fund of individual country analyses and consideration of tax, regulatory and market valuation issues. It appears that the Fund is less concerned about the overall adequacy of the resources suggested under the Brady initiative as it expects to allocate resources to individual countries for debt and debt reduction purposes on the basis of the individual country's access to the Fund quota and facilities.

4. The Fund has prepared three papers for informal discussion by its Executive Directors. The three papers will deal with the following subjects:

(a) The Debt Situation: Country Circumstances and Financing Approaches.
(b) Fund Support for Debt Reduction Operations - Preliminary Considerations
(c) The Fund's Policy on Financing Assurances

cc: Messrs. Hopper, Stern, Qureshi, Bock, Wood, and Shihata

LIST OF PAPERS PREPARED IN THE CONTEXT OF THE BRADY INITIATIVE

	From:	To:	Date:	Memo/note Title: Subject:
1.	Qureshi	Distribution	April 10	Implementation of the Brady Initiative Request for Operations: Support on Projections, Financing Requirements and Debt Reduction Scenarios
2.	Bock	Distribution	April 11	Notes for Board on Brady
3.	Steer	Distribution	April 13	Revised Economic Projections for the HICs and Other High Risk Countries

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 11 1989

TO: Mr. Barber Conable

FROM: Stanley Fischer SF

PHONE: 33774

SUBJECT: Bank Policy and Work on the Brady Plan.

A number of issues about the Bank's attitude to the Brady Plan, and papers we intend to send to the Board need to be resolved. Work completed by the end of last week, and progress and unsettled issues, were summarized in a memo sent to you on April 7. A separate April 10 memo (attached) describes yesterday's meeting with Charles Dallara and Fund representatives. The Fund is moving ahead rapidly with papers to be sent informally to their Board.

1. The major issues for the Bank have been out in several memos to you (this list varies slightly from memo to memo, and depending on which task force is dividing up the work):

- Country eligibility criteria, and implied allocations
- Overall adequacy of financing
- Risks to the Bank
- Alternative forms of debt service reduction and their costs and benefits, from the viewpoint of (a) the country and (b) the Bank; and associated conditionality
- Country-by-country projections of financing needs
- Tax and regulatory incentives for debt service reduction

2. The issues to be considered under each heading are described briefly in a memo I sent you on April 7, and at greater length in the March 30 paper "The Brady Initiative: Issues for the World Bank."

3. It might make sense to revise and update "The Brady Initiative: Issues for the World Bank" and send it to the Board for information on Monday next week. There would be relatively little work involved in making the paper suitable for the Board; by drawing on preliminary results obtained since March 30, we could also give the Board an idea of the way we are likely to come out on some issues. You could request a revision of the paper to be ready cob Friday for discussion first thing Monday and distribution later that day.

4. There are some issues on which you will have to make a decision before sending options to the Board. The most important is the interest pool. The Bank will have to decide how and whether it wants to support interest reductions, and whether it will go beyond its normal credit allocations for this purpose. One way to proceed would be for you to ask for a brief on this subject from Operations, and then to discuss it with your debt group.

5. Similarly, you will want to consider interest guarantees versus the other methods suggested by Ernie Stern. We have been avoiding this issue so far, perhaps on the view that it would be solved by some analysis currently under way. I don't think anything currently under way addresses that issue. You may want to ask Finance to present a brief paper on interest rate reduction methods, including guarantees and the Stern proposal, and again discuss the issue with the debt group.

6. We may be falling behind in working with countries on debt reduction plans. It would be useful to get a precise reading from Moeen of the actual work being done with particular countries, so that you can decide whether you want more or less to be done.

7. In light of Mr. Dallara's discouragement, you might want to reconsider whether we should pursue the tax and regulatory reform issue. I believe we should, but that is now a political decision.

8. We have said that we will want to take papers to the Board within a month. We could follow the Fund in distributing relatively incomplete papers informally. Among the preliminary papers that you might want to request (with possible authors) are:

(i) Eligibility criteria (Dubey/Holsen)
(ii) The Bank's attitude to credit enhancement for interest reduction, guarantees etc. (which will build on the discussions you have under points 4 and 5 above) (Wood/Bock).
(iii) Alternative forms of debt service reduction, from the viewpoint of the country (Fischer)
(iv) Ditto, from the viewpoint of the Bank (this may subsume (ii)) (Wood/Bock)

So long as you insist the first drafts are short, you could have them by the end of next week.

9. Perhaps you could discuss this possible work program before or after PC tomorrow (April 12).

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 10 1989

TO: Mr. Barber Conable

FROM: Stanley Fischer SF

PHONE: 33774

SUBJECT: Debt Meeting with U.S. Treasury.

1. A Treasury team headed by Charles Dallara met today with Bank and Fund groups working on the debt. The Fund was represented by Messrs Erb, Frenkel, Watson and Beza (and perhaps others); the Bank by Messrs Qureshi, Stern, Wood, Fischer, Scott and Bock.

2. Although an agenda (attached) was distributed shortly before the meeting, we did not stick to it closely.

3. Dallara opened by saying that the divergence of views on interest guarantees was probably a reflection of other concerns that the Europeans had about the Brady Plan, but that the U.S. had reason to believe that both the British and Germans were willing to look at guarantees and other options constructively.

4. In response to Moeen Qureshi's statement that our preliminary analysis indicated a preference for debt service, and particularly interest, reduction, Dallara argued that debt reduction brought long-term benefits of lower debt ratios, and was in any case politically advantageous. After listening to our planned work program, Dallara suggested we not put too much effort into the work on tax and regulatory reform, since this would take time to come into effect.

5. Fund representatives said they planned to go to their Board informally with two (or three) relatively brief papers, within two weeks.
. The first would discuss general issues, explaining the basis for a new debt strategy, and the different forms of debt service reduction.
. The second would examine the modalities of set asides, and the question of interest support, which in the Fund context could be achieved through escrow or trust funds.
. The possible third would be a paper on financing assurances.

. In addition, the Fund might take specific country cases to their Board informally even this week (probably Mexico).

6. Mr. Dallara pushed the Bank to move quickly with informal papers to the Board. Among the topics he suggested were:
. A brief paper on two or three different options for interest reduction.

. A paper or three papers (by the end of next week) on the three most crucial areas: set asides, interest reduction, and eligibility.
. A paper on foreign direct investment and how we might include appropriate FDI conditionality in our loans.

He suggested the capitals were looking for analytic papers to help them formulate their views, and that we shouldn't rule out interest guarantees. Earlier in the meeting he had suggested we shouldn't wait on the analytics of different forms of debt service reduction but should get on with country cases.

7. The Treasury ended by saying they would like their staff to get together with ours to discuss the papers on which we are working. David Bock is to be the contact point.

cc: M/M Hopper, Qureshi, Stern, Shihata, Wood, Baneth, Bock, Holsen, Scott, Haug, Husain, Linn.

Th' World Bank/IFC/MIGA
O . . I C E M E M O R A N D U M

DATE: 10-Apr-1989 10:18am

TO: Evelyn S. Castro

FROM: Nonna Ponferrada, FINSV

EXT.: 72811

SUBJECT: Agenda for the meeting with Dallara at 11:45 a.m. today

Ron Myers just phoned in the following agenda for the 11:45 meeting this morning:

(1) Plan of action
(2) Preparation of Board papers
- capital flight
- foreign direct investment
- debt-reduction
- interest support
- modification of policies on financial assurances
(3) Application and specific cases
- Mexico
- Venezuela
- Philippines
- Costa Rica
(4) General Bank waivers

HE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

)FFICE MEMORANDUM

DATE: April 7, 1989

TO: Mr. Conable, EXC

FROM: Stanley Fischer, DECVP SF

EXT: 33774

SUBJECT: Debt Work Program: Overview of Progress

Attached please find the first of what will probably be a weekly review of issues, progress and reports on the work of the Bank Task Force on the Brady initiative.

Overall, we have identified the issues and made some progress on most of them, but more remains to be done on each.

Here is on overview of the progress so far and the key outstanding issues:

(1) Country eligibility and allocations:
Progress: Broad principles on necessary adjustment efforts have been established.
Issues: Work on clear and objective eligibility criteria has to begin soon. Allocation guidelines need to be developed.

(2) Adequacy:
Progress: Preliminary, aggregate projections only. Work on individual countries has started.
Issues: Need to intensify work on individual countries. Provision of new money by commercial and official lenders needs further analysis.

(3) Risks to the Bank:
Progress: Some partial assessment has been made and further work is underway.
Issues: Policy and legal stand of Bank in arrears situations has to be clarified; risks to the Bank of different forms of debt reduction have to be specified.

(4) Forms of Debt Reduction:
Progress: Partial analysis of preferred forms of debt reduction, the pricing, effect on secondary market prices and the benefits of different forms to the country.
Issues: Need clarification on the possible tax and regulatory measures taken by creditor countries and legal issues (sharing clauses).

(5) Regulatory Environment:
Progress: Preliminary analysis
Issues: Tax and regulatory changes that would facilitate commercial bank participation have to be identified for the various creditor country governments.

Attachments

cc: Messrs: Hopper, Qureshi, Stern, Shihata, Wood, Bock

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P-1867

Work Areas Identified

The work to be done for the evaluation of the Brady initiative was initially classified under the following 6 areas, each area followed by the lead person responsible (as decided in the meeting of DB/SF/HS/JW on March 14 (see item 3 on the enclosed list of papers)).

(i)	country eligibility and allocations;	Dubey/Holsen
(ii)	adequacy of external resources;	Bock
(iii)	risks to the Bank;	Wood
(iv)	preferred form of debt service reduction;	Bock
(v)	description/overview of the Brady proposal; and	Fischer
(vi)	country cases.	Bock

In addition, it was later determined that the regulatory environment requires work.

Where Do We Stand:

The Group of Four reconsidered the work program this week (see the memo of April 6 by DB/SF/IS/JW to BC) which led to a slightly different division of work areas and assignments. An assessment is made here to what extent the existing memos and background papers cover the areas identified above and where necessary additional follow-up by other departments has been identified.

(i) country eligibility criteria: apart from the Treasury's list of 39 countries which have rescheduled since 1983 and the necessary conditions on the type of adjustment effort that is expected (see for instance Annex 3 to Shilling's memo, item 13), no explicit further (quantitative) country criteria (e.g., debt burden) have been identified.
Incomplete: need detailed, globally applicable criteria

allocations: so far done on the basis of the 25% rule plus prorating of additional funds and reallocating when deemed necessary and appropriate.
Incomplete: need better allocation rules; have to be made dependent on eligibility.

conditionality and tranching: Annex 5 to memo of Shilling (item 13) provides a "term sheet"; and Annex 3 discusses issues regarding IBRD support.
Incomplete: sequencing, and results on prices and conditionality, is not resolved; and need detailed Operational Guidelines which satisfy eligibility criteria, legal requirements and financial objectives.
Follow-Up: additional support from legal will be necessary in preparing guidelines.

(ii) adequacy: numbers prepared by Hanna (item 12) and Steer (item 18) combined with Steer's notes on external financing requirements (items

7 and 19) provide rough aggregate estimates of the amounts of (relative) debt service requirements filled.
Incomplete: need detailed, individual country studies, which will have to be aggregated.

(iii) risks to the Bank: no full assessment yet; legal considerations: Shihata (item 8, plus the memos/papers he lists); background working paper 1 (item 3); and Annex 2 and 3 to Shilling's memo (item 13).
Incomplete: need complete legal/financial assessment.
Additional Work: need additional legal support on status of the Bank.

(iv) forms of debt reduction: Annex 2 to Shillings' memo (item 13); Johannes (item 21); Fischer (item 10); Underwood (item 9); and Toft: background working papers (item 3);
Incomplete/Insufficient: need further analysis on forms, effects on secondary market price and shape of supply curve.
Additional Work: Legal to provide specific input on contractual issues of forms of debt reduction.

(v) Regulatory Environment: Hay, Annex 4 to Shilling's memo (item 13); background working papers 3 (legal) and 4 (regulatory/tax) (item 3); and Shihata (item 8 and memos/papers he lists).
Incomplete: Need detailed (legal) opinion and solid policy suggestions on regulatory/tax changes.

(vi) Country cases: some individual country assessments by DFS/FRS and operations, not final.
Incomplete: Need detailed country analysis consistent with (pricing of) forms of debt reduction (will fall from now on under work area adequacy as that will be build up from individual country cases, i.e., will fall under Shilling/Steer/Husain).

In addition, it has been decided that Alan Gelb will work on methods to improve the prospects for FDI.

LIST OF PAPERS PREPARED IN THE CONTEXT OF THE BRADY INITIATIVE

	From:	To:	Date:	Memo/note Title: Subject:
1.	Bock	Distribution	March 13	World Bank's Operational Strategy in Heavily Indebted Middle Income Countries Opening remarks by BC and DB for Board meeting on captioned paper
2.	Wood	DB/SF/HS	March 15	Work on the Brady Proposal Outline of Work to be Done on Issues Raised by the Brady Proposal
3.	Toft	Distribution	March 16	Debt Strategy Board Memorandum: Background Working Paper 4 working papers related to Board Paper on Debt Strategy: 1) Illustrative effects of World Bank Involvement in Voluntary Debt Reduction Operations; 2) Illustrative Examples of the Potential Impact of Debt Reduction Exercises on the Debtor Economy; 3) Certain Contractual Issues to be Considered in Cash Buyback Schemes; and 4) Possible Issues in Regulatory and Tax Policy Affecting Debt Restructuring Options
4.	Wood	DB/SF/IS	March 20	Brady Plan Consultations Points to be raised with US Treasury
5.	Qureshi	Distribution	March 20	Mr. Brady's Debt Initiative — The Need for Consistent

			Country Projections Unified Survey Update
6. Watkins	AS/FS	March 20	Preliminary Analysis of the Brady Proposal
7. Steer	Distribution	March 22	Economic Projections for the HICs and Other "High Risk" Countries
8. Shihata	JW/SF/DB	March 22	Legal Issues to be Considered by the Taskforce
9. Underwood	IH	March 23	Estimate of the Impact of the Brady Proposal: Results from a Secondary Market Price Model
10. Fischer	Distribution	March 23	Simple Analytics of Debt Relief Paper by Paul Krugman
11. DB/SF/IS/JW	Conable	March 23	The Brady Plan: Issues for the World Bank Briefing Note
12. Steer	Task Force	March 23	untitled ("Mulford Numbers") Estimates of debt service reduction (numbers by Don Hanna) (reproduced as Annex 1 to item 15).
13. Shilling	Distribution	March 24	Preliminary Assessment of the Brady Plan Annex 1: "Mulford Numbers", projections/estimates of debt reduction; Annex 2: Illustrative Effects of World Bank Involvement in Voluntary Debt Reduction Operations; Annex 3: IBRD Support for Alternative Debt Reduction Techniques; Annex 4: Staff Working Paper:

			Possible Issues in Regulatory and Tax Policy Affecting Debt Restructuring Options; and Annex 5: Draft Operational Guidelines: World Bank Financial Support for Debt Reduction.
14. Steer	JW/DC	March 24	Front-Loading Debt Relief: Some Thoughts
			Discussion of Step-Up Proposals
15. Steer	not listed	March 28	Questions Requiring Judgments
16. Bock	Distribution	March 29	Meeting with US Treasury re Brady Proposal
17. Husain	Conable	March 30	The Brady Initiative: Issues for the World Bank
			Briefing Note
18. Steer	JW/DC	March 31	The Brady Initiative: US Treasury and World Bank Assumptions
			Differences between Treasury and Bank Debt Reductions numbers
19. Steer	Distribution	March 31	External Financing Requirements of the HICs
			Estimates of Financing Requirements under MUD scenario
20. DB/SF/IS/JW	Conable	April 5	Debt Work Program Issues
			Update on Work Program
21. Johannes	Distribution	April 7	Liquidity and Debt Relief Obtained by Various Techniques.
			Calculations of the debt reduction impact of various debt reduction techniques

HOPPER

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

Zaher

I regret that I will be on my way to Toronto for an evening speech on 'Women in Development' when you hold your 1:30p meeting to-day. Stan will be there for PPR.

Enjoy your trip.

W.A.W.

4.13-89

PPR

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 13 1989

TO: Mr. Barber Conable

FROM: David Hopper W.D.H.

PHONE: 75678

SUBJECT: Interest Reduction Support

1. The relative benefits of interest versus debt reduction to different debtor countries depends on their individual circumstances. We should certainly retain the flexibility to allow the set-asides to be used in whatever ways we and the countries jointly decide is in their best interest--subject to safeguards on our exposure.

2. We should not phrase our discussion of going beyond the set-asides in terms of whether we accept the Treasury's proposal that we provide another $2 billion per year for interest reduction. Rather the question is whether we want to go beyond our current lending targets and exposure guidelines for the debtors in support of debt and/or debt service reduction, and by how much. We should not for very much longer avoid taking a position on that issue, for the overall success of the Brady Plan depends not only on what we eventually do but also on what we announce.

3. The main concern in making an announcement that we would be willing to support additional debt service reduction (i.e debt and/or interest reduction) is that we will be wasting our money by supporting operations that do not in total provide sufficient relief to the debtors to significantly increase their growth prospects and the prospects that they will be able to service their debt. We urgently need to work out and put in place procedures to evaluate the overall financing plans of a debtor to whom we are lending in support of debt relief (or for any other purpose) in the post-Brady environment.

4. I believe we should be willing to go beyond the 25% set-asides in support of debt-service reduction in cases where we are reasonably sure that we are thereby contributing to a country's growth and creditworthiness prospects. Preliminary calculations suggest that the increase in our exposure resulting from such operations at a scale of about $2 billion per year would be tolerable.

5. I therefore recommend that we announce our willingness to go beyond the set-asides, on a country-by-country basis, in support of debt and debt-service reduction programs that significantly contribute to the country's growth and creditworthiness prospects. I also recommend that we should make it clear to the Board that we will do so only when our own analysis suggests the country has a viable

financing plan (which can include arrears); the U.S. might object to such an announcement, but the markets in which we borrow would not. We should set some internal limits on the overall scale of such extra financing, but probably not announce those limits.

6. On the issue of whether we provide guarantees directly, or loans to the countries to be used for collateral, this is a matter of entanglement and our total exposure. The tradeoff is clear: the more entangled we are, the greater the debt service reduction the country is likely to receive, and the greater the risk to us. Our decision on how far to become entangled will have to depend on the results of a careful analysis of the options and their relative effectiveness in reducing debt service, which is currently under way.

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: April 13, 1989

TO: Mr. David Hopper, PPRSV

FROM: Stanley Fischer, DECVP SF

EXT: 33774

SUBJECT: Interest Reduction Support

Background Information for Meeting on April 13

1. The benefits and costs of different methods of debt and debt service reduction will vary according to country specific conditions and the likely movement of key country economic aggregates over the time horizon and would also depend on the relative preferences for and the responses of creditors to these different methods. It seems that there are some a priori advantages that may favor Bank support for near term interest reduction over support for buybacks given advantages of the former in near term cash flow relief. But most likely Bank support will have to be for a combination of several instruments. In general, support for debt and debt service reduction will result in a transfer of risk to the Bank.

2. Benefits of Interest Reduction over Buybacks:

(i) Interest reduction generates larger short-term cash flow benefits for the country per dollar of Bank resources. A dollar of Bank resources used for interest reduction would, on average for the HICs, reduce annual debt service by 40 cents, while the same dollar used for debt buybacks would reduce debt service by only 16 cents.

(ii) Interest reduction (support) can be made contingent on the policy performance of the country. This can provide the Bank with some extra leverage vis-a-vis the debtor country in implementing adjustment programs and also generate additional leverage vis-a-vis creditor banks.

(iii) Interest reduction (support) can be made contingent on external factors affecting the country's debt service capacity. A number of adjustment programs have been derailed because of unanticipated external events. Interest reduction could provide an enabling tool for meeting such exigencies.

(iv) Existing regulatory and tax measures may imply a preference of commercial banks for a recognition of losses over time through interest reduction. The commercial banks may prefer interest reduction for this reason as opposed to a recognition of losses all at once through buybacks.

(v) Exchange instruments with lower interest rates may be valued relatively more by creditor banks. The creditors may perceive the exchange instrument to have senior status due to the perceived and actual entanglement with the Bank. This in turn may generate relatively more debt relief per dollar of (nominal) Bank resources used. And

(vi) Exchange instruments may not require waivers from banks for certain countries whereas general buybacks do require waivers. Under the existing agreements Mexico and Chile can exchange debt instruments without requiring any further waivers.

3. Disadvantages of Interest Reductions over Buybacks:

(i) Debt reduction achieves permanently lower debt (service) ratios. In some countries, this may be politically advantageous to implement adjustment programs and the creditors may also consider this in their long term business interests.

(ii) Interest reduction can still leave countries vulnerable to increases in world interest rates. The countries would remain vulnerable to rising interets rates which can easily offset any debt service reduction.

(ii) Buybacks can not result in entanglement. There would be no legal or financial linkages between the Bank and the commercial creditors.

Bank Exposure:

4. Preliminary staff work suggests that the additional $6-7 billion of Bank resources used during the next three years for interest reduction support may not pose a serious problem (it would imply a 3 percentage points increase in the share of IBRD debt of total external debt of the HICs in 1990) and could be accomodated within the Bank's overall lending program. But in individual country cases, providing additional resources beyond the normal lending allocations may result in exceeding the country exposure guidelines.

In principle, Bank support for buybacks or interest reduction instruments will lead to the same increase in Bank exposure. To the extent that the exchange instrument used to achieve the interest reduction derives some of its value from the perception by the creditors that the Bank's involvement increases the likelihood of repayment of the full amount beyond the formally committed Bank resources, the instrument will induce a larger amount of debt relief. However, the risks to the Bank wil rise commensurate. To the extent that the instrument carries some senior status, the preferred creditor status of the Bank can further be diluted.

Guarantees versus Escrow Accounts Support for Interest Reduction

5. In principle, the amounts of debt service reduction achieved will be independent of the financial form in which the Bank provides support, guarantees or capital lent to be escrowed by the country, provided the financial form is independent from other forms of comfort the Bank (is perceived to) provide(s) and all fees are determined correctly. A priori, the incentives for the borrower and the likelihood of the borrower to honor its new obligations, and to prevent a call on the support of the Bank, are identical under both forms. The only differences I perceive between guarantees and escrow accounts are the following:

(i) To the extent that guarantees are associated with a stronger form of involvement by the Bank, the amount of debt reduction that can be achieved will be larger, but so will the risks to the Bank. The implications in the event of a default by the country on the exchange instrument supported by the Bank, e.g., the subordination of claims and the non-reinstitutability of the support, might be more easily handled through guarantees then through escrow accounts. In general, escrow accounts allow for a cleaner contractual and financial structure, less likelihood of undesired entanglement on the part of the Bank and avoid the need of and negotiations on pricing of fees.

(ii) Guarantees provide a more flexible form of providing support as they can be more easily structured over time (e.g., diminishing) and across circumstances (e.g., in a specific currency or dependent on world interest rates). Escrow accounts could be more complicated to provide the desired amount of comfort over time and accross circumstances.

(iii) Support from other lenders for interest reduction might be more easily forthcoming through guarantees than through direct loans as guarantees are contingent off-balance sheet liabilities for many lenders. Such guarantees by other lenders are also less likely to affect their direct lending program.

(iv) The escrow structure would parallel the way in which the Fund would have to provide support for interest reduction.

(v) It might be more complicated to condition the country's actions and the implementation of its adjustment program in case of support through scrow accounts and the leverage obtained in terms of debt reduction might therefore also be diminished.

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HOLSEN

W O R L D   B A N K -- O F F I C E   M E M O R A N D U M

Date: 23 March 1989

To: Messrs. Bock, Fischer, Shihata and Wood

From: John A. Holsen, CECDR

Subject: "Materiality Criteria" for Board Distribution

1. Mr. Conable's memorandum of March 13 asked that Messrs. Hopper, Qureshi and Shihata proceed with finalizing and distributing to the Board the paper on "Materiality Criteria for Bank Operations" that is a companion piece to the Legal Memorandum on "Authorized Purposes of Loans Made or Guaranteed by the Bank".

2. I attach a copy of the proposed paper for your clearance or comments. This paper is substantively the same as the one discussed in the PC except for (i) editorial changes intended to clarify but not alter the meaning of paragraph 7, (ii) some additional language suggested by Mr. Goldberg, and agreed to by Mr. Shihata, at the end of paragraph 7, and (iii) a rewrite of the final sentence of paragraph 8.

3. In view of the close link between this paper and the draft on "Eligibility Criteria for Bank-Supported Debt Reduction", I thought each of you should have another opportunity to look at this paper before the final version was prepared for Board distribution.

cc: Mr. T. Thahane
Ms. M. Haug
Mr. D. Goldberg
Mr. E. Grilli
Mr. J. Shilling
Mr. A. Steer

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Additional Comments

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information. This Policy can be found on the World Bank Access to Information website.

Withdrawn by	Date
Chandra Kumar	Aug 11, 2014

Adjustment Lending

3. The general circumstances under which structural adjustment loans and credits are appropriate are stated in the recent Report on Adjustment Lending (R88-199). Paragraph 31 of that report indicates:

"Adjustment loans that disburse quickly and finance general imports (through either a negative list or a relatively broad positive list) are a form of balance of payments support. This type of financing is only appropriate when a country's growth prospects are seriously affected by actual or prospective external imbalances and the necessary flow of external resources cannot be mobilized through more conventional forms of financing."

4. These circumstances may arise because of adverse external shocks, or after a period of seriously inadequate national economic management, or a combination of the two. In these circumstances, a country may decide to undertake an adjustment program which involves both short-term stabilization measures and longer-term reforms of institutions and policies to encourage a more desirable rate and pattern of economic growth. However, these changes frequently involve short-run costs and dislocations which make them unacceptable or unsustainable unless some autonomous compensatory actions are undertaken simultaneously. Among these short-run costs are reductions in both public and total investment because of insufficient internal and external resources. As a result of these cutbacks, governments are also less able to absorb conventional project or investment loans in the amounts necessary to support an otherwise feasible level of imports, investment and economic activity. Increased levels of foreign resources, on the other hand, will permit higher levels of investment and imports directly, and when combined with the appropriate policy reform, will also permit increased productivity of the existing capital stock. Should this happen, the combined result will be higher output growth. In this context, "investment" has been defined broadly in the Bank's practice to include spending not only for enlarging the production basis of a country, but also for making it more productive. Investment includes both physical and human capital. Moreover, spending which directly substitutes for future investment requirements, such as spending on improved operations and maintenance, also falls under this heading.

5. In the circumstances discussed above, there is little doubt SALs and SECALs can contribute to investment and growth. That structural adjustment lending will in fact do so will, however, depend upon a number of additional factors. As indicated in the recent Report on Adjustment Lending (R88-199), the following criteria seem adequate to satisfactorily establish both the need for and probable effectiveness of structural adjustment loans and credits in terms of their having a material effect on the prospects of investment (intended as above) in the recipient country.

a. There is a demonstrated need for balance of payments support assistance (in the senses quoted above from the Report on Adjustment Lending).

b. There is an understanding with the borrowing government on its structural adjustment program, covering both short-term macroeconomic objectives and the longer-term policy and institutional changes.

c. There is adequate evidence that the government "owns" the adjustment program in the sense that it is understood and supported by the relevant authorities.

d. The structural adjustment program is well designed and can be expected to be sustainable under reasonable assumptions about the effectiveness of government policy measures, the external economic environment, the availability of external financing from non-Bank sources.

Loans and Guarantees to Refinance or Restructure Existing Commercial Debt

6. As the Legal Memorandum indicates, there may be circumstances under which the Bank may also be called upon to use its financial resources in support of loan restructuring, equity conversion or interest rate swaps. Each of these possibilities is discussed in turn below.

7. For debt-restructuring--which is here broadly defined to include schemes for debt reduction--the Legal Memorandum reads as follows: "Should the supported operation be unrelated directly to specific investment, it may still be eligible under the 'special circumstances' provision, if it would otherwise facilitate or enhance investment in the borrowing country, depending on the detailed features of each transaction." Two broad cases may be distinguished. In the first case, the country's growth and development performance will benefit from the temporary or permanent reduction in debt service flows only if the latter is accompanied by a program of structural reform, and such a program, supported by Bank adjustment lending, is already in place or is agreed to at the same time as the Bank-supported debt restructuring. In this case, the criteria for structural adjustment lending are satisfied; in addition the Bank must satisfy itself that the savings resulting from debt reduction will increase resources available for investment, because of the comprehensiveness of the program or specific assurances by the Borrower. In the second case, in countries where the Bank is not currently engaged in adjustment lending, the country may have in place an adequate policy framework (perhaps because of extensive prior action under earlier Bank or Fund operations), but, in order to regenerate growth, it may need to free up domestic savings for investment purposes. In this case, to lend to the country for debt restructuring the Bank would need to show (i) that the reduction in debt service permitted by the operation is expected to be translated into increased productive domestic investment (broadly defined, as above in paragraph 4) and thus enhance economic growth and development even in the absence of an accompanying Bank-supported adjustment program, and (ii) that the government's supportive policy framework is expected to remain in place. In either of these cases, Bank involvement is justified only when (i) Bank intervention is critical to the success of the adjustment program or policy framework, (ii) the resulting reduction in debt service enables the borrower to have a financing plan that effectively supports the country's strategy for adjustment and growth and (iii) the Bank is satisfied that the resulting savings will not be used to finance unproductive purposes. In evaluating items (i) and (ii) above, the Bank shall pay attention to the

magnitude of the discount being achieved and the overall size and significance of the transaction being assisted, together with the likely impact of the transaction in establishing a basis for further debt reduction activities, as part of the agreed strategy to strengthen the country's creditworthiness, promote the repatriation of flight capital and engender higher domestic savings.

8. For debt/equity conversion (direct and indirect) and interest rate swaps the criteria which justify Bank involvement are that Bank lending or guarantees assist the borrower to undertake a specific new investment, to enhance an existing project or, in special circumstances, to pave the way, significantly and materially, for conditions more conducive to investment so as to justify the Bank's intervention. In addition, with respect to a Bank supported adjustment program or, alternatively, an adequate policy framework, the same materiality criteria apply as in the case of debt restructuring (para.7).

SHILLING

Mrs. Haug

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: March 24, 1989

TO: Distribution

FROM: John D. Shilling, DFS

EXTENSION: 72773

SUBJECT: Preliminary Assessment of Brady Proposal

1. Attached for your review and comment is a preliminary assessment of the impact of the Brady proposal on the financing requirements of debtor countries, of the implications of alternative debt service reduction techniques, and of the issues this would raise for the Bank. The assessment is supplemented by a series of annexes which cover the topics in more detail and offer a draft set of guidelines the Bank might wish to establish for participation in debt service reduction operations. The underlying data base still needs considerable work to improve its content, and this in underway. The estimates of various rates of return on different mechanisms depend a great deal on the specific assumptions used for each instrument and can vary substantially with different assumptions. In addition, most analysis is based on the assumption that the transactions are relatively small compared to the market. Large transactions, or an entire program of debt service reduction will have a substantial effect on the market, which may reduce the effectiveness of the operation unless current market prices are somehow locked in. We need to reflect carefully on the impact of any large scale intervention on the tenor of deals that can be done.

2. This is the DFS contribution as agreed by the four notables, but it includes substantial input from FRS, PPR, and IEC. Work is continuing on the country data base, with special attention to country studies for Mexico, Venezuela, Philippines, and Costa Rica, which are of primary concern to the Treasury.

Attachment

Distribution:

Messrs. Stern, Qureshi, Wood, Fischer, Shihata, Steer, Morais

cc: Ms. Haug, Mr. Taylor

SUMMARY OF IMPACT ASSESSMENT AND ALTERNATIVE TECHNIQUES
FOR THE PARTICIPATION OF THE WORLD BANK IN THE BRADY PLAN

Staff have undertaken a series of rapid analyses of the potential impact of the proposals offered by Secretary Brady and of the effects of alternative approaches to providing debt relief. The results of these analyses are summarized below: more detail is provided in the attached notes. On the basis of these preliminary results, some guidelines for the participation of the World Bank in debt and debt service reduction are proposed. It should be noted that the data used for these analyses are still preliminary and subject to a wide range of uncertainty, so the figures cited are indicative only. The specific issues addressed in this note are the adequacy of the funding to resolve the debt issue, procedural issues in the application to the debt strategy, and alternative techniques that might be used.

Adequacy of Funding:

Brady has proposed that a total amount of $20-25 billion be provided by the IFIs to support debt and debt service reduction (DSR). This would come about half from set asides in existing programs and half from supplementary resources, the exact nature of which remains to be determined. The World Bank and IMF would each manage about one half the total. Using the existing distribution of the Bank's adjustment lending as an indicator of country allocation and the current secondary market prices as an indicator of the potential discount available for DSR, we have estimated the potential amount of debt service reduction from use of these resources. about $9 billion net reduction over three years for the set of heavily indebted countries seems possible, using median assumptions for other variables.1/ Details are provided in Annex Paper 1. This compares to a requirement for net financing from the commercial sector of about $8 billion per year ($25 billion over three years) estimated in our paper on the Bank's Strategy in Heavily Indebted Countries. In other words, only slightly more than one third of the capital requirements of these countries would be funded by the Brady proposal.

In aggregate, the program seems underfunded, and by extension, it seems underfunded for the largest debtors. No more than one third

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1/ The treasury has proposed a longer list, but the additional countries do not add much to the total debt outstanding. This calculation covers 80-90% of the universe. Under our assumptions, service payments of $1.2 billion would be saved due to buybacks and $4.7 billion saved due to debt conversions for a total of $6 billion saved per year, or $18 billion for the three year period. However, slightly more than $9 billion of Bank and Fund resources would be diverted from other uses in the debtors during this period to fund the DSR, increasing the financing needed from other sources by a like amount. Thus there are net savings of about $9 billion over the three years.

to one half of their requirements could be supplied by DSR operations within the overall resource constraint, and there are not enough resources available from the other countries to significantly alter this result. For these large debtors, some continuation of new money loans will be required. On the other hand, with a flexible approach and carefully designed programs, it should be possible to achieve a comprehensive resolution of debt problems in a number of smaller countries without materially altering the contribution to the larger countries. If it is assumed that not all heavily indebted countries will qualify for the program, then the degree of underfunding for those qualifying would be reduced.

Nevertheless, even a program of the amount proposed will result in a significant shift of debt to the public sector. As a result of the operations described above, the share of "preferred creditor" debt in the total of these countries will rise from 19% to 24%, and an additional 22% will be granted "quasi preferred" status.2/

Before committing itself to participate, the Bank should determine whether there are additional sources of funding that will materially reduce to the degree of *a priori* underfunding, whether there are modifications in the conventional DSR instruments or the overall environment that will give greater leverage to our resources, and whether sufficient differentiation among countries will be possible to permit comprehensive settlements where feasible, and mixed approaches elsewhere. The question of additional resources is a political one for the G-10 to decide; some ways to increase the leverage of our resources are discussed below. Unless these issues are adequately addressed, the Brady proposal may gain some time, but risks merely perpetuating the same relative stagnation of many debtors that we are trying to grow out of.

Procedural Issues:

Once the adequacy of the program is established, several procedural issues should be defined. Of most importance is the close collaboration with the IMF. DSR operations will have to be firmly imbedded in medium term programs acceptable to both institutions and to the country. In addition to the normal policy conditionality, they will have to include provisions for dealing with disbursements when financing gaps are not fully funded in the classical sense. Our relations with the country are unlikely to change in substance, although forms of conditionality and specific disbursements conditions might be modified.

Our relations with commercial banks will probably undergo more extensive modification. We and the IMF would have to provide sufficient information to banks negotiating DSR operations concerning the adequacy of adjustment programs. In addition, because of the dependence of the medium term program on the terms of the DSR deals,

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2/ This would include conversion instruments covered by official credit enhancement.

we would want to be more closely involved in those discussions, or minimally state guidelines on the range of acceptable DSR agreements that we would agree to support. Some suggestions along these lines are presented in the next section. We would probably not want to see the current cartel structure of bank steering committees retained as the exclusive negotiating forum. It is less likely than a competitive market approach to secure the most favorable DSR for the debtors. More competition should be encouraged among different banks or groups of banks to offer the best deal on DSR to the country.

Before committing itself to participate, the Bank should assure that there is full agreement on the scope of cooperation with the IMF and the general nature of the comprehensive adjustment strategies being supported by DSR operations. It should be understood that the Bank will establish criteria both for the scope and form of DSR operations it will finance and for the countries to be supported. The Bank should be assured that the process of negotiating DSR operations between countries and commercial banks is designed to encourage the most favorable results for the debtors.

Guidelines for DSR Techniques:

Over the past year, staff have analyzed a variety of DSR techniques in detail. There are two basic formats: a buyback and some form of credit enhancement on a portion of a replacement instrument carrying lower service payments. In the latter case, the Bank could provide a loan to fund some account which will enhance the new instrument, or provide a direct guarantee. Annexes 2 and 3 elaborate on these issues. Legal issues involved in these operations are treated in a separate note.

The buyback is a relatively straight-forward operation where the debtor purchases its debt at a discount and retires it. The amount of debt retired is inversely proportional to the price. Current secondary market prices indicate that on average, the highly indebted countries could retire about $3 of debt for each $1 of expenditure, saving about $0.30 in interest service per year, assuming the principal is rescheduled into the distant future.3/ The rate of return on such transactions is about 35%. The amount of discount and the implied rate of return on the use of our loan should be an important determinant of the extent of World Bank support. The secondary market is now very thin, and it is not clear what would happen to prices once a Brady-Buyback operation were in action. They are likely to rise, but no-one knows by how much.

3/ If the Bank lent to replenish reserves, this would in effect shift the ownership of the debt to the Bank, albeit in a lower amount. Interest service to the Bank would be about $0.10 per year for the loan of $1, so the country has a net saving of $0.20 in service payments, but uses up $1 in available borrowing, unless the Bank loan were fully additional.

Debt relief can also be provided by offering a replacement instrument with a lower face value or a lower interest rate than the original loan. The Brady proposal implies that loans for principal defeasance should be made only for discounted exchanges.4/ Credit enhancement would be offered to make exchange offers more attractive whether or not they occur at par through some guarantee for interest payments for one to three years. This can either be done by lending to the country to establish a line of credit or escrow account that would be used to make interest payments if the debtor does not, or by writing a Bank guarantee on interest payments for three years, rolling forward if not called.

From a strictly analytic point of view, any of these three options will yield approximately the same amount of DSR for a given amount of Bank capital lent or committed in guarantee. However, in the case of credit enhancement, to the extent that the lenders perceive the involvement of the Bank as increasing the likelihood that the debtor will pay the contractual rate of interest on the replacement instrument beyond the amount of the guarantee, the banks will accept larger discounts and a relatively larger amount of DSR can be obtained for a given use of Bank resources. However, the larger the amount of this extra benefit, the larger the amount of Bank involvement in the operation and the larger the potential risk to the Bank. Thus a direct guarantee is likely to induce a larger amount of DRS than providing a loan to the country to establish a guarantee fund. Under certain constructions, credit enhancement may also provide somewhat more short term cash flow relief compared to a buyback. The specific construction of each instrument will effect its efficiency in inducing DSR and in protecting the Bank. We believe instruments can be designed which will significantly enhance DSR at little incremental risk to the Bank.

Overall, the most appropriate instruments will be a function of country specific circumstances, and the Bank should be prepared to use a variety of instruments, depending on the context. Our findings indicate that buybacks are probably more effective in countries with large discounts where a single operation should clean up a substantial portion of the commercial debt. For larger countries with lower discounts, credit enhancement would seem more appropriate.

The degree of regulatory support from major creditor governments will also have a significant impact on the attractiveness of various DSR tactics to commercial banks. See Annex 4. Those accepting buybacks will have to realize the loss implied in the discounted selling price, either by reducing profits or reducing reserves, which may also lead to a reduction in regulatory capital. For capital constrained banks, this may be a costly option. Enhanced debt conversions could be structured to allow banks to carry

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4/ To purchase zero coupon bond matures to a value equal to the principal of the replacement instrument when that falls due, usually as a bullet payment in 25 or 30 years, so the lender takes little or no risk on the principal.

replacement instruments at closer to face value and to attribute reduced rate interest to income under FASB15 guidelines. This would allow banks to spread the loss over a longer period and reduce the pressure on their capital, particularly if regulators forced more rigorous accounting and writedowns of assets not included in conversion exercises. In view of the potential underfunding of the overall program, stronger regulatory stances on debt to heavily indebted countries not included in a DSR activity would augment the impact of the resources available.

Before committing itself to participate, the Bank should assure that a full range of options for DSR will be available, subject to prudential limits, so that the most appropriate instruments can be used in individual cases. It should seek the maximum flexibility in its negotiating and operating positions. It should assure that the internal rate of return of such use of resources is adequate in relation to normal lending criteria, or higher criteria established for such DSR operations.5/ The Bank should also seek assurances that creditor governments will take appropriate regulatory action to assure that commercial banks are encouraged to participate in DSR operations that entail substantial benefit to the debtor countries. Without this commitment, it is hard to justify the added risks and efforts that would fall on the Bank.

Criteria for Bank support of DSR operations should be established and announced at the beginning of the program. These should assure that the Bank will only participate in DSR operations that obtain a substantial amount of debt relief within a comprehensive, medium term framework that is viable. The Bank should refrain from writing long-term principal guarantees that are unfunded, and it should not fund buybacks that have only a marginal impact on improving a debtor's situation. It should encourage competition among groups of financial institutions to offer the best deal rather than accepting club deals from current steering committees. Although the initial Brady proposal assumed that the Bank would not participate in the negotiations between the countries and their banks, it is difficult to see how the Bank can be far from those negotiations if it is going to be asked to provide finance for DSR deals. If it is not a party to the negotiations, then it must make very clear the terms on which it will finance DSR operations. It is to be expected that those terms will vary by country on the basis of the analysis of our country teams. A draft proposal for guidelines for Bank involvement in DSR operations is attached as Annex 5.

Attachments

5/ For example, a buyback at a 30% discount (70% of face value) only yields at best a 15% rate of return, which is not necessarily the best use of our funds.

SHIHATA

Record Removal Notice

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From : Ibrahim F. I. Shihata

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Correspondents / Participants
To: Messrs. Joseph Wood, FPRVP, Stanley Fischer, DECVP, David Bock, DFS
From: Ibrahim F. I. Shihata, LEGVP

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Legal Issues to be Considered by the Task Force

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STEER

THE WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE April 13, 1989

TO See Distribution

ADS

FROM Andrew D. Steer, Chief, FRSCR

EXTENSION 72601

SUBJECT Revised Economic Projections for the HICs and Other High Risk Countries

You may recall that as part of the work for the Brady Initiative, we asked Country Departments to submit an updated set of "best estimate" projections for selected countries.

The response from Regional staff has been good, with about 20 countries submitting new projections. These have been analyzed for accuracy, consistency and realism by CEC, IEC and FRS staff. While we believe that some of these projections still err on the side of optimism, they are altogether more accurate and consistent than the earlier Unified Survey results.

The attached note, prepared by Fred Kilby, summarizes the first round results of this exercise. A more complete paper will be distributed in the next few days. In addition, a separate note discussing the realism of assumptions on policy reform and supply response will be issued by Vittorio Corbo.

Attachment

Distribution
Messrs. Wood, Rao
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Harrison, Cohen
FRSCR Staff

April 13, 1989

Economic Projections for the HICs and Other High Risk Countries

Attached is an updated set of tables summarizing the results of the Unified Survey. These tables include revised projections for Argentina, Brazil, Colombia, Cote d'Ivoire, Egypt, Mexico, Philippines, Turkey, Uruguay, Venezuela and Yugoslavia[1/] that were provided in response to Mr. Qureshi's memorandum of March 20:

The main conclusions are as follows:

- The amount of external finance received by the HICs in 1988 (Table 1) is now estimated to have been only $2.4 billion--far less than the estimate of $9.2 billion shown in the tables we circulated earlier. The main changes are in Argentina, Brazil and Mexico (Table 2). These numbers are now considerably closer to the Fund's estimates in the April 1989 World Economic Outlook (WEO). The level of external financing received by the "Other Higher Risk" (OHR) countries in 1988 is now estimated at $6.9 billion compared with the earlier estimate of $9.1 billion. Turkey accounts for most of the difference in this category.

- The growth story for 1988 is little changed. Overall, the HICs growth was fractionally lower than previously estimated (1.7% compared with 1.8%) due to changes in the estimates for Argentina and Brazil. There were no significant changes in the growth estimates for the "OHR" countries.

- 1989 promises to be a much more difficult year for the HICs than earlier projected (Table 3). With the exceptions of Colombia and Yugoslavia, all of the revised projections show higher financing requirements for 1989. But real GDP is now projected to increase by only 1.4% compared with 3.4% earlier. The growth estimates for all four of the major debtors in Tier 1 have been drastically lowered.

- In the medium term, real growth rates are projected to recover strongly in the HICs, although growth in 1990-95 is now projected at 4.3%, compared with 4.9% projected earlier. Overall, financing needs are little changed in 1990-91 ($23 billion per year on average), but the estimates for the Tier 1 countries have been increased relative to the other HICs. In

1/ Revised projections for a further eight countries--Cameroon, Congo, Costa Rica, Dominican Republic, Gabon, Guatemala, Nigeria and Zimbabwe--are expected to be available shortly, providing some outstanding issues that have been raised by IECDI concerning the accuracy of the underlying external debt data used in the projections for these countries are satisfactorily resolved.

the 1992-95 period, overall financing needs decline to an average of $21 billion. But, in contrast to the general trend, Mexico's financing needs are projected to rise sharply in 1992-95. Mexico accounts for virtually one-third of the total requirements of the HICs in this period. There are no significant changes in the medium term growth or financing outlook for the "OHR" countries.

- Although average financing needs during 1989-83 are little changed in the HICs, commercial bank financing requirements have increased from $10.8 billion to $11.5 billion per annum (Table 5). The Tier 1 countries account for 84% of these flows, compared with 64% previously. Private financing requirements in the Tier 2 and Tier 3 countries have fallen sharply, mainly due to reductions in the projected needs of Yugoslavia and Colombia. With the exception of Argentina, the projected financing requirements for the HICs have been explicitly identified by creditor category. Residual capital account movements are not treated as a source of finance and, in an accounting sense, there are no unidentified financing "gaps". There are, however, unidentified "gaps" in the financing projections for a number of the smaller "OHR" countries which are significant in relation to their overall needs.2/

- IBRD net flows are projected to average $3.4 billion annually in the HICs and $1.4 billion in the "OHR" countries, double the level projected by FRS under the base case planning assumptions ($1.7 billion and $0.7 billion respectively). In contrast, use of IMF credit is expected to fall by an average of almost $1 billion annually.

- The projections imply a 3.5% average annual increase in commercial bank exposure during 1989-93 (Table 6). This corresponds to an average interest capitalization rate (net flows as % of interest payments) of 37%. For the Tier 1 countries, the average interest capitalization rate is 42%. Generally, interest capitalization rates are lower in the other country groups; but in a number of countries most notably Chile, Cote d'Ivoire, Egypt, Honduras, Paraguay, Syria, Turkey and Uruguay, the medium term financing projections are based on very high levels of commercial bank support.

Attachments

FKilby:lc

2/ It should be noted that the projections for Brazil, Mexico and Venezuela are not overfinanced. The negative "gaps" are due to the balance of payments conventions adopted for these countries, which impute income earned on flight capital to the current account. Additional financing is required to cover this "cosmetic" adjustment to the current account, which finds its accounting counterpart in net capital outflows.

Table 1: ECONOMIC DEVELOPMENTS IN 1988
A COMPARISON OF LAST YEAR'S PROJECTIONS AND THIS YEAR'S ESTIMATES

	Actual 1987	World Bank /a Projected 1988	World Bank /a Estimated 1988	IMF WEO Estimate 1988
PAC Assumptions				
External Environment				
G-5 Growth (%)	3.3	2.6	4.1	
LIBOR	7.3	8.5	8.1	
MUV (Inflation)	10.7	7.3	6.4	
Oil Prices $/bbl	17.2	16.5	13.6	
Non-Oil Commodity Price Index (1979-81 = 100)	62.7	63.4	69.5	
Regional Projections				
Highly Indebted Countries				
Growth Rates				
Exports (Nominal)	8.5	9.6	12.8	12.1
Imports (Nominal)	3.9	11.2	13.5	10.7
Real GDP	1.1	3.9	1.7	1.5
$ billions				
Current Account Balance	-9.4	-14.7	-10.4	-10.0
Net External Finance	13.5	14.3	2.4	3.3
Change in Reserve Assets (- = increase)	-3.1	0.4	8.0	6.7
Other High Risk Countries				
Growth Rates (%)				
Exports (nominal)	-3.2	11.5	10.9	8.7
Imports (nominal)	-10.6	9.5	5.6	6.1
Real GDP	1.3	3.9	2.5	2.1
$ billions				
Current Account Balance	-10.0	-10.0	-7.1	-9.4
Net External Finance	10.3	11.2	6.9	10.0
Change in Reserve Assets (- = increase)	-0.3	-1.2	-0.5	-0.6

/a World Bank 1988 PAC projections are taken from IEC December 1987 forecasts and Regional economists' projections collected for the June 1988 Portfolio Review. 1988 estimates are based on IEC's February 1989 estimates and the current set of Regional economists' projections (March 1989). IMF estimates are taken from the April 1989 World Economic Outlook.

FRS
12-April-89

Table 2: EXTERNAL FINANCING AND GROWTH IN 1988

This Year's Estimates and Last Year's Projections

	External Finance ($ bn)				Growth (%)			
		1988				1988		
	1987 Actual	Last Year's Projection	Unified Survey Estimates	IMF WEO	1987 Actual	Last Year's Projection	Unified Survey Estimates	IMF WEO
HIGHLY INDEBTED COUNTRIES	14.4	14.3	2.4	3.3	2.0	3.9	1.7	1.5
Tier 1	9.6	7.9	-3.0	-3.4	2.5	3.2	0.9	0.9
Argentina	3.2	3.3	4.1	3.0	1.0	3.7	0.5	0.0
Brazil	2.4	4.4	-3.6	-2.3	3.0	3.0	0.0	0.4
Mexico	3.8	0.4	-3.7	-3.1	0.1	2.0	0.4	0.9
Venezuela	0.2	-0.2	0.6	-1.1	3.0	4.0	4.2	2.7
Tier 2	1.3	2.6	2.1	3.1	-2.7	3.4	3.8	1.6
Chile	0.9	1.1	0.7	0.8	5.7	5.2	6.8	6.3
Nigeria	0.2	2.4	0.7	1.4	-4.6	4.2	5.1	1.2
Peru	0.8	-0.4	1.0	1.1	6.9	2.0	-5.7	-2.0
Philippines	0.4	0.6	0.7	0.8	4.9	5.5	6.9	7.0
Yugoslavia	-1.1	-1.0	-1.1	-0.9	-0.5	1.5	-0.5	-1.0
Tier 3	3.5	3.8	3.3	3.6	0.8	4.7	3.2	4.4
Bolivia	0.5	0.7	0.3	0.4	2.4	3.9	2.8	5.6
Colombia	0.1	0.8	0.7	0.9	5.4	5.0	4.5	5.0
Costa Rica	0.4	0.3	0.3	0.3	3.0	2.0	2.3	3.5
Cote d'Ivoire	0.9	1.1	0.9	0.9	-2.9	1.5	-0.2	-1.3
Ecuador	1.2	0.4	0.6	0.4	-6.9	9.2	8.9	8.0
Jamaica	0.2	0.0	0.3	0.5	5.3	4.0	3.0	3.0
Morocco	0.0	0.5	0.1	0.2	0.2	4.5	5.5	6.0
Uruguay	0.2	0.0	0.1	-0.1	5.1	4.1	1.2	1.0
OTHER HIGH RISK	8.2	12.9	6.9	10.0	1.2	3.6	2.5	2.1
Algeria	-0.1	0.1	0.0	-0.3	0.1	1.7	-2.3	-2.7
Egypt	6.7	8.1	2.9	3.4	5.1	3.0	3.2	0.6
Poland	0.4	1.0	1.1	1.1	0.3	4.0	4.6	4.5
Turkey	0.7	-2.0	-0.7	1.1	1.3	5.0	5.5	5.7

Table 3: UNIFIED SURVEY OUTLOOK - EXTERNAL FINANCE AND GROWTH, 1989 - 1995

	Real GDP Growth			External Finance			
		Unified Survey			Unified Survey		
	WEO 1989	1989	1990-95	WEO 1989	1989	1990-91	1992-95
	(% per annum)			($bn., annual averages)			
HIGHLY INDEBTED COUNTRIES	1.4	1.4	4.3	16.4	18.8	23.3	21.1
Tier 1 Countries	0.8	1.0	4.2	5.3	10.0	13.9	12.9
Argentina	0.0	0.5	2.4	1.3	2.7	3.9	1.7
Brazil	0.0	1.0	4.5	0.6	0.3	3.7	3.6
Mexico	1.6	1.8	3.8	2.7	3.5	3.7	6.8
Venezuela	0.4	-0.5	4.3	0.7	4.0	3.0	1.4
Tier 2 Countries	2.1	2.4	4.6	7.0	4.9	5.6	4.3
Chile	4.0	5.0	4.1	0.9	0.6	1.5	1.0
Nigeria	1.5	2.4	4.7	2.6	1.6	1.1	0.5
Peru	-3.0	-8.0	3.9	1.1	1.3	1.5	1.3
Philippines	6.0	5.9	6.0	3.0	1.9	2.2	2.3
Yugoslavia	1.5	2.8	3.9	-0.5	-0.5	-0.6	-0.7
Tier 3 Countries	3.5	3.1	3.8	4.1	3.8	3.9	3.9
Bolivia	2.7	3.4	2.7	0.7	0.5	0.5	0.5
Colombia	4.5	4.5	4.2	1.0	0.6	0.8	0.8
Costa Rica	3.0	3.5	4.4	0.3	0.3	0.3	0.2
Cote D'Ivoire	0.0	1.3	2.4	1.1	0.9	1.0	1.0
Ecuador	1.0	0.5	4.1	0.6	0.8	0.7	0.8
Jamaica	5.0	4.2	4.0	0.3	0.3	0.2	0.2
Morocco	4.5	4.6	4.8	0.2	0.3	0.3	0.3
Uruguay	4.0	3.6	4.1	0.0	0.1	0.1	0.2
OTHER HIGH RISK COUNTRIES	3.2	3.5	4.2	11.5	11.7	9.3	8.5
Algeria	5.2	3.8	4.7	0.1	0.0	0.1	0.7
Cameroon	-11.6	-4.7	2.8	0.8	0.6	0.5	0.5
Congo	-4.3	4.1	-0.3	0.3	0.3	0.0	0.0
Dominican Republic	3.1	4.0	4.7	0.2	0.4	0.3	0.3
Egypt	0.8	3.0	3.6	5.1	5.7	4.3	4.4
El Salvador	2.0	2.0	2.0	0.3	0.2	0.2	0.3
Gabon	1.3	1.5	2.4	0.4	0.5	0.2	0.1
Honduras	3.0	1.5	4.5	0.3	0.2	0.3	0.3
Paraguay	3.0	2.1	4.4	1.7	0.5	0.4	0.3
Poland	4.5	4.0	4.0	0.3	0.9	0.2	-1.4
Syria	2.0	3.2	3.4	0.7	1.4	1.4	1.4
Turkey	4.3	5.0	5.0	1.3	1.3	1.3	1.6
OTHER BANK BORROWERS	6.5	7.2	6.8	18.4	22.3	24.9	32.9
Of Which:							
China	7.5	9.3	8.1	3.9	7.6	5.8	10.4
India	4.5	5.5	5.6	6.6	5.7	6.8	7.6
Indonesia	5.0	4.2	5.0	2.6	3.3	2.5	3.2
TOTAL BANK BORROWERS	**4.2**	**4.3**	**5.3**	**46.3**	**53.5**	**58.5**	**63.6**

Table 4: UNIFIED SURVEY OUTLOOK - MEASURES OF EXTERNAL FINANCE, 1988 - 1995

	External Finance as % of GDP			External Finance as % of Imports		
	1988	1990	1995	1988	1990	1995
HIGHLY INDEBTED COUNTRIES	0.2	2.3	1.3	1.9	15.4	7.8
Tier 1 Countries	-0.4	2.0	1.2	-4.7	18.9	9.1
Argentina	4.6	4.5	0.6	51.5	51.0	6.0
Brazil	-1.0	1.2	0.5	-20.6	20.0	7.6
Mexico	-2.0	1.4	3.1	-14.7	8.9	14.3
Venezuela	1.1	5.8	1.3	4.7	22.5	3.8
Tier 2 Countries	1.2	2.8	1.4	5.2	10.8	4.9
Chile	3.2	5.3	2.2	10.0	15.6	6.1
Nigeria	2.5	5.0	1.4	11.0	18.5	4.7
Peru	3.8	6.4	3.1	24.3	38.6	18.1
Philippines	1.8	4.1	3.4	7.6	15.7	11.7
Yugoslavia	-1.8	-0.9	-0.7	-8.0	-3.9	-2.7
Tier 3 Countries	3.2	3.3	2.3	14.4	14.0	9.3
Bolivia	7.4	10.0	6.3	38.8	46.3	31.0
Colombia	1.8	1.4	1.1	11.7	9.3	7.2
Costa Rica	5.9	5.6	2.2	16.9	15.0	5.3
Cote D'Ivoire	8.6	9.7	7.6	33.7	34.0	23.1
Ecuador	5.3	6.7	6.2	27.0	31.2	24.5
Jamaica	10.1	5.7	3.0	16.2	11.8	6.6
Morocco	0.5	1.1	0.5	1.6	3.2	1.5
Uruguay	0.8	1.3	1.9	3.9	6.2	8.6
OTHER HIGH RISK COUNTRIES	2.4	3.2	1.9	12.0	14.1	8.1
Algeria	0.1	0.1	1.2	0.4	0.4	5.6
Cameroon	4.6	4.8	2.8	23.9	27.6	18.6
Congo	1.9	3.0	-0.5	3.9	6.1	-1.0
Dominican Republic	4.5	7.3	3.3	10.4	16.8	7.3
Egypt	7.7	15.4	11.3	23.3	30.0	23.2
El Salvador	3.2	2.3	3.8	14.5	12.1	18.5
Gabon	15.5	7.6	1.3	38.3	18.9	3.1
Honduras	5.5	4.9	3.2	21.8	19.2	11.9
Paraguay	9.2	6.6	3.9	35.7	27.2	17.4
Poland	1.6	0.6	-1.9	15.5	5.4	-14.9
Syria	10.9	11.4	9.1	39.6	35.2	25.3
Turkey	-1.0	1.6	1.3	-4.7	6.2	5.4
OTHER BANK BORROWERS	1.0	1.8	1.7	4.6	8.6	7.8
Of Which:						
China	0.8	1.3	1.7	6.3	9.9	13.3
India	1.7	2.1	1.5	17.9	23.3	18.2
Indonesia	3.6	3.0	2.7	15.3	12.8	10.6
TOTAL BANK BORROWERS	0.8	2.1	1.6	4.6	11.1	7.8

Table 5: UNIFIED SURVEY OUTLOOK - EXTERNAL FINANCING REQUIREMENTS, ANNUAL AVERAGES, 1989 - 1993 ($bn)

	Net Flows								
	IBRD	Other Multi-lateral	Bilaterals + Suppliers	Commer-cial Banks/a	IMF	Net Direct Invest.	Net Official Trans.	Gap	Total
HIGHLY INDEBTED COUNTRIES	3.4	2.0	2.6	11.5	-0.9	6.8	0.6	-4.3	21.7
Tier 1 Countries	2.3	0.5	0.6	9.7	-0.6	4.6	0.0	-4.2	12.8
Argentina	0.3	0.2	-0.5	2.2	-0.1	0.4	0.0	0.5	3.0
Brazil	0.6	0.1	0.1	2.5	-0.3	1.4	0.0	-1.3	3.1
Mexico	0.9	-0.1	0.4	3.6	-1.0	2.4	0.0	-1.7	4.5
Venezuela	0.6	0.2	0.6	1.7	0.9	0.3	0.0	-1.5	2.7
Tier 2 Countries	0.6	0.4	1.0	0.9	0.1	1.5	0.3	0.2	5.0
Chile	-0.1	0.0	-0.1	1.3	0.0	0.0	0.1	0.0	1.2
Nigeria	0.4	0.2	-0.1	0.0	0.0	0.5	0.0	0.0	1.0
Peru	0.1	0.1	0.5	0.6	0.0	0.2	0.0	0.0	1.4
Philippines	0.1	0.1	0.2	0.5	0.0	0.8	0.2	0.2	2.1
Yugoslavia	0.1	0.0	0.6	-1.2	0.1	0.0	0.0	-0.3	-0.6
Tier 3 Countries	0.5	1.0	1.0	0.9	-0.4	0.7	0.4	-0.3	3.9
Bolivia	0.0	0.3	0.2	0.0	0.0	0.0	0.1	-0.1	0.5
Colombia	-0.1	0.3	0.2	0.0	0.0	0.4	0.0	-0.1	0.7
Costa Rica	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.2
Cote D'Ivoire	0.1	0.1	0.4	0.5	0.0	0.0	0.0	-0.1	1.0
Ecuador	0.2	0.2	0.0	0.2	0.0	0.1	0.1	0.0	0.8
Jamaica	0.0	0.0	0.2	0.0	-0.1	0.0	0.1	0.0	0.2
Morocco	0.2	0.1	0.0	0.0	-0.2	0.1	0.0	0.0	0.3
Uruguay	0.0	0.0	0.0	0.1	-0.1	0.0	0.0	0.0	0.2
OTHER HIGH RISK COUNTRIES	1.4	0.1	1.7	1.1	0.0	2.0	2.5	0.5	9.3
Algeria	0.3	0.1	0.6	-1.0	0.0	0.2	0.0	0.0	0.3
Cameroon	0.1	0.1	0.2	0.0	0.0	0.1	0.0	0.0	0.5
Congo	0.0	0.0	0.0	0.0	0.0	-0.1	0.0	0.1	0.1
Dominican Republic	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.2	0.3
Egypt	0.3	0.0	1.8	0.3	0.0	1.3	1.0	0.0	4.6
El Salvador	0.0	0.0	0.0	0.0	0.0	-0.1	0.2	0.1	0.2
Gabon	0.0	0.1	0.0	-0.1	0.0	0.1	0.0	0.1	0.2
Honduras	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.3
Paraguay	0.0	0.0	0.0	0.2	0.0	0.0	0.0	0.2	0.4
Poland	0.2	0.0	-0.4	-0.3	0.1	0.0	0.0	0.2	-0.1
Syria	0.0	0.0	0.0	0.6	0.0	0.0	0.9	0.0	1.5
Turkey	0.3	-0.1	-0.6	1.6	-0.1	0.2	0.2	-0.2	1.4
OTHER BANK BORROWERS	4.1	4.6	3.5	6.9	-0.5	6.4	3.5	0.3	28.7
Of Which:									
China	1.1	0.8	0.6	2.4	0.0	2.4	0.0	0.0	7.3
India	1.8	1.2	1.6	0.5	-0.4	0.4	0.6	1.2	6.9
Indonesia	1.0	0.5	0.8	-0.4	0.0	0.9	0.2	1.7	4.7
TOTAL BANK BORROWERS	**8.9**	**6.6**	**7.7**	**20.1**	**-1.4**	**15.9**	**6.7**	**-3.8**	**60.6**

Table 6: UNIFIED SURVEY OUTLOOK - GROWTH IN EXPOSURE, 1989 - 1993 (percent per annum)

	Commer-cial Banks	Bilaterals + Suppliers	IBRD	IMF	Other Multilat-erals	Total	Memo Item Private Interest Cap
HIGHLY INDEBTED COUNTRIES	3.5	5.0	7.8	-4.3	9.4	4.2	36.9
Tier 1 Countries	3.4	1.9	10.5	-5.0	6.0	3.5	42.3
Argentina	4.6	-6.0	9.3	-4.2	8.4	3.1	47.5
Brazil	1.6	0.6	6.2	-12.1	4.9	1.6	36.1
Mexico	4.1	5.2	9.8	-46.3	-2.0	3.5	45.8
Venezuela	4.9	26.0	313.9	..	45.7	10.0	47.7
Tier 2 Countries	4.5	7.7	6.8	7.5	12.4	6.3	16.6
Chile	7.4	-14.6	-5.0	0.0	-2.3	4.9	82.0
Nigeria	0.0	0.8	9.7	..	57.1	2.5	-0.4
Peru	-0.3	10.9	6.4	3.1	4.3	4.8	16.6
Philippines	3.5	2.1	2.7	-2.9	7.8	3.1	36.3
Yugoslavia	-11.2	11.0	3.9	4.9	9.1	-1.7	-118.6
Tier 3 Countries	2.7	5.4	4.1	-21.7	11.2	4.0	30.9
Bolivia	1.0	9.5	-12.4	-100.0	15.6	9.1	17.1
Colombia	0.0	5.1	-1.4	..	12.2	2.3	0.5
Costa Rica	1.7	0.3	1.0	-41.8	3.5	1.1	22.4
Cote D'Ivoire	4.7	12.3	4.9	0.0	15.6	6.6	67.3
Ecuador	4.0	0.1	15.8	-100.0	9.8	4.8	30.9
Jamaica	3.9	3.9	6.7	-25.6	7.5	2.0	12.2
Morocco	0.9	3.8	7.2	-29.3	9.4	3.0	11.3
Uruguay	4.6	3.6	7.0	-47.3	9.4	3.4	46.6
OTHER HIGH RISK COUNTRIES	1.7	2.5	10.5	9.8	0.9	2.8	22.4
Algeria	-7.4	8.0	22.2	..	57.8	0.3	-89.6
Cameroon	-1.0	15.3	16.2	..	15.2	11.3	-10.1
Congo	..	..	..	5.5	..	5.5	..
Dominican Republic	..	..	..	..	..	..	..
Egypt	3.4	5.6	12.8	-44.2	-0.8	4.7	42.2
El Salvador	-22.0	3.9	3.4	..	-1.1	0.8	-336.0
Gabon	-22.1	3.5	52.0	-11.1	22.0	-0.4	-208.2
Honduras	7.6	2.0	1.3	9.7	2.8	3.3	72.5
Paraguay	11.3	3.2	-5.4	..	1.4	6.5	137.4
Poland	-2.4	-0.7	..	..	-2.9	-0.3	-30.1
Syria	8.5	..	74.6	..	74.6	6.6	441.2
Turkey	6.2	-6.8	4.5	-100.0	-3.5	2.7	66.0
OTHER BANK BORROWERS	3.5	4.0	11.0	-11.2	13.2	5.6	41.4
Of Which:							
China	9.3	5.5	33.5	0.0	16.0	10.9	124.2
India	5.3	8.6	23.9	-35.4	7.7	8.8	77.6
Indonesia	-2.7	3.3	8.5	6.5	20.0	3.7	-32.4
TOTAL BANK BORROWERS	3.3	3.9	9.3	-5.4	9.5	4.2	36.6

STERN

Ernest Stern, Senior Vice President, Finance

Talking Points for
Financial Press Briefing
April 5, 1989, 11:15 a.m.
Room C-1006

A great deal of discussion about the Brady proposals. I would like to focus on the financial aspects of these for the Bank.

The Brady proposals are an important step in the debt strategy, although, as you know, many details of implementation are to be worked out by the Fund and the Bank. We welcome the legitimization of debt reduction---either in the form of reducing the stock of debt or lower interest rates---as an important addition to the menu of options by which commercial banks can provide funds to the developing countries.

And this is vital because the process had almost deadlocked. By itself, debt reduction may not meet the full external capital requirements of each developing country. Nor is it intended to. There are many other sources of capital---MDB lending, trade credits, export credit agencies---particularly Japan---, direct investment and new lending from commercial banks. But debt reduction adds to the system's flexibility. Moreover, (i) it is important politically in the indebted countries, (ii) it recognizes the reality in the banking system that some, not necessarily all, are prepared to swap debt either at par with lower interest rates or for new instruments at a discount. This reflects the success of the past strategies which has substantially strengthened the world financial system and the individual banks, against this risk exposure.

One important point. These proposals for an expanded debt strategy do not solve the underlying development problem. They will only help those who help themselves. The need for structural reform remains as urgent as ever in many countries. It was not the existence of debt which distorted trade regimes, kept domestic energy prices at less than half of world market levels; reduced incentives to exports; spread subsidies; allowed inefficient public enterprises to drain the budget; or failed to pay farmers market prices for their products.

But a reduction in debt can help provide the external capital needed by those engaged in effective reform programs---such as Mexico,, Chile, Philippines---designed to restore growth and to make a high rate of growth sustainable. And that is an objective which is paramount to us.

Now, how does this relate to the finances and creditworthiness of the Bank itself?

Talked a lot last year about the GCI. As you know, the GCI has since been agreed. It was, as you know, the largest ever, increasing our capital by 74.8 billion for a total of $171 billion. This put us in a very strong financial position---bolstered further by steps taken in the course of the year.

First, on the GCI. (i) The capital increase is intended to enable us to raise our lending levels to about US$20 billion from the current level of US$15 billion. (ii) the subscription period is open for five more years---but major shareholders have acted expeditiously to subscribe their full shares. UK was first ($3.8 billion), Germany next ($3.8 billion). Japan just passed its legislation authorizing full subscription ($5 billion). In addition, a dozen other members have subscribed. Thus, we will have, by the end of the FY, over 25% of the new capital---an unusually rapid pace, reflecting the broad support of our shareholders.

Second, we have strengthened our financial structure by recasting our currency management practices. Briefly, what the new procedure does is (i) reduce our exposure to interest rate risk, (ii) immunizes our reserve to loan ratio to exchange rates---thus providing substantially more discretionary income, and (iii) provides our borrowers with a more transparent, less volatile real lending rate.

Third, we have strengthened our reserve position by revising our provisioning policy.

These factors are in addition to our $10 billion of reserves, our $19 billion of liquid assets, and annual profits in excess of $1 billion.

The strength of the Bank is reflected in the narrow spread over governments which we have achieved this year in all markets, as well as the remarkable success we have had in our expanded swap program into dollars.

What this means is that we have ample <u>financial</u> capacity to handle the Brady proposals---<u>both</u> on the lending side and on the borrowing side.

What is involved in Brady?

(1) <u>Set asides</u> - Part of lending program. Involves neither greater country exposure nor increased use of capital. Ergo, no need for other borrowers to worry that Brady proposals come at the expense of their lending programs.

(2) <u>Interest enhancement for below-market rate swaps</u>. Financial impact on our balance sheet will be modest. Might increase lending to the eligible countries by 5-10%, depending on scale and terms.

These modest implications for our balance sheet must be seen in the context of the objectives of the proposals---to improve, and eventually restore, the creditworthiness of our borrowers. Obviously, our own portfolio would be strengthened by that, as well.

Of course, the world does not consist of Latin America, or the highly-indebted countries, alone. Many of our member countries are the low-income countries of Africa and Asia. They rely primarily on IDA, which commits about US$4.5 billion annually in these highly concessional funds, rather than on the Bank. IDA has become the center of a coordinated aid effort in Africa and is the major source of multilateral assistance in many countries.

IDA, as you know, consists of grants from governments and it has to be replenished every three years. We have recently started the negotiations for the ninth replenishment of IDA. It is too early to say much about the process. We had our first meeting in Washington in February, and we expect to hold our next meeting in mid-May in London. We plan to meet once more before the Annual Meetings, and then hope to conclude our negotiations before the end of the year.

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. Barber B. Conable — March 20, 1989

FROM: Ernest Stern *ES.*

SUBJECT: **Enhancement of Interest Payments in Debt Reduction Schemes -- Loans or Guarantees**

As you know, I am concerned about the risks associated with IBRD guarantees of interest payments. The concern stems primarily from the position that the Bank would find itself in the event of call. At a time in which relationships between creditors and the debtor would inevitably be strained, the Bank would be required to negotiate a work-out schedule with the borrowers. More generally, there is a risk that the Bank's relationship with the borrower would be dominated by the effort to avert the triggering of the guarantee to the detriment of our policy dialogue, our ongoing lending program, and prospects for timely service of the country's overall debt to the Bank. This could also compound the risk to the preferred-creditor status of the Bank, which is likely to be diluted in any event by the addition of credit-enhanced exit bonds (issued under the debt conversion scheme) and by reduction of commercial bank debt and buybacks. While it may well be true that we could rely on Mexico's record of servicing its bonds, any approach should be assessed in terms of the substantial number of countries which will eventually participate. Clearly, the guarantee is not without risk, or else banks would not be so eager to obtain them.

Since some form of enhancement on interest payments may well be essential both for debt reduction and debt payment relief, and since we ought to help in this effort, we should actively explore ways of providing the same credit enhancement at a lower risk to the Bank. Three alternatives could be considered. The weakest form of Bank involvement would be to ensure an adequate overall financing program to allow the debtor to set aside sufficient foreign exchange to collateralize one or two years of interest payments. It is probable, however, that this would provide insufficient comfort to the commercial creditors. A second alternative would be for the Bank to commit a loan equal to one year's interest payments to the borrower to be disbursed only in the event of, or in order to avoid, a default on interest payments on the enhanced bonds. Disbursements would then be available to cover part of the interest payments on the bonds. This could be made to be attractive to the bondholders, but may create even greater problems of "entanglement" for the Bank, since disbursement would have to be authorized when a default had occurred. A third option would be for the Bank to make a loan to the borrower which would be drawn and the funds placed in an escrow account reserved for the purpose of collateralizing interest payments on the new bonds. This lies between the other two options, in terms of achieving a balance between IBRD involvement and debtor responsibility. There are a number of potential advantages to this approach:

(a) The liability would lie with the borrowing government from the outset. In the event of a default, payment from the escrow account would be automatic, as would the continuing debt service obligation to the Bank.

(b) A loan is a well established mechanism for providing a mobilizing cofinancing, from Japan and other countries.

(c) An escrow fund can further be supplemented from the first year's savings of the borrower resulting from either debt reduction or interest rate relief.

(d) The cost to the country of carrying the escrow fund would be modest. Interest earned by the fund would be used to service the IBRD loan. Our preliminary calculations suggest that an IBRD loan would be a cheaper means for enhancing interest payments than a guarantee.[1]

(e) A loan would avoid negotiations on guarantee fees and legal debates with commercial bank on the issue of subrogation.

A number of technical issues would need to be worked out. These include, for example, the need to link the currency and maturity of the escrow account to the interest obligations on the enhanced bonds, but this should all be relatively straightforward. I understand that from a legal standpoint, this approach would pose no legal problems above and beyond those associated with a guarantee of interest payments.

A potential drawback of the collateralization approach is that it would appear as adding to the country's debt while a guarantee would not. Similarly, debt service would appear to be higher under a loan than a guarantee, and debt service obligations to the Bank would result in lower net disbursements and transfers than under a guarantee. These are essentially matters of perception rather than reality, since the escrow account would "service itself"; in terms of net liabilities, this scheme would be no different than a guarantee. To the extent perceptions are important, moreover, we should also take account of the very negative association that interest guarantee are likely to evoke in the financial markets. These are not scare tactics. Moody's has already asked for a conference call today to explore how guarantees and debt reduction might affect our balance sheet; on Wednesday, Telerate flashed an advisory to all its subscribers suggesting they not buy or hold Bank bonds until matters are cleared; as a result of which we have had many calls from our regional COLTS dealers expressing concern and seeking guidance on whether to continue to market the COLTS.

I suggest we discuss this with Messrs. Qureshi, Fischer and others.

cc: Mr. Qureshi
Mr. Fischer

1/ Fees paid to the Bank for a one-year rolling interest guarantee would probably be of the order of 60-75 basis points per year at a minimum. The carrying cost of a loan is estimated at 10-50 basis points (on the assumption that the funds invested in the escrow account could earn LIBID). A note is available giving more details of cost estimates.

TAYLOR

The World Bank/IFC/MIGA
OFFICE MEMORANDUM

DATE: 28-Mar-1989 08:31am

TO: See Distribution Below

FROM: John Taylor, DFS (JOHN TAYLOR)

EXT.: 73125

SUBJECT: Some Issues for Mr. Conable Concerning the Brady Proposals

In our discussions late last night, I sought to provide a list of the main issues of policy that seem to be emerging from the work of staff on the Brady proposals and from the discussion with Mr. Conable. These issues are outlined below in order to assist Mr. Conable in his various discussions and meetings today and tomorrow, and will be refined and elaborated over the next few days. As you will understand, given the very short time to prepare the list I have been unable to consult with all concerned: these consultations will proceed with all haste, so that a more complete issues list will be available on Thursday, as promised yesterday morning.

The list I proposed to you was as follows:

1. The Bank stands ready to play a positive and constructive role in developing and implementing a program for Bank involvement in debt reduction transactions conferring significant benefit to the Bank's borrowers, in a manner consistent with the maintenance of sound financial policies and the excellent standing of the Bank in the world's capital markets.

Issues: Our involvement must confer significant benefit and we must preserve our AAA borrowing status.

2. In any such role, the Bank expects to work in close cooperation with the Fund and with creditor countries in devising a mutually acceptable joint approach, including the making of collaborative commitments as appropriate to the individual circumstances of each debtor country.

Issues: We will not "go it alone" and we expect both the Fund and creditor countries (e.g., Japan) to make financial commitments to support debt reduction as may be needed.

3. Based on preliminary Bank estimates, the amount of debt reduction that the Bank and the Fund together could effect over the next three years represents about one-third of the total net financing requirements of the debtor countries. Accordingly, any debt reduction program must be accompanied by the flow of new

money from official and commercial sources to the extent required to ensure appropriate levels of growth in the debtor countries concerned.

Issues: The Bank will want assurance on a case-by-case basis that debt reduction is workable and that debtor countries can look forward to a more secure financial future.

4. The Bank support for debt reduction will be decided on a case-by-case basis and will depend upon many factors, including especially:

(a) The debtor country implementing a comprehensive medium-term adjustment program acceptable to the Bank and the Fund;

(b) The debtor country developing a viable medium-term external financing plan [you asked us to confirm whether this was still essential];

(c) The commercial banks accepting a comprehensive and substantial reduction in debt or debt service;

(d) A minimum rate of return on Bank participation of not less than ...% [you felt that 20% would be too low];

(e) The creditor countries adopting tax and/or regulatory policies supportive of the debt reduction process.

Comment: The above are designed to achieve our objective of a significant debt reduction under circumstances where our preferred creditor status will be maintained.

5. There are numerous techniques that the Bank could adopt in supporting debt or debt service reduction. The Bank must maintain flexibility in determining the precise modality in each particular case, so as to preserve its ability to encourage maximum debt reduction within risk parameters acceptable to the Bank.

Comment: Flexibility is essential. We should not limit ourselves a priori to any specific instruments or types of debt reduction. We should not agree to the Fund playing one role and ourselves playing another, a priori.

6. Within the above policies, the Bank looks forward to developing its response to the Brady Proposals in further discussions with our shareholders and the Fund.

Comment: There is still a long way to go to put "the flesh on the bones" and we are working very hard to this end. However, we do not wish to be stampeded into positions that could jeopardize our continued ability to act as the premier international development finance institution.

Mr. Stanton

The World Bank/IFC/MIGA
O F F I C E   M E M O R A N D U M

DATE: 28-Mar-1989 08:31am

TO: See Distribution Below

FROM: John Taylor, DFS (JOHN TAYLOR)

EXT.: 73125

SUBJECT: Some Issues for Mr. Conable Concerning the Brady Proposals

In our discussions late last night, I sought to provide a list of the main issues of policy that seem to be emerging from the work of staff on the Brady proposals and from the discussion with Mr. Conable. These issues are outlined below in order to assist Mr. Conable in his various discussions and meetings today and tomorrow, and will be refined and elaborated over the next few days. As you will understand, given the very short time to prepare the list I have been unable to consult with all concerned: these consultations will proceed with all haste, so that a more complete issues list will be available on Thursday, as promised yesterday morning.

The list I proposed to you was as follows:

1. The Bank stands ready to play a positive and constructive role in developing and implementing a program for Bank involvement in debt reduction transactions conferring significant benefit to the Bank's borrowers, in a manner consistent with the maintenance of sound financial policies and the excellent standing of the Bank in the world's capital markets.

Issues: Our involvement must confer significant benefit and we must preserve our AAA borrowing status.

2. In any such role, the Bank expects to work in close cooperation with the Fund and with creditor countries in devising a mutually acceptable joint approach, including the making of collaborative commitments as appropriate to the individual circumstances of each debtor country.

Issues: We will not "go it alone" and we expect both the Fund and creditor countries (e.g., Japan) to make financial commitments to support debt reduction as may be needed.

3. Based on preliminary Bank estimates, the amount of debt reduction that the Bank and the Fund together could effect over the next three years represents about one-third of the total net financing requirements of the debtor countries. Accordingly, any debt reduction program must be accompanied by the flow of new

money from official and commercial sources to the extent required to ensure appropriate levels of growth in the debtor countries concerned.

Issues: The Bank will want assurance on a case-by-case basis that debt reduction is workable and that debtor countries can look forward to a more secure financial future.

4. The Bank support for debt reduction will be decided on a case-by-case basis and will depend upon many factors, including especially:

(a) The debtor country implementing a comprehensive medium-term adjustment program acceptable to the Bank and the Fund;

(b) The debtor country developing a viable medium-term external financing plan [you asked us to confirm whether this was still essential];

(c) The commercial banks accepting a comprehensive and substantial reduction in debt or debt service;

(d) A minimum rate of return on Bank participation of not less than ...% [you felt that 20% would be too low];

(e) The creditor countries adopting tax and/or regulatory policies supportive of the debt reduction process.

Comment: The above are designed to achieve our objective of a significant debt reduction under circumstances where our preferred creditor status will be maintained.

5. There are numerous techniques that the Bank could adopt in supporting debt or debt service reduction. The Bank must maintain flexibility in determining the precise modality in each particular case, so as to preserve its ability to encourage maximum debt reduction within risk parameters acceptable to the Bank.

Comment: Flexibility is essential. We should not limit ourselves a priori to any specific instruments or types of debt reduction. We should not agree to the Fund playing one role and ourselves playing another, a priori.

6. Within the above policies, the Bank looks forward to developing its response to the Brady Proposals in further discussions with our shareholders and the Fund.

Comment: There is still a long way to go to put "the flesh on the bones" and we are working very hard to this end. However, we do not wish to be stampeded into positions that could jeopardize our continued ability to act as the premier international development finance institution.

DISTRIBUTION:

TO: Marianne Haug	(MARIANNE HAUG)
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QURESHI

U.S. SENATE

The World Bank
Washington, D.C. 20433
U.S.A.

MOEEN A. QURESHI
Senior Vice President, Operations

DATE: April 10, 1989

TO: Distribution

SUBJECT: Implementation of Brady Initiative

Decisions taken during the past week in the Development and Interim Committee meetings have given strong support to the central role of the World Bank in the next phase of the debt strategy, which will involve much greater use of debt and debt service reduction techniques for debtor countries pursuing strong adjustment programs. A great deal of reflection and careful judgement have gone into the decisions to pursue the initiative launched by Secretary Brady, expectations have been built in the heavily indebted countries and elsewhere, and it is now time to move quickly. Fortunately the Bank is well prepared to act: the recent report to the Board on the Bank's Strategy in Heavily Indebted Countries provides the analytic basis for the Bank's role in debt service reduction and the Directors' endorsement for the approaches outlined in that paper. The Unified Survey provides a consistent qualitative basis for developing coherent debt work-out programs on a country basis.

I am personally chairing a Bank-wide Task Force consisting of Messrs Shihata, Wood, Fischer, and Bock to manage and implement the Bank's action program in this area. The Task Force will oversee the preparation of a series of papers in the next several weeks that will clearly define the modalities of World Bank intervention in debt reduction and help prepare the first country cases. These activities will be undertaken in conjunction with the IMF, which will be preparing similar studies covering that institution's role. As you know, jointly agreed programs are expected for debtors participating in this initiative, so I emphasize the importance of working closely with the IMF staff to reach consistent programs for each country.

The studies being undertaken will cover i) criteria for country participation, ii) assurances of adequate financing and monitoring of adjustment programs, iii) individual country financing requirements, iv) regulatory environment issues, v) analysis of the costs and benefits of different debt and debt service reduction techniques, vi) the modalities of the use of Bank resources, vii) risks to the institution and sources of funds for these operations, and viii) ways to encourage more direct foreign investment in debtor countries as part of their adjustment programs. (The IMF is looking at ways to encourage repatriation of flight capital.) These studies should be completed in the coming two to four weeks, and some will probably be discussed with the Board.

While most of the work will be handled directly by the central units of the Task Force members, development of the financing requirements and preferred debt reduction options will require extensive cooperation between DFS, who is coordinating that task under the direction of Mr. Shilling, and the CDs, who best understand the country programs and projections. These will be the foundation for eventual negotiations with countries and their banks. To facilitate these projections, I have asked DFS staff to prepare a standard analytic form in which to develop debt workout options. (Example attached.) In the first instance, projections could be those recently prepared for the Unified Survey, with adjustments as needed for oil price changes and interest movements. However, revised projections still using consistent PAC assumptions should be done where there is any material change. On the basis of the adjustment programs and financing gaps, estimated by country economics, debt reduction strategies will be developed with the assistance of central staff from DFS, EAS, IECDI, and FRS. Because the eventual program will have to be agreed with the IMF and the country, it is essential that the CD prepare i) adequately detailed data on debt outstanding to identify rescheduling and reduction possibilities, ii) a clear statement of the adjustment program that would justify the debt service reduction program, and iii) an analysis of the impact of the debt service reduction on the country's prospects and of the efficiency of this use of public resources. I urge CD staff to coordinate informally with their IMF colleagues to be sure that both institutions are using consistent projections and approaches in each country as far as possible. We do not need to have identical numbers, but we should note significant differences and be prepared to defend our position as appropriate. The list of countries to be analyzed and their relative priority is attached. Work with the country economists is beginning this week.

Pending the completion of other studies, the exact amount of funds to be available to each country and the specific debt reduction instruments are not yet known. For planning purposes, assume that 25% of the current, high case adjustment lending is available for debt reduction activities, plus a similar amount of additional money. For countries where adjustment lending is currently low or absent, assume up to 12% of the total lending program; but in these countries, an adjustment program must be defined that would qualify for SAL or SECAL lending. You may assume that a minimum of about 30% discount equivalent would be required for Bank participation (a higher discount would be the norm), and that a viable long term prospect must result from the reduction program.

I have no doubt that these analyses and the subsequent negotiations will be arduous and complex. But this is an important challenge for the Bank, and I have every confidence that you will all give your best efforts, and that as a result, we will have a major impact on improving the situation in our heavily indebted clients.

Moeen A. Qureshi
Senior Vice President, Operations

Distribution:

Messrs./Mmes. Serageldin, Madavo, Isenman, Koch-Weser, Gillette, Sandstrom, Landell-Mills, Amoako, Gorjestani, Adams, Hinkle, Messenger, Christoffersen, O'Brien, Westebbe, Lateef, Varon, Squire, Laporte, Grave (AFR).
Asanuma, Kaji, Burki, Alisbah, Cheetham, Golan, Clift, Ikram, Pearce, Ritchie, Raghavan, Yenal, Huang, Leipziger, Greene, Baird (ASIA).
Kopp, Dervis, Stoutjesdijk, Lari, Bouhaouala, Cohen, Grais, Ayub, Bhatia, Nouvel, Hinds, Hasan, Ayub, Wall, Harrison (EMN).
Choksi, Steckhan, Loh, Bottelier, Wessels, Nankani, Martinez, Marshall, Iskander, Selowsky, Wijnbergen, Derbez, Miovic, Sokol, Bery, Tyler (LAC).

cc: Messrs./Mmes. Hopper, Stern, Wapenhans, Shihata, Fischer, Wood, Husain, Jaycox, Karaosmanoglu, Thalwitz, Bock, Dubey, Grilli, Baneth, Holsen, Morais, I. Husain, Steer, Thumm, Bouchet, Bruce, Brun, Flannery, Hatano, Jones, Lamdany, Nielsen, Paul, Rajasingham, Sung, Shilling, Taylor, Toft, Zachau, Gooptu, Hay, Jans, Konomos.

Debtor Country

Table 1: Financing Program

Including Plausible Capital Inflows (before "Brady Operations")

	1987-88	1989	1990	1991	1992	1993	1994	1989-91	1992-94	1989-94
Non-Interest Current Account										
Base Projections										
Oil price adjustment										
Interest Payments										
Base Projections										
LIBOR adjustment										
Correction for currency composition										
Adjustment for Debt Reduction										
Additional Interest on Gap Financing										
Base Projections										
Adjustment for changes in LIBOR										
Interest on Reschedulings and New Loans										
IBRD										
Regional MDB										
Other Multilateral										
IMF										
Bilateral										
Commercial & Gap										
Current Account										
Gross Reserves Increases										
Required Capital Flows										

	1987-88	1989	1990	1991	1992	1993	1994	1989-91	1992-94	1989-94
CONTRACTUAL AND OTHER PROJECTED AMORTIZATIONS										
Multilateral										
IBRD										
Regional MDB										
Other										
Bilateral										
IMF										
Bonds										
Private Non-Guaranteed										
Short Term & Other Capital Flows										
Commercial Banks MLT										
Gross Financing Requirements										
COMMITED AND OTHER PROJECTED CAPITAL INFLOWS										
Direct Investment										
Gross Disbursments										
Multilateral										
IBRD										
Regional MDB										
Other										
Bilateral										
IMF										
Bonds										
Private Non-Guaranteed										
Short Term & Other Capital Flows										
Commercial Banks MLT										
Other Private										
Gross Financing Gap										

	1987-88	1989	1990	1991	1992	1993	1994	1989-91	1992-94	1989-94
Gross Financing Gap										
Additional Capital Flows										
IBRD (net)										
Set-Aside" for Debt Reduction										
Additional for Debt Reduction										
Other Additional										
Other Multilateral (net)										
Additional Regional MDB										
Other										
Bilateral (net)										
Paris Club Rescheduling										
JEXIM Untied Cofinancing										
Other										
IMF										
New Programs (Net)										
Set-Aside" for Debt Reduction										
Additional for Debt Reduction										
mmercial Banks										
Rescheduling										
New Money Loans										
Private Non-Guaranteed & Short Term										
Cost of Debt Reduction Operations										
Buy-Back										
Purchase of Collateral										
Interest Trust Fund										
Net Gap										
Changes in Foreign Liabilities due to Debt Reduction Operations										
Loans Retired										
Brady Bonds										
Funds Used for Buy-Baks										
Debt - Equity Conversion Programs										
omestic Currency Bonds										
Capital Gain from Debt Conversion										

..emo items

The figures in the first column are the averages for 1987 and 1988.
Short Term & Other Capital Flows includes E. & O. for 1987-88.

Interest Rates on New Money	10.0%	10.0%
Debt Denominated in Low coupon currencies	15.0%	15.0%
Interest Rate Differential	3.00%	3.00%

Adjustment for changes in oil prices:

Each dollar increase, raises the average NICA by 0.5 billion.

Average Prices Assumed in projections	13.0	16.0
New Average Price	13.0	16.0
Annual Change on Current Account	0.0	0.0

Adjustment for changes in LIBOR:

Almost all of Mexico's Debt is linked to short term interest rates.
For simplicity we assume that 100 billion are linked to LIBOR.
Hence, each increase of 1% in the projected LIBOR leads to an increase in interest payments due of 1 billion.

Average LIBOR assumed in projections:	8.40%	7.73%
New LIBOR projections	8.40%	7.73%
Change in LIBOR	0.00%	0.00%
Debt linked to short term rates	100.0	100.0
Change in interest payments due:	0.0	0.0

MEXICO

Table 2: Voluntary Debt Reduction Operations

Total Debt:	105.0
Commercial Banks:	70.0
Secondary Market Price: (March 1989)	35%

Funds available for Debt Reduction Operations

	Set Aside	Additional	Total
World Bank	0.85	1.25	2.10
IMF	1.20	1.25	2.45
Total	2.05	2.50	4.55

BUY-BACK

Funds 0.55 billion
Assumed average price: 36.7% (5% above secondary mkt. price)
Debt Retired: 1,5 billion
Annual 0.15 billion

EXIT BONDS

Amount: 25 billion
Interest Rate: 5%.
Maturity: 30 year bullet.
Credit Enhancement:
Collateralized Principal.
Two years interest guarantee on a roll-over basis.
Funding of Credit Enhancement:
Purchase of collateral: 1.5 billion
650 million from IMF and 850 million from World Bank Set-Aside Funds.
The interest guarantee is funded using the 2,5 billion
in additional funds from the World Bank and the IMF.
Additional Features:
For regualatory capital purposes banks would be allowed to keep
the exit bonds in their books at their face value.
For tax purposes banks would be allowed to take an immediate tax
loss of between 25% and 30% of the amounts exchanged.

Assuming that the total 25 billion in exit bonds are subscribed
Debt Retired: 0
Annual Interest Payment Reduction: 1.25 billion

Annual cost of additional funds: 0.25%

MEXICO

Table 3: Financing Program

Including "Brady Type" Voluntary Debt Reduction Operations

	1987-88	1989	1990	1991	1992	1993	1994	1989-91	1992-94	1989-94
Non-Interest Current Account										
Base Projections										
Oil price adjustment										
Interest Payments										
Base Projections										
LIBOR adjustment										
Correction for currency composition										
Adjustment for Debt Reduction										
Additional Interest on Gap Financing										
Base Projections										
Adjustment for changes in LIBOR										
Interest on Reschedulings and New Loans										
IBRD										
Regional MDB										
Other Multilateral										
IMF										
Bilateral										
Commercial & Gap										
Current Account										
Gross Reserves Increases										
Required Capital Flows										

	1987-88	1989	1990	1991	1992	1993	1994	1989-91	1992-94	1989-94
CONTRACTUAL AND OTHER PROJECTED AMORTIZATIONS										
Multilateral										
IBRD										
Regional MDB										
Other										
Bilateral										
IMF										
Bonds										
Private Non-Guaranteed										
Short Term & Other Capital Flows										
Commercial Banks MLT										
Gross Financing Requirements										
COMMITED AND OTHER PROJECTED CAPITAL INFLOWS										
Direct Investment										
Gross Disbursments										
Multilateral										
IBRD										
Regional MDB										
Other										
Bilateral										
IMF										
Bonds										
Private Non-Guaranteed										
Short Term & Other Capital Flows										
Commercial Banks MLT										
Other Private										
Gross Financing Gap										

	1987-88	1989	1990	1991	1992	1993	1994	1989-91	1992-94	1989-94
Gross Financing Gap										
Additional Capital Flows										
IBRD (net)										
Set-Aside" for Debt Reduction										
Additional for Debt Reduction										
Other Additional										
Other Multilateral (net)										
Additional Regional MDB										
Other										
Bilateral (net)										
Paris Club Rescheduling										
JEXIM Untied Cofinancing										
Other										
IMF										
New Programs (Net)										
Set-Aside" for Debt Reduction										
Additional for Debt Reduction										
mmercial Banks										
Rescheduling										
New Money Loans										
Private Non-Guaranteed & Short Term										
Cost of Debt Reduction Operations										
Buy-Back										
Purchase of Collateral										
Interest Trust Fund										
Net Gap										

Changes in Foreign Liabilities
due to Debt Reduction Operations

Loans Retired

Brady Bonds
Funds Used for Buy-Baks
ebt - Equity Conversion Programs
mestic Currency Bonds

Capital Gain from Debt Conversion

Debtor Country
Table 5: COMPARISON OF BASE CASE WITH DEBT REDUCTION SCHEME

	1987-88	1989	1990	1991	1992	1993	1994	1989-91	1992-94	1989-94
Interest Payments										
Base Case										
with Rescheduling and New Money										
with B.I. Transactions										
IBRD Net Flows										
Base Case										
with B.I. Transactions										
IMF Net Flows										
Base Case										
with Rescheduling and New Money										
with B.I. Transactions										
mmercial and Gap										
Base Case										
with Rescheduling and New Money										
with B.I. Transactions										
Interest /GDP										
Base Case										
with Rescheduling and New Money										
with B.I. Transactions										
Interest/Exports										
Base Case										
with Rescheduling and New Money										
with B.I. Transactions										
New Money/Payments to Commercial Banks										
Base Case										
with Rescheduling and New Money										
with B.I. Transactions										

Group I Countries likely to negotiate Brady packages in the immediate future.

Costa Rica
Ecuador
Mexico
Morocco
Nigeria
Philippines
Venezuela

Group 2 Countries where performance, importance, or credit situation indicate potential for negotiating Brady packages in near future.

Bolivia (IDA)
Cameroon
Chile
Honduras
Poland
Uruguay

Group 3 Countries where situation is less propitious than Group 2 for negotiating Brady package in near future.

Argentina
Brazil
Colombia
Cote d'Ivoire
Jamaica
Hungary
Yugoslavia

Group 4 Countries where dialogue or other factors lead one to expect significant delay before a Brady package could be negotiated.

Egypt
Peru

These groupings are indicative and used only as a basis of setting current work priorities. As circumstances change, the groupings can change. Work should continue on all countries, but for the moment, there is less urgency for the lower groups.

MH
BBC

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

'RESPONDENCE DATE : 89/03/17 DUE DATE : 89/04/05
LOG NUMBER : 890321012 FROM : Gore, Wirth, Kasten
SUBJECT : Thanking for meeting with Senators Gore, Kasten, Heinz & himself
to discuss LA debt-environment issues, debt-for-nature swaps, etc
OFFICE ASSIGNED TO FOR ACTION : Mr. M. Qureshi (E-1241)

ACTION:

______	APPROVED
______	PLEASE HANDLE
______	FOR YOUR INFORMATION
______	FOR YOUR REVIEW AND RECOMMENDATION
______	FOR THE FILES
______	PLEASE DISCUSS WITH ______
✓	PLEASE PREPARE RESPONSE FOR BBC's SIGNATURE
______	AS WE DISCUSSED
______	RETURN TO ______

COMMENTS :cc: Messrs. Hopper, Stern & Aguirre-Sacasa, Ms.J. Maguire and
Mrs. Koch-Weser Note: Please clear final response with
Mr. Aguirre-Sacasa prior to submission for Mr. Conable's sig.
Info: Sen. Kasten wrote separate letter to BBC thanking him
for the meeting held on 3/11. BBC sent reply dated

EXPEDITE

United States Senate

WASHINGTON, DC 20510

March 17, 1989

Mr. Barber B. Conable
President, The World Bank
1818 H Street, NW
Washington, D.C. 20433

Dear Barber:

Thank you for meeting with us on March 1 to discuss Latin American debt-environment issues. We strongly support your decision to investigate ways in which the World Bank can act as a broker for debt-for-nature swaps and serve as a repository for funds to implement such programs. As indicated during our meeting, we would like the Bank to implement the recommendations contained in the U.S. Treasury Department Report to Congress on Debt-for-Nature Swaps (copy enclosed).

You may recall from our discussion that Dr. Thomas Lovejoy, Assistant Secretary for External Affairs of the Smithsonian Institution, is a world authority on tropical rain forests and he is credited with the concept of debt-for-nature swaps. We believe it would be highly beneficial for your staff, accompanied by staff from the Treasury Department, to meet with Dr. Lovejoy to get the benefit of his ideas on developing an overall plan for the Bank to function in a clearinghouse role for debt-for-nature swaps, including development of a pilot program as recommended in the Treasury report.

With regard to the other issues we discussed, the up-dates you provided concerning the status of Brazil's second power sector loan and the natural resources management loan (Polonoreste II) were most helpful. We hope that these loans, and other Bank development efforts, conform to the recently announced implementation of President Sarney's "Our Nature" plan. Please keep us informed of any changes in the status of these two very significant loans.

We are encouraged by the Bank's efforts to facilitate an agreement between the International Finance Corporation and The Nature Conservancy to ensure protection of the rain forest at Mbaracayu, Paraguay. Your continued involvement in this matter undoubtedly will help bring about prompt resolution of any differences that may remain, so that protection of this significant area can be assured.

The need for standard loan conditions for environmental protection is a high priority issue for us and we will follow-up on your suggestion to approach this matter through the G-7. In addition, we urge you to exercise whatever options are available to the Bank to encourage other facilities and institutions to adopt standard environmental conditions.

On a related matter, we believe that the environmental conditions of existing loans must be met by the borrowing nations and we urge you to use whatever leverage or incentives the Bank possesses to make this happen. We will particularly appreciate your continued efforts to encourage debtor governments to significantly increase the involvement of indigenous tribes and other local groups in the design of projects, and to ensure better implementation and monitoring of other conditions for projects made possible through Bank funding. These initiatives must fully comply with the requirements of U.S. law as enacted through the Foreign Operations Appropriations Committee.

Again, thank you for meeting with us (a copy of the memo summarizing our meeting is enclosed). You have our full support for your efforts and achievements in integrating environmental considerations into World Bank policies. We especially welcome your efforts to explore ways that the Bank can take a leading role in facilitating debt-for-nature swaps, and look forward to continuing dialogue with you on this subject. Please let us know if there is anything we can do to be of assistance.

Sincerely,

Albert Gore, Jr.

Timothy E. Wirth

Robert W. Kasten

John Heinz

Enclosures (2)

cc: Secretary Brady
T. Lovejoy

U.S. TREASURY DEPARTMENT REPORT TO CONGRESS ON

DEBT-FOR-NATURE SWAPS

Introduction

This report is being submitted as required by Section 537 (c) of the Foreign Operations Appropriations Bill (Public Law 100-202).

> The Secretary of the Treasury shall undertake an analysis of potential initiatives, to be implemented through the MDB's, the IMF and other existing or newly created institutions, to enable developing countries to repay portions of their outstanding debt through investments in conservation of tropical forests, wetlands and other conservation activities. The Secretary of the Treasury shall report his findings and implementation plan (including projected timetable) for such "debt for conservation" initiatives, including, but not limited to conservation exchanges, to the Committees on Appropriations by April 1, 1988. Initiatives to be considered shall include, but not be limited to:
>
> (1) the operation of mechanisms to purchase, at a market discount, developing country debt in exchange for domestic currency investments in conservation at the full par value of the purchased debt;
>
> (2) the operation of mechanisms to reschedule substantial amounts of developing country debt to longer term maturities with reduced interest rates in exchange for borrower country conservation investment in local currencies; and
>
> (3) the establishment of programs by the World Bank and IMF to encourage the private purchase of developing country debt at discount rates in exchange for local currency conservation investments at the full par value of such debt.

The preface of the report is organized in such a way as to give the reader a description of debt-for-conservation swaps and Internal Revenue Service Revenue Ruling 87-124, progress to date, and the prospects for the development of new financing tools by commercial banks to facilitate these transactions.

The main body of the report discusses current World Bank and other multilateral development bank environmental programs. This is followed by possible World Bank initiatives as well as a tentative schedule for following through on these proposals.

While the distinction between debt/conservation and debt/environmental swaps is acknowledged, for simplicity this report will refer to both as debt-for-nature swaps.

1. Description of "Debt-for-Nature" Swaps

"Debt-for-nature" swaps involve an exchange or cancellation of an external debt obligation in return for environment-related action on the part of the debtor nation. Typically, a conservation or environmental group buys or receives as a donation the external debt of a developing country; exchanges the debt paper for local currency from the Central Bank of the developing nation; and pledges to use the proceeds for conservation programs in that country. In every case, the host government has granted prior approval to convert the debt into local currency or bonds for use in environmentally-related projects.

The local currency equivalent of the debt obligation must be negotiated between the central bank and authorities in the debtor country, and the environmental or conservation group. The host government may not always agree to exchange debt obligations which sell at a discount in the market at the full par value of the debt.

Benefits of these debt conversions can be manifold. Banks may donate loans that have been reserved against or that have been written down on their books, or as a means to "exit" from new concerted lending packages. Developing countries benefit from reduced debt servicing payments, and from the programs undertaken and financed by U.S. charitable organizations for conservation and environmental improvements.

While the amounts at stake vis-a-vis the external debt of debtor governments are currently relatively small, these swaps could have a significant positive effect on conservation, where even small amounts of money can achieve substantial results.

Carefully controlled swaps involving relatively small amounts of debt should not create inflationary pressures in the host country. Steps can be taken to "sterilize" the local currency so there is not an immediate, substantial increase in money supply. For example, several transactions that have been negotiated are structured such that the local currency is converted into bonds with maturities staggered over the life of the program.

It is important to note that these debt-for-nature swaps must be negotiated between the sponsor and the host government. The development of additional mechanisms to facilitate these debt conversions will likely be voluntary, and will be generated primarily by conservation and environmental organizations, private bankers, and host governments. The Treasury Department's role is to help reduce tax and regulatory obstacles to such debt conversions, where feasible.

Indeed, the work of many environmental and conservation groups in formulating and marketing the debt-for-nature swap concept is proof of the wealth of new ideas arising from such initiatives, and stimulates the overall debate on much needed options to save tropical habitat in the most productive way.

2. IRS Revenue Ruling 87-124

The Internal Revenue Service of the U.S. Treasury Department (IRS) issued Revenue Ruling 87-124 in November 1987 to provide guidance to U.S. banks, corporations and other institutions in assessing the U.S. income tax consequences of entering into debt-equity swaps and debt-charity swaps. The ruling clarifies the tax treatment of possible gains or losses arising from the conversion of debt to equity claims, as well as the donation of debt instruments to U.S. charitable organizations for environmental or other social purposes in developing countries. By making the swaps through the central banks of the developing countries, as outlined in the ruling, the donor is able to take a deduction both for a loss and for a charitable contribution.

Although the ruling does not answer all the questions that arise in a swap transaction, the ruling does provide some useful guidance. Generally, it has been well received by U.S. banks and corporations. Treasury staff is continuing to work with conservation and charitable organizations to answer their concerns on valuation and other issues. Further, an Agency for International Development conference with Treasury participation is in the planning stages to improve understanding and communication with the private sector regarding these debt conversions. Non-profit institutions will be asked to participate actively.

3. Progress to date

Several debt-for-nature swaps have been consummated to date, most involving the purchase of bank claims by conservation groups in the secondary markets.

The central bank of Costa Rica, acting on a proposal presented by the Minister of Natural Resources, Energy and Mines, created a conservation fund in August of 1987 for the conversion of up to $5.4 million of Costa Rican bank obligations. The local currency equivalent can be up to 75 percent of the face value of the debt, and will be held in the form of bonds, bearing interest of over 25 percent per annum, with maturation periods of up to five years. The proceeds of the bonds will be used for the management of national parks, land purchases for conservation purposes, environmental education, deforestation control projects and reforestation of reserves, and research and development projects related to sustainable uses of natural resources.

The U.S. Embassy in San Jose, Costa Rica, reported on March 24, 1988, that $4.3 million of debt has been committed to debt-for-nature swaps, though the central bank reports that none of these transactions has yet been effected. Of the $4.3 million, members of the World Wildlife Fund (WWF) in the U.S. and Canada agreed to buy $3 million in Costa Rican debt. The agreement, signed in Washington on March 18, 1988, obliges the WWF to acquire the debt over three years, and to transfer the debt to the central bank for conversion into bonds denominated in local currency which will then be given to the private national park foundation to support the national parks and to purchase tropical forest lands for the Guanacaste National Park.

The WWF has also purchased $1 million of Ecuadorian debt, which the central bank of Ecuador will convert into nine-year bonds which will then be transferred to a local conservation group. The proceeds will be used to establish and manage parks and reserves, train scientists, teach children about the natural world, or serve other conservation needs. Ecuador's central bank has authorized a debt-for-nature swap program totaling $10 million.

Conservation International was involved in a debt swap last year in Bolivia in which $650,000 of debt was purchased from a Swiss bank for about $100,000 and swapped to the Bolivian Government in return for the Government's agreement to expand the Beni Biosphere Reserve. The reserve is in Bolivia's Amazon basin and is home to 13 species of endangered plants and animals, more than 500 different varieties of birds, and more species of trees than all North America.

To date, it is believed that only one donation of bank claims has taken place. Fleet National Bank in Rhode Island donated $254,000 to The Nature Conservancy to endow a 25,000 acre jungle habitat of endangered species of birds and mammals in Costa Rica. The Nature Conservancy will swap the debt for a five-year, $190,000-equivalent Costa Rican currency bond. The proceeds of the bond paid by the Costa Rican central bank will be used by the Nature Conservancy to buy and maintain a strip of rain forest that connects La Selva's tropical forest station to the existing Braulio Carillo National Park.

A number of countries have expressed an interest in debt-for-nature swaps, including Jamaica, the Philippines, Brazil, Mexico, Peru, Colombia and the Dominican Republic.

The Treasury Department has been encouraged by these developments and supports the further development of country programs aimed at attracting funds for the conversion of debt.

4. Prospects for Development of New Financing Tools

Debt Reschedulings

Any donation or purchase of bank claims for use in the debtor nation must be a negotiated transaction. This negotiation could conceivably take place within a bank advisory/ debt rescheduling forum, but would have to be mutually agreed upon by the parties involved. While the Treasury Department does not have a role in intervening in these discussions, it has and will continue to advocate debt-for-conservation swaps as an item on the "menu" of alternative financing techniques from which all banks can choose.

MDB and IMF Loans

While the World Bank and other multilateral development banks (MDBs) are generally supportive of such exchanges, debt-for-conservation swaps directly involving World Bank and IMF loans cannot be part of the "menu" of options because World Bank, IMF and other MDB loans are not saleable in the secondary markets, cannot be converted to grants for environmental purposes, and are not reschedulable.

The "Menu" Approach

The Treasury Department supports the conversion of developing nations' debt into local currency for conservation and environmental use, as part of the "menu" approach proposed by Secretary Baker in the Spring of 1987 to facilitate commercial bank support for debtor nations through the development of a variety of alternative financing options. Other possible items on the "menu" include balance of payments loans, trade credits, project loans, on-lending facilities, new money bonds, debt-equity swaps, limited voluntary interest capitalization, and debt-bond exchanges. This approach emphasizes a negotiated, market-oriented way of resolving debt problems, and the Department has encouraged commercial banks and debtors alike to pursue efforts to develop this approach further.

5. The Role of Multilateral Development Banks in Environmental Work

Regional Development Banks

In the Inter-American Development Bank (IDB) two senior environmental experts have been added to the Bank's permanent staff, an ecologist and an expert on rain forests. The IDB has a permanent high-level environmental committee which screens all loans with potential negative impact on biodiversity and to assure the sustainable development of natural resources.

The Asian Development Bank (ADB) and the African Development Bank (AFDB) have small environmental line units. The ADB has an environmental review procedure which operates throughout the project cycle. The AFDB improved its environmental review procedures by the addition of two full time environmental positions. These regional MDBs have increased the number of environmentally related projects and project components.

The World Bank's Environmental Programs

An increased emphasis on environmental work is one of the top priorities for the World Bank. Indeed, one of the most important objectives of the U.S. Administration in negotiations for the World Bank's general capital increase (GCI) has been to strengthen Bank policies and programs on a broad range of environmental issues. They are crucial to the protection and preservation of our natural resource base in all parts of the world. They are critical if successful and sustainable development and growth is to be achieved in developing countries over the longer term.

President Conable has placed particular emphasis on the protection of renewable resources and pledged a substantial increase in staffing and financial resources for these purposes. He also has sought to integrate environmental concerns more effectively into the mainstream of the Bank's work.

In negotiating the terms of the GCI, the Administration has sought to reinforce President Conable's efforts and to extend their effectiveness for years into the future. In reporting on the recent conclusion of negotiations on a GCI for the World Bank, the Bank's Board of Directors has called for:

- additional emphasis on the need for better management of human and natural resources so that countries can achieve fully sustainable development;
- integration of environmental work into country development strategies, policies and programs;
- evaluation of the environmental costs of Bank projects;
- mitigation or elimination of adverse effects of Bank projects; and
- support for national and regional programs to improve environmental management.

This language commits both developed and developing countries to an overall framework for environmental work over the next several years.

World Bank Organization and Staffing

Significant progress has been made in the area of organization and staffing reforms at the World Bank. During 1987, the World Bank carried out a major reorganization of its management and staff. A major aim was to strengthen the Bank's capacity to deal more effectively with environmental issues.

Environmental units have been established in all four regional offices, and a central Environment Department has been set up in the Senior Vice Presidency for Policy, Planning and Research. Thus far, 45 full time permanent positions dedicated to environmental issues have been authorized for these offices. In addition, funds have been authorized for the equivalent of 18 full time consultants to work on various environmental issues. Training on environmental issues is continuing in the Economic Development Institute and special training courses for staff are being introduced.

The Environment Department provides leadership in terms of conceptual approaches and dealing with key environmental issues and it provides support to regional staff where conceptual guidance and/or specialized expertise may be necessary. Task forces have been established to deal with the issues of deforestation, conservation of biological diversity, desertification, salinity and environmental health aspects of irrigation and watershed rehabilitation. Other issues such as hazardous waste disposal, risk assessment and accident avoidance in industry and urban air pollution, are being addressed, as well. The Department is also involved in Bank staff training on environmental issues; this includes development of seminars for staff at large, participation in workshops to update skills, and dissemination of information through meetings and workshops. For example, to inform staff on debt-for-nature swaps, the Environmental Department has prepared a departmental working paper entitled: "Debt-for-Nature Swaps: Overview and Discussion of Key Issues", dated February 1988.

The regional staff possesses the detailed knowledge of environmental issues in each region necessary to identify particular projects for debt-for-nature financing.

Environment work requires the consideration of complex intersectoral effects. In addressing broad environmental issues and improving project design and implementation, the Bank is making a special effort to reconcile different views that cut across sector lines. Providing technical assistance for debt-for-nature swaps is no exception to the interdisciplinary nature of environment work. Such assistance would require input from the Environment Department and regional environmental units, as well as financial consultation from the Financial Intermediation Department and/or specialized consultants.

Environmental Issues Papers

The Bank's Country Operations Divisions have the responsibility to prepare environmental issues papers for each borrowing country by the fall of 1989. They are being assisted by the Regional Environmental Units and the Environment Department. The papers identify the major environmental issues in each country and outline strategies to address these issues.

Environmental Assessments, Technical Assistance, and Lending Operations

The Bank has begun an in-depth analysis of key environmental issues in a number of countries. It is expected that thirty of these studies will be completed over a five-year period, with assistance from the United Nations Development Programme (UNDP) and bilateral donors. A number of studies have already been initiated. For example, a major Bank report on Indonesia is tackling numerous issues including tropical deforestation and questions related to critical ecosystems and species conservation.

In-depth studies are also underway in a number of other countries, including Madagascar, Rwanda, Lesotho, Sudan, Bolivia, and the Philippines. The results of these studies can form the basis of technical assistance to organizations and for government ministries concerned with environmental management in the developing countries.

World Bank technical assistance can strengthen the regional and country operations and lead to more effective protection and/or development of conservation and wilderness areas, national parks, and coastal ecosystem reserves. Technical assistance can provide a small but operational contribution readily available to the private sector. This includes information sharing of non-confidential reports such as supervision mission reports and other project related information.

Both technical assistance grants and loans can be used to identify environmentally sound projects. These projects are the basis on which these debt-for-nature swaps can be carried out by the private sector. Technical assistance can also improve project design by identifying priority investments for conservation or environmentally related activities in Bank supported projects.

There will be a need to strengthen the management capacity of public entities charged with conservation and/or natural resource management. In addition, enforcement of swaps requires careful monitoring. Potential problems in implementation include corruption by powerful interest groups, establishment of incentives and conditions to maximize compliance with the terms and condition of the swap, policing requirements, and the development of a budget dedicated to maintain the project or conservation area.

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(a) The Bank could help to identify banks in bank syndications for a given country. Some environmental groups have claimed that currently some countries do not know which smaller, regional banks -- the most likely candidates for these conversions -- should be contacted as potential donors or sellers of their claims.

(b) The agent could also act as an information broker, so that private initiatives could, for example, piggy-back World Bank and other environmental programs. The Financial Intermediation Department in cooperation with the Environmental Department or Country Operations Divisions may be able to assist in these endeavors.

(4) Stuctural Adjustment and Sector Loans

While it is acknowledged that the Bank has already taken concrete measures to preserve biodiversity through its Wildlands Policy, the Bank should provide incentives for sustainable resource management and improved project design through structural adjustment and sector loans.

(5) Pilot Program

In order to integrate the aforementioned recommendations, it is suggested that the World Bank consider starting a pilot program with one or more countries that has a debt-for-nature program or is committed to starting one. Such a pilot program would draw on the financial and environmental expertise of the Bank in structuring and implementing a debt-for-nature swap program.

In this context, it is recommended that the Bank analyse the prospects for (a) making new loans available specifically for tropical forest and wetland protection, and (b) offering technical assistance grants to cover start-up costs associated with debt-for-nature financing.

7. A Global Biological Diversity Action Plan: Improved Aid Coordination

Many bilateral and conservation agencies have expressed interest in collaborating with the Bank in development of a global Biological Diversity Action Plan for raising political awareness, mobilizing additional resources and ensuring improved collaboration among donors in the financing and implementation of biological diversity conservation programs. This would build on the experience already gained by the Bank in collaboration with UNDP, the Food and Agriculture Organization (FAO) and leading non-govermental organizations (NGOs) developing the Tropical Forest Action Plan. The Bank is actively pursuing the goal of a global Biological Diversity Action Plan with special attention to early involvement of national NGOs and both national and international conservation groups in the policy dialogue.

Sectoral adjustment and sector loans already place additional demands on the limited management resources available in most developing countries. Debt-for-nature swaps may require additional measures to manage environment programs, including the establishment of an entity to administer reserves, sell research rights, ensure the protection of indigenous groups on the protected areas, and other administrative measures which may be deemed necessary to promote biological diversity.

6. Recommendations for World Bank Initiatives

(1) Establishing Priorities

Broadly speaking, the functions of the Environment Department can be useful in helping developing countries establish priorities for conservation and environmental projects as part of country reviews.

Policy and Research -- Possible areas of analysis include establishment of a system to identify priority projects, analysis of the economic value of biodiversity, and establishment of a biodiversity policy.

Information Systems -- Data base systems can be established for species groups, critical ecosystems, biogeographic regions and major tropical wilderness areas. The Department can analyze the potential for linking into other established environmental data bases.

A Bank Task Force involving both Bank staff and outside scientific experts met in March 1988 to discuss ways the Bank could put more emphasis on biodiversity. The recommendations of this task force have been completed and can readily serve as a basis for integrating the use of debt-for-nature financing with other initiatives being implemented by the Bank.

(2) Piggybacking onto World Bank Loans

Environmental and conservation organizations, and borrowing countries may be able to piggyback debt-for-nature swaps onto World Bank and other MDB loans for environmental purposes. Such swaps could complement the Bank's efforts and provide additional resources to extend the scope of conservation programs.

(3) An Agent Function

A number of environmental groups interested in debt-for-nature swaps have expressed the need for a clearing house to help facilitate these transactions. The Bank should review its role as an agent with a view to whether it can provide any of the following functions:

8. Timeframe

The World Bank has been informed of the aforementioned recommendations, and the following timeframe is suggested for following up with the Bank:

April - September 1988

1. Review recommendations and possible pilot program with Bank management.

2. Establish action plan for implementation of agreed-upon changes or initiatives, including the pilot program.

September 1988 - January 1989

1. Monitor progress of World Bank Task Force on Biodiversity, especially implementation of task force recommendations by Bank management, and progress being made towards development of a Global Action Plan.

2. Implementation of action plan based on consultations with Bank management.

MEMORANDUM

TO: Senator Gore, Senator Heinz, Senator Kasten

FROM: Timothy E. Wirth TEW

DATE: March 16, 1989

SUBJECT: Summary of March 1 Meeting with Barber Conable

I <u>Second Power Sector Loan</u>: This loan is on hold now and may be permanently on hold due to numerous problems that will be difficult to resolve.

<u>Action</u>: A follow-up letter to Mr. Conable concerning agreements reached at the March 1 meeting will include a request for the Bank to keep the Senators informed if there is a change of status on the loan. (Senator Wirth lead.)

II <u>Implementation of Loan Conditions</u>: Concerns are: (1) rubber tappers and indigenous groups are not being involved adequately in development project planning; (2) loan conditions are not being implemented fully and there is a tendency toward symbolic actions which look good on paper, but are not carried out in the field.

Mr. Conable believes there are some improvements in this area:

- o The Brazilians are doing a better job now of monitoring loan conditions.
- o Rubber tappers met last week and they are becoming more involved in project planning.
- o Indian tribes met in late February to coordinate their opposition to dams and other projects which affect their land.

Mr. Conable points out that Brazil has only about 400 forest guards, too few to carry out significant protection or monitoring of environmental conditions.

<u>Action</u>: The follow-up letter to Mr. Conable will encourage continued World Bank efforts to ensure full involvement of rubber tappers, indigenous tribes, and other local groups in project planning, and also will encourage continued efforts to ensure full implementation of loan conditions for environmental protection.

III <u>Implementation of Treasury Department Recommendations</u>: Mr. Conable agreed to give detailed consideration to requests by the Senators that the Bank take a leading role in facilitating debt-for-nature swaps. Two key recommendations contained in the <u>U.S. Treasury Department Report to Congress on Debt-for-Nature Swaps</u> are: (1) the Bank should consider serving as an agent or clearinghouse to broker such swaps, and (2) the Bank should consider starting a pilot program with one or more countries that has a debt-for nature program or is committed to starting one.

An overall plan is needed to describe how the Bank could serve as a broker and how a pilot program could be established. A neutral mechanism which is not focused on any particular country would be advisable for holding debt-for-nature swap donations, e.g. establish a Foundation for Tropical Rain Forests and let donors make contributions to a general fund or contributions ear-marked for the country or purpose of their choice.

Issues that will have to be worked out include: (1) approval by World Bank member countries; (2) Mr. Conable's concern that funds involved in debt-for-nature swaps should not be diverted from development projects; and (3) whether the Bank would be expected to put its own funds into debt-for-nature swaps or to guarantee the debts.

> Action: The follow-up letter to Mr. Conable will include a suggestion for appropriate staff from the World Bank and from the Treasury Department to meet with Dr. Thomas Lovejoy to exchange information concerning an overall plan of action for World Bank facilitation of debt-for-nature swaps.

IV Standard Environmental Policies: There is consensus that standard environmental policies are needed to discourage borrowing nations from shopping around for the least restrictive loan conditions. Mr. Conable stated that the World Bank does not have leverage over other facilities or institutions to force them to adopt and implement a standard policy. He suggests the best avenue to bring about standard policies is to deal with the major sources of capital, through the G-7.

> Action: The follow-up letter to Mr. Conable will urge the Bank to exercise whatever options are available to encourage adoption of standard environmental conditions by all international financial institutions. A separate letter from the Senators to Secretary Brady (with a copy to David C. Mulford, Assistant Secretary for International Affairs) will request that Treasury push this issue vigorously in the next meeting of the G-7. (Senator Wirth lead.)

V Polonoreste II Loan: Activity on this proposed loan is at an advanced stage. The Bank believes the Natural Resources Management loan, as it is now called, will consolidate projects and ensure that environmentally sound projects occur in the appropriate locations.

Brazil has not yet asked the Bank for an appraisal and the loan is not scheduled for a Bank vote yet.

Mr. Conable pointed out that Brazil has had problems maintaining conditionality and the Bank cannot promise additional loans will be made unless they perform well. The Bank will continue to put pressure on Brazil to carry out loan conditions.

Action: The meeting follow-up letter to Mr. Conable will include a request to keep the Senators informed on the status of this loan.

VI Mbaracayu, Paraguay: Mr. Conable reported that the Bank is working with the International Finance Corporation (IFC) and The Nature Conservancy (TNC) to negotiate an agreement for protection of Mbaracayu. Price is a major issue. The IFC is urging TNC to develop a plan whereby the Bank retain title to the land and lease it to TNC. The Bank and IFC would like to see a plan that would protect part of the rain forest and allow development of part of it to help pay the IFC.

The Bank has had some questions about the relatively small size of the area and it significance. Senator Wirth visited the area in January; it is the last large tract of temperate/tropical rain forest left in that part of South America and is highly significant.

Mr. Conable pointed out that because Paraguay has no program with the Bank, the Bank has very little leverage to exercise with them to help ensure Paraguay's cooperation in efforts to protect Mbaracayu.

Action: A letter from the Senators to the IFC, TNC and the Bank will encourage them to come to agreement on a program that will ensure protection of Mbaracayu, and offer the assistance of the Senators. (Senator Wirth lead.)

DEALING WITH THE DEBT CRISIS
World Bank Symposium (1/26-27/89)

DEALING WITH THE DEBT CRISIS

A WORLD BANK SYMPOSIUM

PROGRAM

JANUARY 26–27, 1989

International Economics Department
Debt & International Finance Division
The World Bank

Note: All sessions will be held in the World Bank H Building Auditorium. The entrance is located on G street, between 19th and 20th streets.

Dealing With the Debt Crisis
A World Bank Symposium
Program

Thursday, January 26
Registration: 8:15–8:55 am

Session 1. The Debt Crisis in Perspective (9:00 am–12:45 pm)
Chair: Stanley Fischer, World Bank

Barber Conable, President, World Bank
Welcome and Opening Remarks

Jean Baneth, Director, World Bank
Introduction and Review of World Debt Tables

John Cuddington, Georgetown University
"The Extent and Causes of the Debt Servicing Crisis of the 1980s"
Discussant: Albert Fishlow, University of California, Berkeley

John Underwood and Chuch Humphreys, The World Bank
"The External Debt Difficulties of Low-Income Africa"
Discussant: Stephen O'Connell, University of Pennsylvania

Coffee Break

Barry Eichengreen, University of California, Berkeley, and CEPR, and Richard Portes, Birkbeck College, London, and CEPR
"Dealing with Debt: The 1930s and the 1980s"
Discussant: Marilyn Skiles, Federal Reserve Bank of New York

E.V.K. Fitzgerald, K. Jansen and Rob Vos
Institute of Social Studies
"Structural Asymmetries, Adjustment and the Debt Problems"
Discussant: Simon Teitel, IDB

Lunch

Session 2. Alternative Approaches I (2:30–6:00 pm)
Chair: David Bock, World Bank

William Cline, Institute for International Economics
"The Baker Plan: Progress, Shortcomings and Future Evolution"
Discussant: John Shilling, World Bank

Eugene Versluysen, World Bank
"A Review of Recent Proposals to Deal with the Debt Overhang"
Discussant: Richard Feinberg, Overseas Development Agency

Michel Bouchet and Jonathan Hay, World Bank
"The Market Menu"
Discussant: Luis Luis, Institute for International Finance

Coffee Break

Jeffrey Sachs, Harvard University
"Efficient Debt Reduction"
Discussant: Macelo Selowsky, World Bank

Stijn Claessens and Ishac Diwan, World Bank
"Conditionality and Debt Relief"
Discussant: Guillermo Calvo, IMF

Friday, January 27

Session 3. The Constraints on Creditors and Debtors (9:00–10:15 am)
Chair: Jean Baneth, World Bank

Harry Huizinga, Standford University
"The Commercial Bank Debt on Developing Countries: How Have Banks Been Affected?"
Discussant: Anthony Saunders, New York University

Ishrat Husain and S. Mitra, World Bank
"Future Financing Needs and the Constraints on Scope of Action"
Discussant: Mohsin Khan, IMF

Coffee Break

Session 4. Lessons From Secondary Markets (10:30 am–12:45 pm)
Chair: Jean Baneth, World Bank

Vasilis Hajivassiliou, Yale University
"Do Secondary Markets Believe in Life After Debt?"
Discussant: Homi Kharas, World Bank

Daniel Cohen, CEPREMAP
"Is the Discount on the Secondary Market a Case for LDC Debt Relief?"
Discussant: Eduardo Borenzstein, IMF

Peter Nunnenkamp and Hans–Joachim Huss,
The Kiel Institute of World Economics
"Bank Lending to Developing Countries in the 1980s"
Discussant: Ken Froot, MIT

Lunch

Session 5. The Fiscal Adjustment in Debtor Countries (2:30–3:40 pm)
Chair: DC Rao, World Bank

William Easterly, World Bank
"Fiscal Adjustment and Deficit Financing During the Debt Crisis"
Discussant: Sweder van Wijnbergen, World Bank

Helmut Reisen, OECD
"Selected Aspects of Domestic and Foreign Public Debt"
Discussant: Vito Tanzi, IMF

Coffee Break

Session 6. Alternative Approches II (4:00–6:00 pm)
Chair: DC Rao, World Bank

Michael Dooley, IMF
"An Analysis of Self Financed Buy–Backs and Asset Exchanges"
Discussant: Andrew Steer

Ruben Lamdany, World Bank
"The Brazilian Debt Package"
Discussant: Robert Kahn, Federal Reserve Board of Governors

Donald Lessard, MIT
"Beyond the Debt Crisis: Alternative Forms of Financing Growth"
Discussant: Jonathan Eaton, University of Virginia

ABSTRACTS

The papers abstracted here represent the views of the authors. They do not necessarily represent the views of the World Bank, its Executive Directors or the countries they represent.

THE EXTENT AND CAUSES OF THE DEBT CRISIS OF THE 1980s

John Cuddington, Georgetown University

This paper describes the growth in external lending to developing countries in the 1970s as well as the emergence and extent of the debt servicing problems encountered in the early 1980s. In doing this, Part I analyzes the movements in LDCs' debt/GDP and debt/export ratios, which are often used as indicators of creditworthiness. It also considers differing views on the relative importance of various underlying causes of the developing-country "debt crisis." Contributing factors include shocks that are external to the LDCs involved, as well as policy choices in the LDCs themselves.

Part II describes the macroeconomic and financial environment in which the debt build-up occurred. Changing patterns of international capital flows are identified and the movements of key macroeconomic variables are examined to determine the extent to which the experience of the 1970s and early 1980s should be considered atypical. In an environment characterized by numerous sources of uncertainty, it is often difficult to determine whether individual borrowers and lenders acted in a manner that should *ex ante* have been judged to be imprudent, or whether their current problems are more accurately attributed to "bad luck." Some risk-taking is obviously desirable. Policy makers—both borrowers and lenders—must assess the nature of various risks in order to act in their constituents' best interests.

The paper is, for the most part, a restatement of ideas already in the literature. Its primary objective is to put the remaining papers in the volume into an appropriate historical perspective. It concludes that, although the threat to the stability of the international financial system has gradually subsided, the crisis of restoring sustained economic growth in developing countries remains. Their debt servicing problems are large in magnitude and have been very persistent. It is now clear that the debt problem is not just a short-term nuisance that a couple of years of strong worldwide economic growth can eliminate—contrary to optimistic expectations in the early years of the crisis. Hence, the need for new policy initiatives by official institutions and the "international community" at large is as pressing as ever. Dealing with or coping with the LDC debt crisis is likely to be the single most important issue in global economic development policy for the 1990s.

THE EXTERNAL DEBT DIFFICULTIES OF LOW-INCOME AFRICA

Charles Humphreys, Africa Technical Department, The World Bank
&
John Underwood, International Economics Department, The World Bank

Two debt crises affect developing countries. The more highly publicized crisis affects the middle-income "Baker Plan" countries, including Nigeria and Cote d'Ivoire in sub-Saharan Africa. The other, less well known, debt crisis affects the majority of a set of 34 low-income African countries. The total external debt of these countries, $72 billion, is less than the debt of Mexico alone. International bank exposure in these countries totals less than $10 billion. Their liabilities are mainly loans from or guaranteed by official creditors. Their debt represents no threat at all to the international financial system, which is the reason for the relatively small amount of publicity about their plight. Yet, the external debt of these low-income African countries represents, by many measures, a more severe burden to their economies than the middle-income country debt represents to those economies. At the same time, the poverty and economic rigidities in African countries make it harder for them to grow out of their debt problems without special assistance.

Official creditors and donors have recognized the difficult and long-term nature of the debt and development problems facing highly-indebted low-income countries. Since 1978, several bilateral donors have converted concessional development loans to grants in many of these countries. The World Bank's Special Program of Assistance and the Fund's Enhanced Structural Adjustment Facility, both backed by bilateral donors, were launched in 1987 to address these problems more directly. Most recently, at the 1988 Toronto Summit, donor governments endorsed the concept of concessional debt relief for low-income debt distressed countries. Industrial country governments have worked out the exact forms of that relief and have rescheduled the debt of the Central African Republic, Madagascar, Mali, Niger, and Tanzania under the new arrangements. The near term relief from these reschedulings will not be large, but the important principal of orderly debt reduction has now been put into practice. Together, these actions by official creditors and donors are important steps in restoring normal creditor-debtor relationships in these countries.

Commercial bank claims, while not a major share of total claims on debt distressed countries, remain a significant problem in a number of the most debt distressed low-income African countries. Commercial banks may tend to benefit disproportionately from the additional aid and debt reduction provided by official creditors. Some method of achieving equitable burden sharing would be useful to assure that these official resources are used to support growth. One method would be the creation of an officially backed "deep discount" debt facility to buy up long-term commercial bank claims, at heavily discounted prices, and pass the discount on to the debtor country in the form of conditional debt forgiveness, along the lines of the Bolivia buy-back, but in a manner that avoided the price increases that resulted from the method used in the Bolivian cases. Other methods include increased official tax and regulatory support for commercial bank donations of claims to aid or charitable organizations. Those organizations would use the local currency payments to support their programs in the debtor country.

To grow out of their debt crisis, even with the recent measures outlined above, debtor countries themselves must take the lead in establishing and maintaining workable medium-term adjustment programs. Once orderly and sustained adjustment is occuring, it is in the interest of donors and creditors to provide adequate external resources to support these programs. The measures noted above are steps in that direction. The external support now in place covers mainly the years 1988-90. Recovery in low-income Africa, with its economic rigidities, low investment and savings rates and infrastructural weaknesses, will extend well into the next decade. Donors must keep in mind the special external financing needs of these countries after the end of 1990, especially during discussions surrounding the upcoming Ninth Replenishment of the soft-loan International Development Association.

BANK LENDING TO DEVELOPING COUNTRIES IN THE 1980s: An Empirical Test of Major Hypotheses on Voluntary and Involuntary Lending

Peter Nunnenkamp and Han–Joachim Huss
Kiel Institute of World Economics

Considerable confusion prevails about the major factors underlying commercial bank lending to less developed countries after risk illusions have been destroyed. In the rich body of theoretical literature it is heavily debated, for example, whether or not a favourable economic performance of borrowers is honoured by increased capital inflows. It is the major aim of the paper to assess the empirical relevance of the various conjectures raised on the determinants of commercial lending to developing countries in the1980s. This is done on the basis of the hypothesis that lending is no longer governed by a uniform set of incentives but rather taking place under different lending regimes. Most importantly, a distinction between credit constrained and non–constrained borrowers, and voluntary versus involuntary lending is required.

Annual data for the 1983–86 period are pooled for 36 borrowing countries in the OLS–regressions performed to explain the distribution of net transfers and disbursements of long–term loans from private creditors. It is mainly with regard to credit disbursements that the differentiation into different lending regimes matters. In the case of involuntary lending, there is some support for the Krugman line of reasoning that unfavourable performance leads to higher disbursements; whereas it is more difficult for smaller problem debtors not benefitting from concerted lending activities to attract new credits. However, the incentive of banks to protect existing claims does not result in higher net transfers. Standard sovereign risk arguments dominate in this respect. Increasing default risks add to the reluctance of private creditors to provide additional transfers. In deciding on whether or not to continue lending, banks rely on the effectiveness of trade sanctions particularly. Moreover, in contrast to the 1970s and early 1980s, better economic policies and favourable economic performance of debtors are clearly honoured by private creditors after the debt crisis erupted. It is thus likely to pay for today's problem borrowers to intensify adjustment efforts in order to restore their international creditworthiness.

STRUCTURAL ASYMMETRIES, ADJUSTMENT AND THE DEBT PROBLEM

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A world economy composed of a small number of large countries and a large number of small countries is poorly designed for stability. Policy in the large countries is determined in the main by *ex–ante* domestic considerations with the world economy taken as given: there is little interest in external repercussions except to the extent that they frustrate such policy. Nonetheless, the size of the major industrial economies is such that these repercussions—and particularly their interaction—define the state of the world economy. In contrast, macropolicy in small economies is to a great extent determined by the state of the world economy and as markets do not clear smoothly, imbalances are resolved through relative economic power. Only when, by coincidence or by design, the major economies of the world are simultaneously situated on a consistent expansionary path can there be stability and progress in the world's economic and financial relations. Unfortunately, such periods are rare.

The purpose of the present paper is modest although its scope is wide. Our analysis of the global macroeconomic imbalances that gave rise to the current economic and debt crisis of the Third World indicates that the debt crisis is largely the reflection of the subordinate position of developing countries in a unstable world economy: the ripple in the economies of the industrialized countries in the North becoming a tidal wave in the Southern oceans. Rather than serving to smooth inter–regional imbalances, international financial intermediation has contributed to international instability. This paper traces the aggregate adjustment patterns of developing countries in reaction to these external shocks, concentrating on the problems in international finance and differentiating between "private" and "official" borrowers as the two main "blocks." These two not only have different debt characteristics but also, due to their different economic structures and capacities (which gave rise to the lending differentiation in the first place) have adjusted in rather different ways to the crisis. In particular, we argue that successful efforts have been made to raise tax ratios and to export a larger proportion of output by both blocks, in line with current orthodoxy on structural adjustment. In the case of private borrowers, this would clearly have lead to both fiscal and trade surpluses were it not for the debt service burden. In the case of official borrowers, the deficits persist for structural reasons. Against the background of these findings, we discuss three recent proposals to deal with the debt crisis in terms of their potential contribution to the rectification of imbalances in world trade and finance, and to the attainment of a sound macroeconomic equilibrium consistent with renewed growth in the Third World. Rather than trying to formulate new policy solutions, this paper assesses these proposals in relation to the observed behaviour of the international economy and the domestic economies of our two categories of developing countries.

A REVIEW OF RECENT PROPOSALS TO DEAL WITH THE DEBT OVERHANG

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The paper provides a detailed review of the more recent debt proposals that recommend alternatives to market-based debt workouts. Proposals differ widely in their recommendations, depending on whether they seek to stimulate new lending, or to provide unilateral debt relief, but the explicit aim of most is to reduce the amount of net resource transfers to creditors, especially for countries where negative resource flows have accentuated the decline in living standards or occur before the basis for resumed growth has been established.

Debt proposals fall into two main categories—new money plans and debt relief plans—that aim to deal respectively with cases of "mild" debt overhang (debtor illiquidity) or "severe" debt overhang (insolvency).

The author argues that additional commercial lending--the main tenet of new money plans--may be of little help in countries where overindebtedness has created severe debt overhangs. In such cases, adding to the debt burden is unlikely to stimulate growth and investment, especially in environments of uncertain commitment to adjustment. But, even then, long-term official lending at below-market rates and with strict conditionality, can support adjustment efforts or, when it funds specific projects, promote productive investment and growth. This justifies efforts to increase the volume of official lending to all borrowers regadless of the severity of their debt overhangs.

On the other hand, eligibility to debt reduction and forgiveness should be reserved for countries with severe debt overhangs that have not yet benefited from voluntary debt reduction, and be subject to strict conditionality and surveillance. For the same reasons middle-income countries with mild debt overhangs should not be granted debt relief, except on a voluntary basis through market-negotiated debt reduction and reschedulings.

The paper recommends continued adherence to a case–by–case approach on the grounds that plans that aim to provide an all–embracing solution to the debt crisis with a single mechanism could create more problems than they would solve. In addition, excessive globalization would also make it more difficult to establish consensus among several protagonists with diverging interests.

The paper observes that plans to raise official and commercial lending to the HICs are receiving widespread support, and that some proposals are already being implemented. The Japan recycling plan is in force; the World Bank's recent capital increase will enable it to expand its own project and program lending; a number of developing countries are already active in risk hedging through interest and currency swaps; through co–financing programs and direct guarrantees, the World Bank is increasing its catalytic role to stimulate commercial lending to selected HICs.

By contrast, proposals to grant formal and unilateral debt relief to selected HICs have so far been shunned for two main reasons. Official circles balk at the budgetary implications of appropriating tax revenues to fund debt concessions. For their part, commercial creditors fear that large–scale debt relief would involve substantial losses.

But recent developments indicate that in the longer run the political and market consensus may support publicly–funded debt relief to selected HICs if their debt servicing should threaten to degenerate into total economic collapse and political chaos in problem debtors. The first precedent is that Paris Club creditors have already agreed on the need for genuine concessions to low–income Sub–Saharan Africa and are now applying debt relief formulas in their debt reschedulings to those countries. More importantly, since late 1987 VDR has gained greater acceptance from commercial banks and, as exemplified by Brazil's debt rescheduling agreement of late 1988, there is an emerging consensus in banking circles that VDR can be compatible with new lending.

THE RISE OF THE MARKET-DRIVEN "MENU" APPROACH TO THE DEBT WORKOUT PROCESS

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The purpose of this paper is to examine the various elements which underlie the evolution of the debt workout process and the emergence of a "menu" of financial instruments. In particular, the paper considers the legal and regulatory obstacles to a widening of the menu and to the negotiation of further debt reduction between commercial banks and debtor countries.

Since the inception of the crisis in 1982, the concerted debt strategy has been aimed at normalizing the relationships between debtors and creditors through a process of economic adjustment supported by negotiated financial relief necessary to carry borroweers through a difficult period. Debtor countries were called upon to adjust faster and more drastically than they might otherwise have done, owing to a sharp reduction in external finance and despite mounting social demands for immediate economic gains. The banks were invited to put up more fresh money than their shareholders may have wished in the face of capital and profitability constraints. Throughout this process, international financial institutions have provided leadership in designing and monitoring sound macroeconomic policies and also in financing a substantial—and growing—portion of LDCs' overall borrowing requirements.

The coordinated case-by-case approach to the debt workout process, essentially a crisis containment strategy, has produced notable results. For one thing, although a chain reaction of defaults was a spectre that many, at the outset, thought was inevitable, there have not been any massive and generalized defaults during this period. Most of the highly indebted countries have embarked on socially demanding economic adjustment programs resulting in a partial restoration of growth, notwithstanding sharply reduced current account deficits. In addition, in the period 1982–88, external financing support of adjustment has been provided by private and official creditors, in the form of debt rescheduling and "concerted lending" operations by the former, and conditional financing by the latter, including the rescheduling of a large portion of principal and interest payments by Paris Club creditors.

The aforementioned achievements resulted from the so-called "conventional approach" to the debt workout process that has been the modus operandi for the last five years. Four main elements helped to impose the "system's order" at the time of Mexico's 1982 debt crisis. Firstly, the international financial system was in a highly fragile position in 1982. Many banks were overexposed to LDCs in relation to their capital. The concentration of assets in a small number of large debtors—essentially in Latin America—raised the spectre of a severe liquidity crisis in many banking institutions if a series of concerted refinancing operations could not be implemented. Secondly, the systemic risk of a chain-reaction of defaults in the wake of Mexico's crisis was a serious concern for bankers and policy-makers in the OECD. The emergence of a cartel of debtor countries has been a recurrent threat during the initial phase of the crisis. Third, a rigid legal and regulatory framework has bound creditor banks together despite large differences in exposure and long-term strategies. Fourth, an orderly resolution of cash-flow difficulties has been imposed through a uniform and sequential treatment applied to all debtor countries. A set of core rules comprised the following elements: the approval of a Fund's standby arrangement conditional on a "critical mass" of bank commitments; a specified cut-off date for rescheduling debt service payments; punctual servicing of interest payments, i.e., no rescheduling or capitalization of interest; and a pre-crisis base date for determining pro rata new money contributions.

This strategy, adopted in the fall of 1982 and refocussed by the Baker Plan of October 1985 has, however, been facing mounting challenges in the last three years. In particular, an adequate combination of economic adjustment and external financing has not been achieved for several reasons. First, commercial banks are becoming increasingly skeptical about the prospects for improved creditworthiness in the debtor countries within a realistic time frame. Adverse developments in the world economy and policy slippages in several debtor countries—including the largest debtors—have delayed the resumption of growth and a gradual return of these countries to capital markets to an unforeseeable future and, consequently, weakened the credibility of the concerted lending process as a short–term temporary measure. Even under optimistic scenarios, the potential trends in debt indicators and mounting domestic political difficulties in implementing reform programs suggest that the process of restoring creditworthiness and reaccess to markets will be long and uneven. As a result, banks' willingness to participate in concerted packages is clearly flagging while countries' readiness to embark upon socially difficult adjustment programs is also flagging, owing to shrinking net external financing support.

Second, a gradual fragmentation of the international banking community has emerged owing to varying regulatory regimes to which banks in different countries are subject, divergent long–term business interests in LDCs, and large differences in country risk exposure. The improvement in commercial banks' financial conditions has removed much of the systemic pressures for defensive lending. Banks show meager appetite for new money facilities that end up taxed by loan–loss provisions and penalized by secondary market discounts. As a result, individual bank behavior is increasingly driven by accounting, regulatory and fiscal considerations. The extensive set of contractual provisions that were initially helpful in facilitating the cohesion of commercial banks in restructuring and new money negotiations, is less and less effective in maintaining the forced solidarity among creditor banks. In addition, banks face intensified pressures, both regulatory and competitive, to strengthen their balance sheets. The syndication of new money loans, therefore, is proving to be very complicated and subject to long delays, and the benefits of holding all the creditor banks together are increasingly questioned.

Third, the community of active creditor banks keeps shrinking as a growing number of institutions are not prepared to contribute to new money exercises. Regional and small–exposure banks strive at redirecting their lending toward traditional domestic and trade financing business. Some banks may wish to leave the lending process–even at the cost of significant writedowns. As a result of these developments, in various countries that have refrained from rescheduling their debt, economic adjustment and punctual servicing of debt obligations have not always been rewarded by the financial markets. Commercial banks have reduced their exposure in a few countries (sometimes those with the better economic programs) where concerted lending operations did not require that stable or slightly rising exposure be maintained. Overall, the growing reluctance of banks to provide additional financing and the weakening of bank cohesion have resulted in mounting strains on the conventional "new money" approach.

In response to these increasing strains, the "market rationale" is being substituted for the "system rationale" which has been the prevalent mode from the outset of the debt crisis, notwithstanding its efficiency gradually losing in credibility. A "market-based menu approach" has begun to emerge particularly during the negotiation of Argentina's 1987 debt restructuring. More recently, the August 1988 comprehensive debt restructuring for Brazil included a number of attractive features that aimed at encouraging a prompt response of the commercial banks. This menu approach recognizes the diverse interests and constraints of the international banking community by providing more flexibility in the debt workout process. In addition, the menu approach implicitly reflects the longer-term framework that the protracted nature of the problem facing the highly indebted countries requires.

EFFICIENT DEBT REDUCTION

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It is now widely acknowledged that under some circumstances, debt reduction can improve the welfare of creditors as well as debtors. A large overhang of debt can lead to important inefficiencies that worsen the economic performance of the debtor, and thereby diminish the expected returns of the creditor. Despite the recognition of this point by leading banks, and the international financial institutions, the actual implementation of debt reduction has been remarkably limited. Bolivia remains the only case of a sovereign debtor that has been able to negotiate a fairly comprehensive arrangement (with favorable results in line with the basic argument for debt reduction). This paper explores the reasons for the limited progress in debt reduction, focussing on the structure of debt negotiations as a major impediment to efficient debt reduction agreements.

The main theme of the paper is that debt reduction poses important collective action problems that cannot be efficiently handled in the framework of "voluntary, market-based" approaches currently championed by the World Bank and the rest of the creditor community. A number of important distortion arise in the negotiating process because of the special position and incentives of the money center banks, and the recognized readiness of the official creditor community to contribute funds to avoid a brekdown of creditor–debtor relations

The paper also suggests practical remedies to the collective action problem, stressing that debt restructuring cum sub–market interest rates (perhaps linked with credit enhancement from the official creditors) provide the most direct mechanism for an efficient an equitable sharing of losses among the creditors banks.

CONDITIONALITY AND DEBT RELIEF

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A large external debt can have perverse incentive effects on the willingness of a country to adjust and invest and on the willingness of the creditors to provide new financing. This can lead to inefficient outcomes as investment opportunities that can benefit both the debtor and its creditors are not undertaken in the debtor country. Without an injection of liquidity and/or a writeoff of future debt obligations, additional investment will not be undertaken by over indebted countries. At issue in the debt crisis is thus the way in which the current costs and the future benefits of additional investment will be divided between the debtor and creditors.

This paper shows how more efficient sharing mechanisms can be achieved which exploit existing investment opportunities and achieve a high growth equilibrium by the infusion of appropriate amounts of liquidity and by appropriate reductions of future debt obligations. The combinations of liquidity and debt relief chosen will, however, have to satisfy a time consistency constraint, i.e., the debtor will have to have the right incentives after receiving the new liquidity to invest such that the creditors are appropriately rewarded. The paper shows that under this constraint, many Pareto improving combinations of liquidity and debt relief are possible and that the chosen combination will depend on the bargaining strengths of the two parties.

More importantly, the paper shows that a technology which allows debtors to precommit themselves to investment levels can lead to additional efficiency gains over and above the gains from appropriate amounts of liquidity and debt relief. Allowing for precommitment on investment releases the time–consistency constraint and allows for larger investments, larger amounts of liquidity and larger debt repayments. As a result, the set of allocations for which debtor and creditors stand to gain increases and high growth equilibria can be achieved.

The analysis yields important policy implications, with particular important interpretations in terms of conditionality and debt relief. The paper shows that debtors that have lost their creditworthiness fall in two broad categories: those that experience a weak debt overhang and those that have a strong debt overhang. In cases of weak debt overhang, new loans and precommitments on investment can be sufficient to restore creditworthiness and achieve a high growth equilibrium. However, in cases of strong debt overhang, debt relief is also needed in combination with precommitments on investment. In this latter case, the third party, e.g., multilateral institutions, should refuse to provide the precommitment technology unless a portion of the outstanding debt is written off. Otherwise, new loans cannot lead to a restoration of creditworthiness.

The important problem the precommitment technology raises for the third party (e.g., the multilateral) is how the efficiency gains will be distributed between the creditors and the debtor. Besides strategic concerns, the existence of externalities can influence this choice.

THE COMMERCIAL BANK DEBT OF DEVELOPING COUNTRIES:
How Have Banks Been Affected

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The last six years have not seen the gradual dimunition of the developing country debt crisis that many observers had predicted and hoped for. Instead, third world indebtedness has remained high—in fact the ratio of medium- and long-term debt to GNP has gone up from 50.1 percent in 1985 to 53.7 percent in 1987 for the set of highly-indebted countries. At the same time, real economic growth in the developing countries has proven disappointing—at lukewarm rates of 3.0 and 2.5 percent in 1985 and 1987 for the same group of countries. As the current debt strategy of "muddling through" appears unlikely to produce a timely and satisfactory outcome of the debt crisis, it is warranted to discuss and explore other avenues. This chapter brings to any such discussion an account of the experience of the main creditor banking systems with LDC debt.

A main question the chapter attempts to answer is to what extent the commercial banks at present could possibly absorb LDC loan losses. Some losses by private creditors are likely to be a part of any resolution of the debt crisis in the years to come, and such losses are implicit in some of the many proposals for dealing with the debt crisis. Extending earlier work by Sachs and Huizinga [1987], the chapter finds that bank stock prices to a large extent already reflects the low quality of LDC loans, and that thus no major US bank is likely to fold if it gets a return on its LDC debt from now on that is consistent with the prices of LDC debt observed in the secondary market. Major banks in other creditor countries, such as Canada, France, Germany, Japan and the United Kingdom, are shown to be less heavily exposure to the developing countries than the top US banks. Thus these banks turn out to be even less imperiled by their LDC portfolios than the US banks.

The relative safety of almost all the top creditor banks renders their unfailing insistence on full servicing of the LDC loans less urgent and less appealing, and in principle it could open the road to partial debt forgiveness. However, it also enables the banks to boycott the by now routine reschedulings and new money packages, and at the same to withstand the accounting consequences of such a move. Some form of debt forgiveness in practice may lead to a quicker resumption of private capital flows to the LDCs and increased investment in the developing countries—although such flows may never again reach the avalanche proportions of the 1970s, which resulted from a unique coincidence of sluggish economic growth in the OECD, large OPEC surpluses, and a number of regulatory changes within the creditor countries that directed bank leading overseas.

Commercial bank debt constitutes the largest part of LDC debt and it is in some ways the most difficult to handle—both because of the myriad of individual borrowers and lenders and because some of the relevant information is private. In 1987 commercial bank claims on LDC's stood at $644 billion, which is approximately 57 percent of a total LDC external debt of $1,130 billion; $257 million, which is somewhat less than half of all bank lending, is concentrated in Latin America, with smaller commercial bank indebtedness of $125 billion in Asia and $61 billion in Africa. The balance of this chapter is organized as follows: Section 2 reviews recent developments in the secondary market for LDC loans. It shows that secondary market prices have been on a relentless downward path, and it presents some sketchy evidence on the volume of secondary market trading of LDC loans. Section 3 looks more closely at the recent experience of the US banking system with their LDC debt, extending and updating the work on this issue in Sachs and Huizinga [1987]. As noted, a main conclusion that emerges is that the solvency of the US banks appears not in jeopardy at present on account of LDC debt. Section 4 replicates, as far as possible, the analysis for the non–US banks. If anything, the major non–US creditor banks are shown to be even less endangered by their LDC exposure than their US counterparts.

Some understanding of the regulatory environment in which commercial banks now operate is necessary to be able to construct and evaluate any plans for action and reform. The tax, accounting and regulatory treatment of LDC exposure continues to differ widely internationally, even as proposals for harmonizing bank capital requirements across nations are being ratified. Some features of the creditor nations' tax and accounting rules as they relate to LDC debt are summarized in Section 5.

FUTURE FINANCING NEEDS AND THE CONSTRAINTS ON SCOPE OF ACTION

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The demand for external financing by developing countries arises primarily to supplement domestic resources for acelerating investment and growth. Among the group of seventeen Highly–Indebted Middle–Income countries, domestic resources have been transferred abroad since 1983 to service the debt contracted in the 1970s and early 1980s. The consequences of this strategy are stagnant or declining per capita incomes, rising unemployment, falling wages and a general lowering of standards of living.

This paper asks the question: What amount of external resources would be required to achieve a reversal of the recent trends in investment and achieve some modest growth in per capita incomes? Under two differing assumptions of world economic growth and given sound domestic policies of adjustment, empirical estimates of the financing needs are made.

Under the base scenario assumptions, the seventeen countries would require about \$18 to \$20 billion of net new disbursements annually. While other types of financing would together provide \$8 to \$10 billion, it is doubtful if commercial banks would be able to fill in the gap of \$10 to \$12 billion a year. The reasons for the dearth of commercial bank lending are analysed in depth. It is also speculated that a more adverse external environment than assumed in this paper would pose major risks for the HICs. So would the lack of sustained domestic policy adjustments by the debtor countries.

The paper concludes that for at least 12 out of the 17 countries studied, a combination of concerted new lending, debt reduction, and reflows of capital flight would be necessary to meet a modest growth of per capita incomes. In some instances, intermittent arrears accumulations may occur.

DO THE SECONDARY MARKETS BELIEVE IN LIFE AFTER DEBT?

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This paper employs panel–data econometric techniques to examine the case for external debt relief, by exploring the relations between measures of creditworthiness and the debt discounts on the secondary market. It investigates empirically whether the discounts on the secondary market reflect a history of past repayments problems or whether they anticipate future debt crises. The answer to this question has different implications about the desirability of debt relief: If the secondary market discount is a good predictor of future debt problems and not merely a reflector of such problems of the past, then debt relief, in averting anticipated problems, will reduce the secondary market discounts and thus increase the value of the debt held by the international lenders. The estimated models are also used to analyze other issues in the international finance literature, such as whether large surpluses by the oil–exporting nations affect significantly the international lending markets after the first major oil–shock, the question of "liquidity vs. solvency," the degree to which discrepancies between official and black market exchange rates can predict future financing problems, and the importance of world factors exogenous to a country in causing debt crises. Finally, the models are used to investigate the stability over time of the processes that determine external debt repayments problems.

IS THE DISCOUNT ON THE SECONDARY MARKET A CASE FOR LDC DEBT RELIEF?

Daniel Cohen, CEPREMAP

A discount in the secondary market is a case for debt service relief but not necessarily for a write-off. I derive a "maximum repayment" rescheduling program, which trades off higher current investment for lower current debt service. The following results emerge from the analysis.

Proposition 1. The "maximum repayment" program the lenders would like to monitor involves a fixed investment rate that is smaller than the socially optimal rate and larger than the post-default rate. It involves a transfer of resources from the debtor that is a fixed fraction of GDP—a fraction that is smaller than the cost of default.

Proposition 2. When the debt-to-GDP ratio is above a floor value (h^*), the lenders can capture the "maximum repayment" value (V^*) by fictitiously splitting the debt into performing and nonperforming components. Each period, they should ask the borrower to service the performing component of the debt only, and let the performing component grow at a rate equal to the economy's expected growth rate. Meanwhile, the nonperforming asset is automatically capitalized at the riskless rate. When the actual growth rate of the economy is above (below) its expected level, the performing part of the debt is scaled up (down). When this "maximum repayment" rescheduling strategy is undertaken, the equilibrium market value of the debt is equal to V^*.

Proposition 3. When the debt-to-GDP ratio is above the threshold h^*, the debt can be written down to h^* GDP without impairing the lender's return. If the write-off is repeated each time the economy declines, and if the rescheduling is undertaken according to Proposition 2, the lenders capture the "maximum repayment" while the market price of the debt is stabilized at a constant equilibrium price below par.

Implication. Observing a discount on the debt does not automatically warrant a write-off. The discount implies the possibility of default, but lenders should not write the debt off until the possibility materializes. But the service of the debt should always be scaled down by its market value rather than kept in line with its face value.)

Proposition 4. When the lenders reschedule the debt on a period–by–period basis, they induce the country to follow a growth pattern that exactly mimics the post–default path. The lenders capture each period the penalty they could impose on the defaulting country. As a result, they get more on a period–by–period basis, but less on average than under the "maximum repayment" schedule. Under such a ("time consistent") rescheduling strategy, a write–off and multiyear rescheduling may prove beneficial, but the gains fall short of the strategy defined in Proposition 2.

How relevant is the idea of "debt overhang" (according to which the market value of the debt may depend negatively upon its face value)? Empirical evidence presented here indicates that, at a 75 percent confidence level, 9 of 33 countries studied may suffer from a debt overhang problem. At a 90 percent confidence level, only 4 of them may be affected by it.

DEALING WITH DEBT: The 1930s and the 1980s

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This history of foreign lending in the 19th and 20th centuries offers a rich lode of evidence on the operation of international capital markets. The last hundred years have been punctuated by a series of crises—in the1870s, 1890s, and 1930s to cite three instances—bearing a striking resemblance to the debt crisis of the 1980s. For the historian, that experience provides an exceptional opportunity to study the long–term evolution of international markets and their adaptation to repeated shocks. For the economist, it is not possible to extrapolate directly from historical experience, since institutional aspects of the lending process, including the relative importance of bank and bond finance, the rise of supranational agencies such as the World Bank and the International Monetary Fund, and the role of creditor–country governments in rescheduling, have changed fundamentally over the past century. But even though the extent of institutional variation renders naive the hope that one might be able to draw simple "lessons from the past," it still offers the only evidence we have on the efficiency and distributional effects of different approaches to organizing international lending and readjusting existing debts.

In a series of papers we have examined the interwar debt crisis from this perspective. Our analysis has spanned the lending of the 1920s, the defaults of the 1930s, and the debt readjustments of the 1940s and 1950s. This paper summarizes and extends the main conclusions of that research. The discussion will be organized around nine major findings.

1. Interwar investors exhibited sophistication and foresight at the lending state. Our analysis suggests that the past repayment record of a country, its current political circumstances and its economic policies all figured in the determination of the risk premia on foreign bonds floated in the 1920s. There is little evidence that capital markets have grown more sophisticated over time, or that banks have a comparative advantage in processing the relevant information. To the contrary, the bond market's response to borrowers characteristics during the 1920s bears a remarkable resemblance to experience during the post–1970 era of bank finance.

2. Neither monocausal explanations, nor for that matter multivariate explanations limited to economic variables, suffice to explain the incidence and extent of default. While authors such as Diaz–Alejandro (1983) and Fishlow (1985) have pointed rightly to the magnitude of the external shock, proxied typically by the extent of terms of trade deterioration, as a leading indicator of default, our own work reveals the importance of other economic variables, including the burden of the debt and the nature of the domestic policy response, as well as non economic variables, such as proximity to a major military power and international policy links.

3. The implications of different debt–management strategies for subsequent macroeconomic performance remain difficult to isolate. In the 1930s as in the 1980s, efforts to maintain debt service tended to be associated with fiscal austerity, import compression and export subsidies, while the decision to suspend payments was often accompanied by fiscal expansion, monetary reflation and policies of import–substituting industrialization. This wholesale reorientation of a country's macroeconomic stance renders problematic any attempt to pick out the effects of external–debt management strategies and subsequent macroeconomic performance.

4. There is little evidence that countries which defaulted in 1930s incurred a cost in terms of inferior capital market access after World War II. Following the conclusion of negotiated settlements with the creditors, countries which previously had suspended interest payments and amortization were offered virtually identical access to the capital market as were countries which had maintained debt service without interruption. This is not to suggest that default was without costs in terms of market access, only that those costs were not borne differentially by countries which interrupted service on their debts, once they reached settlement agreements with the creditors. Many of the costs were external to the defaulting countries: neither defaulting nor nondefaulting debtors had significant access to portfolio capital in the decades immediately following World War II.

5. The readjustment of defaulted debts entailed a protracted process of negotiation. The analogy with Chapter 11 corporate bankruptcy proceedings, in which default and readjustment permit a clean break

with the past, is no more applicable to the 1930s than to the 1980s. In many cases, interruptions of debt service were only sporadic, and uncertainty over the magnitude of transfers lingered for a period of decades.

6. In contrast to the experience of the 1980s, interwar default in some cases led to a substantial reduction of transfers from debtor to creditor. What we might call "selective debt relief" was, however, compatible with a reasonable overall rate of return to the creditors. The risk premia charged *ex–ante* sufficed to evaluate the average realized rate of return on sovereign loans above the yields on Bristish and US Treasury bonds. Losses to creditors on provincial, municipal and corporate loans, although more extensive, were still sufficient to yield positive ex post returns to Bristish investors.

7. Nothwithstanding the contrast conventionally drawn between the extent of government involvement in debt negotiations in the 1930s and the 1980s, creditor–country governments often were intimately involved in the readjustment of interwar debts. The difference between the 1930s and 1980s lies not in the extent of government intervention but in its direction. Whereas in recent years creditor–country governments have exerted continuous pressure on the debtors to maintain service on their external debts, in the1930s and 1940s creditor–country governments pressured debtors and creditors alike.

8. Global schemes to short–circuit the protracted process of bilateral negotiation proved unavailing. Nearly every element of the global plans proposed in the 1980s—a special international lending facility, matched injections of private and public funds, conversion of existing assets into new ones featuring different contingencies—was first suggested in the 1930s. Ultimately, those global schemes foundered on the issues of who should fund and control the administration of these schemes. The failure of the global plans offered in the 1930s does not leave one optimistic about their prospects in the 1990s.

9. Unlike global plans, market–based debt reduction made a useful contribution to resolving the debt crisis of the 1930s by reducing the debt overhang and eliminating marginal creditors. There is little systematic evidence that debt buybacks had a significant impact on secondary market prices, whose movement seems to have been influ-

enced primarily by changes in the prospects for a negotiated settlement. In contrast to their public statement of disapproval, creditor organizations were willing in private to entertain buybacks out of reserves as a component of the readjustment process.

FISCAL ADJUSTMENT AND DEFICIT FINANCING DURING THE DEBT CRISIS

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The sharp reduction in external financing to most high–debt countries in the 1980s forced major adjustments in macro policy, especially in the management of fiscal deficits. The debt crisis itself initially worsened public finances, since the governments of debtor countries often felt compelled to assume external liabilities of the private sector and financial system. At the same time, the near–termination of external capital flows required an increase in internal finance of public deficits. The result in most high–debt countries was increased inflation, output stagnation, and falling private investment. By contrast, some high–debt countries avoided a drastic decline in their capital inflows and did not have to reduce public deficits as sharply or increase reliance on internal financing. The outcome was much more favorable in these countries, with steady growth, low and stable inflation, and healthy private investment.

In order to study the nature of adjustment to the debt crisis, this paper focuses on a group of seven debtor countries that experienced a sharp reduction in external capital flows and rescheduled their debt in the period 1982–87; Argentina, Brazil, Chile, Mexico, Morocco, the Philippines, and Yugoslavia. The study contrasts a group of five countries that avoided rescheduling over 1982–87 and maintained access to external capital: Colombia, Indonesia, Korea, Turkey, and Thailand. The former group of countries will be referred to as "crisis countries" and the latter as "non–crisis countries."

The purpose of discriminating between the two groups is to show the adverse consequences of the cut off in external financing to the "crisis" group and the resulting policy response. The combination of a more favorable external environment and wiser policy choices made for better performance in the "non–crisis" group.

The central role of fiscal deficits and their financing has recently received increased attention in the voluminous literature on the adjustment to the debt crisis.

This paper seeks to contribute to this literature through refinement of the theoretical framework and through detailed empirical results. The paper first examines the nature of changes in external debt flows, which will show how the external debt crisis contributed to a parallel fiscal crisis in the crisis countries but not in the non-crisis countries. The adjustment efforts were concentrated on public investment in the crisis countries, while the non-crisis countries maintained stable levels of most fiscal aggregates. A resource surplus was generated in the crisis countries through the investment-led contraction of absorption, even though overall production was stagnant. By contrast the non-crisis countries had obtained a resource surplus by the end of the period through healthy growth of both production and absorption. The overall amount of fiscal adjustment was less than the decline in external financing in the crisis countries, so that they had to recur increasingly to domestic financing.

I also discuss the macroeconomic implications of the increased reliance on domestic financing of public deficits, including the significance of domestic versus external finance and the different types of domestic finance. A simple theoretical model relates the means of domestic financing utilized in the sample countries and on levels of interest rates and inflation. It shows that the crisis countries relied heavily on implicit taxes on financial intermediation to domestically finance their deficits, which explains the poor performance of private investment and inflation. The non-crisis countries largely eschewed taxes on financial intermediation for domestic borrowing at market rates, with successful results. The policy conclusions are that larger deficit reductions—preferably implemented through tax reform and reduction of current expenditures—and less distortionary means of financing would lead to improved outcomes in the crisis countries.

PUBLIC DEBT, NORTH AND SOUTH

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The recent rise in domestic public non–monetary debt and in domestic bond yields is imposing a heavier interest burden on the affected governments in countries such as Brazil and Mexico than foreign public debt does. This is a relatively new experience for developing countries, not, however, for OECD countries. The discussion of selected aspects of rising government indebtedness will therefore not only deal with some major clients of the World Bank—Brazil, Mexico, Indonesia, Korea—but also with the experiences of Belgium, Ireland and Italy.

The paper tries to answer three questions. First, what explains rising government debt since 1984 in spite of rationed foreign lending and efforts at fiscal consolidation? Major debt determinants found are: external transfers, since they imply an internal transfer of resources from the private to the public sector; fiscal rigidities because of failure to broaden tax bases and to cut government consumption; high interest rates coupled with low GDP growth, both largely explained by depressed savings and investment; massive devaluation of the real exchange rate and high swings in the value among key currencies. Second, how can the rise in government debt almost certainly not be stopped in the longer run ? The answer is: through a burst of inflation, even when it is largely unanticipated, because the demand for base money is now too small relative to public domestic debt; nor through domestic and foreign default unless the government runs a substantial primary surplus (what is mostly not the case) and can credibly commit not to default again (which is unlikely). Third, what are the possible remedies? The paper provides calculations of the required non–interest surplus which the governments have to run to stabilize (and then to reduce) public debt ratios and make their budgets consistent with other macroeconomic targets. It also discusses how fiscal adjustment can foster growth, while minimising real depreciation of the exchange rate and reducing the cost of domestic public debt.

SELF-FINANCED BUY-BACKS AND ASSET EXCHANGES

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Buy-backs of external debt that are financed by the debtor through asset sales generally result in unchanged or lower market prices for remaining debt. The contractual value of debt is reduced by some multiple of the market value of assets sold. The use of assets as collateral for new debt that is exchanged for old debt has effects equivalent to buy-backs financed by sales of the same assets.

THE MARKET-BASED MENU APPROACH IN ACTION:
The 1980 Brazil Financing Package

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On June 22, 1988 Brazil and its Bank Advisory Committee reached an agreement on a Financing Package for 1988 – 1989, which formally terminated the moratorium declared by Brazil in February 1987. This was the first financial package structured along the lines of what has been called the market-based menu approach to sovereign debt workouts. This approach was first advocated by US Secretary of Treasury J. Baker and by Brazil's Finance Minister Dilson Funaro in April 1987. This approach consists on tailoring the forms of participation in the package to the different needs and preferences of different banks. The development and the mechanics of many of the options in the menu, including most of the options in the Brazilian package are discussed in Cline (1987), The World Bank (1988) and Bouchet and Hay (1989).

The 1988 Brazilian Financing Package has three basic components:

- the restructuring of US$62 billion of outstanding debt into a single Deposit Facility in Brazil's Central Bank.
- 5 New Money Facilities which amount to US$5.2 billion (3 of these facilities include some type of World Bank involvement).
- the renewal of trade and interbank credit lines.

The package also includes an exit option, which may substitute for both the restructuring and the new money. Each component of the package was structured to allow for many different options, referred to as "bells and whistles", which are attractive to different groups of banks.

The package was well received by creditor banks; over 90% of the new money was committed in less than one month. The creditors' favorable response may be due to the wide variety of instruments and options in the package, which are tailored to the regulatory and tax needs of banks in different jurisdictions. In addition, the disbursement of new money is linked in different forms to actions by the World Bank and the IMF, which banks expect will enable them to treat the new money differently from the old. Given its success and comprehensiveness, the Brazil package is likely to become the model in future negotiations.

This paper describes the structure and main components of the 1988 Brazilian Financing Package. It analyzes the economic and financial effects of those instruments and facilities in the package that may be relevant in structuring packages for other debtor countries. It is important to notice that the inclusion of each clause and option in any agreement is negotiated between the debtor and its creditors. Hence, the fact that we show that the inclusion of a particular option in the package had a negative effect on the debtor does not imply that the debtor erred in allowing such an option. In order to assess whether the inclusion of the option was an error it is necessary to compare the costs related to the option with the benefits that the debtor may have received in compensation. This assessment requires an analysis of the bargaining process, which, however, is beyond the scope of this paper.

The paper is structured in the following manner. Section II summarizes the elements of the refinancing and new money packages. The effects of currency switching and interest retiming on Brazil and on the creditor banks are discussed in more detail in subsequent sections. Sections 5 and 6 study the relending and the debt conversion programs, respectively. Finally, section 7 analyzes the role and pricing of exit bonds.

BEYOND THE DEBT CRISIS:
Alternative Forms of Financing Growth

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This paper examines the potential benefits of, and obstacles to, the inclusion of alternatives to general obligation finance such as direct investment, portfolio equity investment, quasi–equity investment, and commodity–price indexed debt in the external financing of LDCs. The advantage and obstacles are first considered for a country starting with a clean slate, then for a country suffering from a debt overhang in the context of both concerted and voluntary exchanges.