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BRETTON WOODS COMMITTEE - March 10/89
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BRETTON WOODS COMMITTEE

MARCH 10, 1989

TALKING POINTS

We meet in an atmosphere of expectancy - as the existing consensus on debt is reviewed by popular demand. It's all on the table, and many political and economic diagnosticians are calling for major surgery. Let's not cut the heart out of the Baker plan, because 3 of its vital parts - policy reform, economic growth and long-term investment - are still needed to keep the patient alive. Lets keep these three items on the table, whatever else we do.

The World Bank has been heavily involved in debt. It would be strange if we didn't have views about possible debt proposals. We are grateful Secretary Brady is taking today's initiative, just as we are grateful to our long-time allies, the Bretton Woods Committee, for providing such a knowledgeable forum.

Here are the elements we believe must be included in a sustainable debt plan:

1. It must differentiate on the basis of performance. This is another way of saying it must encourage developing countries to enter and sustain economic reform programs for growth. Debt reform based on the same old debtor country policies is a waste of time. To cancel all the debt in the world, but not to change the policies which created it, would be risk without reward.

2. It must be even handed - not in that it is available to all - but in being available to all who accept the obligations of self help, sound management and the financial responsibility which will make it safe and effective.

3. It must be designed to accelerate the return to creditworthiness. That should be its goal, because development requires a lot of investment, rather than a drying-up of new money from the international community. If you abolished debt but lost the battle against poverty you would have a Pyrrhic Victory.

4. It must be flexible enough to be adaptable to a diversity of developing countries so great that after two years in my present post I am still constantly astonished at how different countries can be - even neighbors. It must also be big enough to make a real difference in the yearly burden of debt service.

5. It must be wisely implemented by knowledgeable people, who don't send the wrong messages or create the wrong precedents. The best chances for success must be taken first, to maximize the opportunities for a happy learning process.

6. It must not bankrupt the commercial banks or the multilateral lending institutions, or dissipate unnecessarily capital they need for their other responsibilities. It must have the effect of expanding, not shrinking, the global economy.

I maintain a good place to start would be with Mexico. Mexico has indicated a willingness to engage in major reform, it has substantial prospects but substantial debt, and it has lived up to its obligations.

In return for maintaining and deepening the changes in economic policy and structural change Mexico has put in place in the last 5 years, the international financial community should offer Mexico a wider than traditional range of options to finance its requirements over the next several years.

Such options might include:

1. Significant debt reduction, swapping current loans for long-term bonds at a discount (Mexico did this last year on a minor scale).

2. Exit bonds at below market interest rates with whatever added attractions will make them enticing.

3. A debt equity swap program.

4. Strong support from multilateral agencies of a traditional adjustment nature.

5. Commitment by governments to facilitate regulatory, tax and trade improvements, and to encourage the private sector investment which can give the Mexican economy new potential for growth.

One caveat: new money will be needed in Mexico's case even after significant debt reduction. Financing gaps cannot be filled by magic and adjustment needs support. The World Bank will do its share in this and other cases. But it cannot do it alone.

If this does not sound adequately idealistic on our part, I would remind you of two characteristics of idealism:

> Bill Buckley said: "Idealism is fine, but as it approaches reality the cost becomes prohibitive."

> John Galsworthy said: "Idealism increases in direct proportion to one's distance from the problem."

BRETTON WOODS COMMITTEE

MARCH 10, 1989

TALKING POINTS

WE MEET IN AN ATMOSPHERE OF EXPECTANCY - AS THE EXISTING CONSENSUS ON DEBT IS REVIEWED BY POPULAR DEMAND. IT'S ALL ON THE TABLE, AND MANY POLITICAL AND ECONOMIC DIAGNOSTICIANS ARE CALLING FOR MAJOR SURGERY. LET'S NOT CUT THE HEART OUT OF THE BAKER PLAN, BECAUSE 3 OF ITS VITAL PARTS - POLICY REFORM, ECONOMIC GROWTH AND LONG-TERM INVESTMENT - ARE STILL NEEDED TO KEEP THE PATIENT ALIVE. LETS KEEP THESE THREE ITEMS ON THE TABLE, WHATEVER ELSE WE DO.

THE WORLD BANK HAS BEEN HEAVILY INVOLVED IN DEBT. IT WOULD BE STRANGE IF WE DIDN'T HAVE VIEWS ABOUT POSSIBLE DEBT PROPOSALS. WE ARE GRATEFUL SECRETARY BRADY IS TAKING TODAY'S INITIATIVE, JUST AS WE ARE GRATEFUL TO OUR LONG-TIME ALLIES, THE BRETTON WOODS COMMITTEE, FOR PROVIDING SUCH A KNOWLEDGEABLE FORUM.

HERE ARE THE ELEMENTS WE BELIEVE MUST BE INCLUDED IN A SUSTAINABLE DEBT PLAN:

1. IT MUST DIFFERENTIATE ON THE BASIS OF PERFORMANCE. THIS IS ANOTHER WAY OF SAYING IT MUST ENCOURAGE DEVELOPING COUNTRIES TO ENTER

AND SUSTAIN ECONOMIC REFORM PROGRAMS FOR GROWTH. DEBT REFORM BASED ON THE SAME OLD DEBTOR COUNTRY POLICIES IS A WASTE OF TIME. TO CANCEL ALL THE DEBT IN THE WORLD, BUT NOT TO CHANGE THE POLICIES WHICH CREATED IT, WOULD BE RISK WITHOUT REWARD.

2. IT MUST BE EVEN HANDED - NOT IN THAT IT IS AVAILABLE TO ALL - BUT IN BEING AVAILABLE TO ALL WHO ACCEPT THE OBLIGATIONS OF SELF HELP, SOUND MANAGEMENT AND THE FINANCIAL RESPONSIBILITY WHICH WILL MAKE IT SAFE AND EFFECTIVE.

3. IT MUST BE DESIGNED TO ACCELERATE THE RETURN TO CREDITWORTHINESS. THAT SHOULD BE ITS GOAL, BECAUSE DEVELOPMENT REQUIRES A LOT OF INVESTMENT, RATHER THAN A DRYING-UP OF NEW MONEY FROM THE INTERNATIONAL COMMUNITY. IF YOU ABOLISHED DEBT BUT LOST THE BATTLE AGAINST POVERTY YOU WOULD HAVE A PYRRHIC VICTORY.

4. IT MUST BE FLEXIBLE ENOUGH TO BE ADAPTABLE TO A DIVERSITY OF DEVELOPING COUNTRIES SO GREAT THAT AFTER TWO YEARS IN MY PRESENT POST I AM

STILL CONSTANTLY ASTONISHED AT HOW DIFFERENT COUNTRIES CAN BE - EVEN NEIGHBORS. IT MUST ALSO BE BIG ENOUGH TO MAKE A REAL DIFFERENCE IN THE YEARLY BURDEN OF DEBT SERVICE.

5. IT MUST BE WISELY IMPLEMENTED BY KNOWLEDGEABLE PEOPLE, WHO DON'T SEND THE WRONG MESSAGES OR CREATE THE WRONG PRECEDENTS. THE BEST CHANCES FOR SUCCESS MUST BE TAKEN FIRST, TO MAXIMIZE THE OPPORTUNITIES FOR A HAPPY LEARNING PROCESS.

6. IT MUST NOT BANKRUPT THE COMMERCIAL BANKS OR THE MULTILATERAL LENDING INSTITUTIONS, OR DISSIPATE UNNECESSARILY CAPITAL THEY NEED FOR THEIR OTHER RESPONSIBILITIES. IT MUST HAVE THE EFFECT OF EXPANDING, NOT SHRINKING, THE GLOBAL ECONOMY.

I MAINTAIN A GOOD PLACE TO START WOULD BE WITH MEXICO. MEXICO HAS INDICATED A WILLINGNESS TO ENGAGE IN MAJOR REFORM, IT HAS SUBSTANTIAL PROSPECTS BUT SUBSTANTIAL DEBT, AND IT HAS LIVED UP TO ITS OBLIGATIONS.

IN RETURN FOR MAINTAINING AND DEEPENING THE CHANGES IN ECONOMIC POLICY AND STRUCTURAL CHANGE MEXICO HAS PUT IN PLACE IN THE LAST 5 YEARS, THE INTERNATIONAL FINANCIAL COMMUNITY SHOULD OFFER MEXICO A WIDER THAN TRADITIONAL RANGE OF OPTIONS TO FINANCE ITS REQUIREMENTS OVER THE NEXT SEVERAL YEARS.

SUCH OPTIONS MIGHT INCLUDE:

1. SIGNIFICANT DEBT REDUCTION, SWAPPING CURRENT LOANS FOR LONG-TERM BONDS AT A DISCOUNT (MEXICO DID THIS LAST YEAR ON A MINOR SCALE).

2. EXIT BONDS AT BELOW MARKET INTEREST RATES WITH WHATEVER ADDED ATTRACTIONS WILL MAKE THEM ENTICING.

3. A DEBT EQUITY SWAP PROGRAM.

4. STRONG SUPPORT FROM MULTILATERAL AGENCIES OF A TRADITIONAL ADJUSTMENT NATURE.

5. COMMITMENT BY GOVERNMENTS TO FACILITATE REGULATORY, TAX AND TRADE IMPROVEMENTS, AND TO ENCOURAGE THE PRIVATE SECTOR INVESTMENT WHICH CAN GIVE THE MEXICAN ECONOMY NEW POTENTIAL FOR GROWTH.

ONE CAVEAT: NEW MONEY WILL BE NEEDED IN MEXICO'S CASE EVEN AFTER SIGNIFICANT DEBT REDUCTION. FINANCING GAPS CANNOT BE FILLED BY MAGIC AND ADJUSTMENT NEEDS SUPPORT. THE WORLD BANK WILL DO ITS SHARE IN THIS AND OTHER CASES. BUT IT CANNOT DO IT ALONE.

IF THIS DOES NOT SOUND ADEQUATELY IDEALISTIC ON OUR PART, I WOULD REMIND YOU OF TWO CHARACTERISTICS OF IDEALISM:

BILL BUCKLEY SAID: "IDEALISM IS FINE, BUT AS IT APPROACHES REALITY THE COST BECOMES PROHIBITIVE."

JOHN GALSWORTHY SAID: "IDEALISM INCREASES IN DIRECT PROPORTION TO ONE'S DISTANCE FROM THE PROBLEM."

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: March 8, 1989

TO: Mr. Francisco Aguirre-Sacasa, Director, EXT

FROM: David R. Bock, Director, DFS

EXTENSION: 72942

SUBJECT: Bretton Woods Debt Conference

Here are some quick notes.

Question 1: Please refer to the debt paper. The key point is to indicate some degree of pessimism about the likelihood that countries would be able to sustain adjustment programs and that adequate external financing would be forthcoming. The projections continue to show that growth oriented adjustment with full debt servicing is possible in principle. However, one needs to be cautious about the likelihood of all or even most countries being able to do this successfully.

Question 2: Capitalization of interest is essentially an alternative to new lending although less attractive from a financial standpoint for banks. However, it still represents a debt increase in strategy and is subject to the same caveats about the possibility of success noted above. Interest capitalization also runs the risk of being too automatic. Voluntary debt reduction obviously has a significantly more positive effect on debt ratios in the near term. At this stage, expanding debt reduction seems likely to be effective in terms of strengthening the commitment to policy reform, although this will depend upon the specific country and technique of debt reduction. Also, we need to be cautious about how debt reduction is passed to the borrower so as not to undermine the commitment to implementing reforms on a sustained basis.

Question 3: The answer to this question will need to be quite general. Obviously, we have found considerable success in encouraging specific reforms with our sector and structural adjustment lending. We believe the process needs to be strengthened along the lines that we have been proceeding in recent years, i.e. with specific lending operations tied to specific policy reforms. Uncertain and inadequate financing is one of the important obstacles to strengthened and a sustained policy implementation.

Question 4: Here I would make the following points:

- First, there are many different types of voluntary debt reduction techniques that the Bank could in principle support through credit enhancement of other resources.

- Second, World Bank resources that could be used for this purpose are limited and thus must be deployed in a highly catalytic fashion.

- Third, the Bank's intervention would likely be most catalytic in securing more comprehensive debt reduction schemes in countries where the new money process has already broken down, in particular in smaller countries that are of lesser long term interest to commercial banks.

- Fourth, in major countries the scope for the Bank to have a significant effect on debt reduction with its existing resources is somewhat limited, but the Bank would be able to administer special resources contributed for this purpose.

cc: Mr. Stanton
Ms. Haug

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: March 8, 1989

TO: Mr. David Bock, DFS

FROM: Francisco Aguirre-Sacasa, EXTDR

EXTENSION: 73770

SUBJECT: **Bretton Woods Debt Conference**

Following are four questions which will be directed to Messrs. Conable, Camdessus and Iglesias on Friday by Paul Volker. Could you suggest four or five points which Mr. Conable should stress in his response to each? Many thanks.

We need this Thursday noon if possible.

1) What is the outlook for the heavily indebted countries, given present internal policies, debt policies, and projected capital inflows? Can debtor countries sustain satisfactory economic recovery and still meet present debt servicing requirements?

2) The burden of debt servicing can be deferred by partial or total capitalization of interest or reduced through voluntary debt reductions. What considerations should bear on decisions about these approaches? Which approach can most effectively be linked to policy reform?

3) Policy reform is critical to the more efficient use of resources in debtor countries and to promote repatriation of flight capital. What has been the experience of the Bank and the Fund in encouraging policy reform through conditionality? How could the process be strengthened? What are the obstacles?

4) A variety of proposals have been made for expanding the volume of voluntary debt reductions (that is, debt equity swaps, debt buybacks, exit bonds, etc.). Is there a feasible role for the Bank and the Fund in facilitating these transactions?

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The Debt for Development Coalition, Inc., represents not-for-profit organizations committed to finding ways to turn the international debts of countries into economic development opportunities.

If a portion of the external debt of developing nations can be converted—*by donation or purchase*—into local currencies, not-for-profit organizations can use the funds for development projects needed to help spur economic growth in Latin America, Africa, Asia, and the Pacific.

Coalition members are U.S. colleges and universities, cooperatives, private voluntary organizations, and research institutes engaged in economic development programs overseas. The coalition also maintains close cooperation with various U.S. environmental organizations.

The coalition works closely with non-government organizations in debtor nations to identify programs important to each country's economic priorities such as education, public health, nutrition, agriculture, small business enterprises, research, housing, credit, and natural resource management programs.

The coalition works with host governments—especially central banks—international development agencies, U.S. banks, corporations, and others to encourage investment in developing countries.

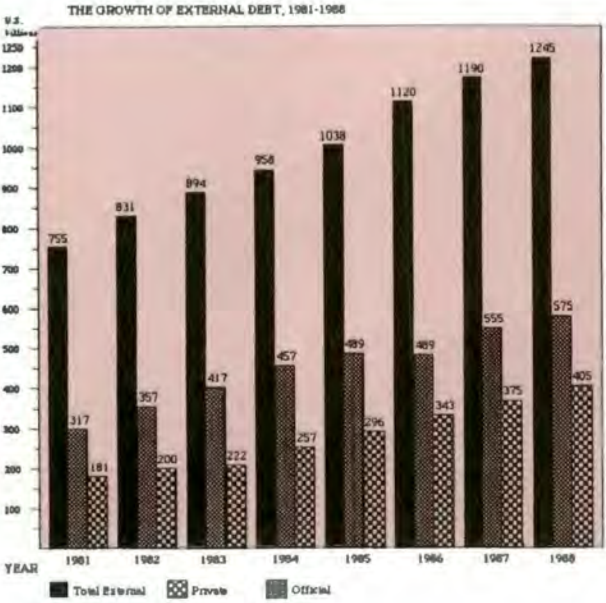
THE PROBLEM

The external debt of developing nations is about $1.2 trillion.

It has been almost six years since Mexico announced that it could not service its external debt, placing the international debt problem on the world economic agenda.

Debt servicing obligations continue to absorb a crushing portion of resources available to debtor countries. Policy adjustments to service debts have curtailed sharply imports of needed goods and services by debtor nations, and, consequently have reduced business opportunities for their traditional trading partners.

The persistence of the debt problem has caused many to talk about "debt fatigue and frustration." Solutions have been difficult; debt composition, policy responses, and options for debt reduction vary country-by-country.



Although a general default has been avoided in Latin America, there have been long interruptions of interest payments to banks, and countries in the area continue to have weak and sputtering economic growth. New solutions to debt reduction must be found.

There is evidence though of greater flexibility in the search for innovative approaches to coping with the debt problem. Fifteen heavily indebted nations that recently experienced payment difficulties were able to reduce the value of their commercial bank debts by about $10 billion in 1988.

While fallout from the international debt problem remains large, debt for development can be an important approach to making a marginal—but sizeable—impact on the overall problem; an approach that will benefit debtor nations and development organizations, international and local national groups.

The Concept

The debt for development concept generally offers four ways to utilize foreign debt to support development programs:

✔ Not-for-profit groups can purchase developing country debts in secondary financial markets and convert them to local currencies; resources can be pooled to support joint ventures.

✔ Commercial banks or other firms can donate debts as charitable contributions to not-for-profit organizations under U.S. Internal Revenue Service ruling 87-124.

✔ Debt for development programs can be crafted as important components in rescheduling debt plans by creditor nations.

✔ Private institutions can convert their debt into equity positions—including joint ventures—if suitable investment opportunities can be identified.

The prospect of donating debt as a charitable contribution is clearly attractive for most of the not-for-profit community. However, members of the banking community have been reluctant to pursue this avenue. While banks are not in business to give away assets, there are sound business reasons to make certain donations. There are, however, technical issues which still need clarification such as the determination of debt values for conversion purposes, tax incentives, and public financial accounting treatment of donations.

Debt for development discussions with developing country officials have raised key issues. Local currency payments, for example, must be scheduled to minimize the impact of inflation on local economies, as well as cushioning financial strains on government budgets. Mechanisms also must be devised to shield principal, while assuring sufficient income to ensure development of quality development programs.

U.S. Perspective

The U.S. government—as well as the World Bank, International Monetary Fund, and other multilateral assistance agencies—favor measures that trim foreign debts accumulated by developing countries, lessen the risks of serious financial crises, promote economic development, and avoid inflationary pressures. These goals are to be achieved within a framework of sound economic management by debtor nations. Debt for development programs can assist in reducing the impact on the poorest segments of societies that debt adjustment programs often hit the hardest.

Former U.S. Treasury Secretary, James A. Baker, III, now Secretary of State, supported the debt for development concept in a September, 1987, address to the annual meeting of the International Monetary Fund and International Bank for Reconstruction and Development.

The U.S. Internal Revenue Service issued ruling 87-124 in November, 1987, clarifying the tax consequences of a bank donating a debt obligation of a lesser developed country for development purposes. Banks can claim a portion of the loans contributed—depending largely on the local currency provided—while the balance is treated as a loss for tax purposes.

The U.S. Agency for International Development is issuing regulations which set procedures to be followed in the use of its grants for debt conversion financing by U.S. not-for-profit groups.

Hearings conducted by the U.S. Congress have supported the conversion of foreign debt into donations. Legislation passed by Congress in September, 1988, authorized U.S. participation in a General Capital Increase in the World Bank Fund. U.S. representatives were instructed to encourage discussion with international finance institutions to provide assistance to those countries wishing to engage in debt for development and "debt for nature" swaps, debt restructuring, and debt conversion.

The new Bush Administration and the 101st Congress have indicated that the international debt problems are high on their current agenda.

Developing country governments also have supported the debt for development concept as a way to lessen external debt and respond to the need for financial restructuring, while maintaining support for basic development programs that spur economic growth.

Coalition Goals

Among the goals of the Debt for Development Coalition are to:

✔ Develop a process that will facilitate not-for-profit groups obtaining debt donations and/or enabling them to purchase discounted debt for development programs.

✔ Serve as an information clearinghouse, updating interested parties on the latest debt for development initiatives and research, and providing data on aspects of conversion transactions.

✔ Create mechanisms to ease purchases of lesser developed country debt obligations by not-for-profit organizations.

✔ Seek to resolve public accounting, tax, legal, and other technical issues surrounding the debt for development concept.

✔ Provide a forum for dialogue on the debt for development issue among the non-profit community, financial institutions, government agencies, and lesser developed countries.

✔ Facilitate cooperation among the non-profit community on debt for development issues.

✔ Advocate the debt for development concept before government agencies, legislatures, bankers and other creditors, and lesser developed countries.

Benefits

The debt for development concept has benefits for host nations, the non-profit community, and the U.S. banking and government communities.

Among *host country* benefits are:

✔ Total outstanding debt payments—due in U.S. dollars and other hard currencies—are reduced.

✔ Payments are made in local currency.

✔ Debt payments go toward projects that enhance economic development, training, and conservation, which in turn will generate capital, better housing and health services, and other improvements to the quality of life.

✔ Austerity program pressures are eased.

✔ New investment and development funds can be attracted as a result of improved debt service.

Benefits accruing to the *non-profit community* include:

✔ The utilization of even a small portion of outstanding debt for development programs represents a major funding increase for such programs.

✔ The scale of funding could allow not-for-profit organizations to implement long-term agreements which, for many projects, enhances the likelihood of success.

✔ The debt for development process permits leveraging of funds to maximize their utility.

The *U.S. banking and governmental communities* receive these benefits under the debt for development approach:

✔ Debt is earmarked for constructive projects without forgiving the debt.

✔ By linking programs to productive enterprises, banks increase the likelihood that some loans will be repaid; additionally the banks become associated with quality programs aimed at improving the working environment in host countries.

✔ Debt renegotiation can be streamlined by reducing the number of creditor banks. In most cases, there are a large number of banks holding small amounts of debt.

Coalition Members

Members of the debt for development coalition are umbrella organizations, representing a wide segment of the not-for-profit community. These groups provide a centralized source of information for their constituents and assist in representing their members' interests to various agencies.

In the context of the coalition, members will provide information to their institutions and identify organizations within their constituencies to assist in coordinating joint efforts.

The coalition serves the broader development community, however, rather than individual constituencies.

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