FOR AGENDA

EBS/89/77

CONFIDENTIAL

April 19, 1989

To: Members of the Executive Board

From: The Acting Secretary

Subject: The Debt Situation - Country Circumstances and Financing Approaches

Attached for consideration by the Executive Directors is a paper on country circumstances and financing approaches related to the debt situation. This paper, together with the paper on preliminary considerations regarding Fund support for debt reduction operations (EBS/89/78, 4/19/89) and the paper on the Fund's policy on financing assurances (EBS/89/79, 4/20/89), is scheduled for discussion at informal sessions to be held on Friday, May 5, 1989 and Wednesday, May 10, 1989.

Mr. Dooley (ext. 7671) or Mr. Watson (ext. 7350) is available to answer technical or factual questions relating to this paper.

Att: (1)

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INTERNATIONAL MONETARY FUND

The Debt Situation: Country Circumstances and Financing Approaches

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Proposals have been made by several countries--including France and Japan, and most recently the United States--designed to strengthen the debt strategy and to place greater emphasis on debt and debt service reduction. This paper discusses the relevance of debt and debt service reduction, implemented through various options, to countries facing different economic circumstances. The intention is to facilitate an informal discussion among Executive Directors that could help orient continuing work--particularly on the "eligibility" of countries for debt and debt service reduction and on the implications of different financing techniques. A companion paper seeks to explore the issues that arise for the Fund's own operations in this connection.

The objectives of the debt strategy remain a return to satisfactory economic growth and to access to credit markets for debtor countries. As Executive Directors have noted in recent discussions, voluntary debt and debt-service reduction initiatives can be a useful means to this end for some debtor countries.

The need for, and the central importance of, improved economic policies in debtor countries is universally accepted. Still, many debtor countries judge the likelihood of working their way out of debt, even with reasonably good policies, to be increasingly problematic. Commercial bank creditors for their part have indicated through building reserves against loan losses, and by selling loans at deep discounts in the secondary market, that they also regard the economic performance of debtor countries as highly uncertain. Each year that sees a further build up of debt without conviction among foreign and domestic savers that there has been a decisive improvement in the prospects for sustained growth reduces the likelihood of any return to normal credit market access.

The case for incorporating debt and debt service reduction in an adjustment program depends on an assessment that such operations can help break this cycle. By providing a better chance for eventual success, governments of debtor countries will gain support for a sustained adjustment effort. But this is not to deny that concerns and risks arise: debt reduction requires changes in existing loan contracts

and established financing techniques, and such initiatives require negotiations between debtors and creditors that will at times be difficult. Specifically, creditors may see an interest in maintaining the status quo, since concerted lending--or any form of interest refinancing--can help assure them of a share in future success of the economy; such a strategy, however, leaves out of account any potential damage to economic performance from a debt overhang. In reality, it is in the interest of all parties to see, in any country case, a sufficiently substantive attack on the debt burden to contribute to turning around the expectations of foreign and domestic providers of capital.

Debt reduction will not, in and of itself, bring about a change in such expectations. Thus, it is desirable that any official support of debt reduction only be applied when policies are being implemented to strengthen growth in the country, and that negotiations on changing contracts take place in the context of a strong adjustment program in order to limit the danger of moral hazards. Strong macroeconomic and structural policies should also encourage an inflow of foreign direct investment and a return of flight capital.

To evaluate the implications of alternative strategies, and to provide background for negotiation between the parties involved, a medium-term review of types and degrees of debt reduction, for each country, will be important. Medium-term scenarios can provide a framework to appraise the prospects of a return to payments viability, including a sustained recovery in secondary market debt prices. But two caveats are necessary.

First, domestic and external uncertainties mean that any projection must be viewed as indicative. In light of these uncertainties, an important advantage of market-based debt reduction is that creditors who opt to hold existing claims and to continue to contribute through the effective refinancing of part of interest payments--rather than to sell or exchange their claims--stand to benefit from unanticipatedly good outturns. This benefit could perhaps be shared if creditors who exchanged debt were to retain a claim on the debtor country which would become realizable if an unanticipated good outturn occurred and persisted. Thus a significant degree of freedom and room for alternative strategies for individual banks remains. This is true even under circumstances where creditors may be concerned about the initial diversion of resources to debt reduction.

Second, the analytical framework to relate savings, investment and growth to outright debt reduction in such scenarios is not precise in nature. This is a new and difficult analytical problem; more than an accounting framework is involved. Some assessment of the benefits of reducing rather than refinancing debt is needed. There appear to be several important linkages between debt reduction and increasing the likelihood of a successful adjustment program. To the extent that the private sector perceives a debt overhang, this implies claims on the

debtor country's future output that are not expected to be met in present circumstances. A reduction of this overhang would mean that potential investors, both resident and nonresident, would anticipate lower and less variable "taxes" on their future income as well as more predictable economic policies in debtor countries. In this perspective, debt reduction may reduce a source of uncertainty for private investment in real productive capital.

In light of the considerations set out above, eligibility for official support for debt reduction could be defined in terms of the implementation of appropriate economic policies; the judgment that debt reduction along lines projected in each country case would be beneficial in terms of restoring ultimate access to credit markets; and an assessment, based on the rates of return involved, that the approach and scope of reduction in each case represents an efficient use of scarce resources.

The above does not mean that all debtor countries with strong programs will find that debt reduction is among the most efficient techniques for the use of scarce resources. The relative merits of applying resources to productive investment need to be assessed on a case-by-case basis. Thus, it is probably inappropriate to apply uniform quantitative criteria since alternative domestic opportunities are likely to vary in ways that are not simple to codify. Nor should member countries consider such resources as an entitlement. At the same time, cases for which new money needs will be sizable but for which many banks resist new money initiatives offer opportunities for market-based debt reduction. In such cases, discounts in secondary markets are likely to be substantial.

This approach to eligibility would thus feature a case-by-case evaluation of the relative benefits of debt reduction over time, rather than ex ante identification of a list of countries and amounts.

The amounts of debt reduction possible will depend largely on the scope allowed the debtor in finding the required financing. Once the funding for debt reduction is established, one needs to provide a quantitative assessment of the amounts of debt and debt service reduction that are feasible with the resources available. This is relevant both because of funding limitations and because of the need to consider opportunity costs of using resources in this way. In this regard, a relatively conservative estimate of the amount of debt reduction possible with any given pool of resources would appear prudent, and it may be useful to review a few key techniques.

For simple buybacks the amount of net debt reduction is roughly what is suggested by the market price observed after the terms of the buyback are announced or generally known. Statistical models can be used to estimate this in advance, but not with precision.

For debt exchanges involving the auction of new debt enhanced by interest or principal collateral/guarantees, the market will establish an exchange ratio between old and new debt. This ratio appears likely to equalize the risk adjusted present value of the assets voluntarily exchanged, assuming that the "country risk" on the country's portion of both old and new instruments is identical (i.e., there is not credible subordination). It is important, however, that countries be free to explore with their creditors different possibilities for combining interest rate reduction and principal reduction (through a single instrument or a combination of instruments) in ways that distribute cash flow relief optimally over time, based on their prospective financing needs and the effectiveness of different approaches in light of bank portfolio preferences.

It could be argued that this approach understates the amount of debt reduction made possible by exchanges, because new instruments will be regarded by market participants as superior forms in which to hold claims on the debtors' resources. This is an important question, because any greater leverage of official/country resources would be most valuable. Since Mexico's debt exchange in 1987, proponents of this view have pinned their hopes most strongly on three possible factors:

--A positive "halo effect" of official enhancement, especially in the case of interest guarantees, either because availability of such guarantees has intrinsic merit in signaling subordination of other claims, or because the potential official involvement is considered to exceed the amount accounted for.

--Regulatory or tax advantages/penalties conditioned specifically on participation in an exchange; an example would be the right to value an asset at 100 cents on the dollar when its market value is less than this; economic benefits could result to the extent financial markets attach value to such conservation of regulatory capital, in association with potential official support for exposed banks.

--Provision simultaneously of a contingent claim, which would preserve a portion of the creditor's option on future economic outturns more favorable than those centrally projected; the resource costs of exchanging debt for a contingent claim rather than for cash could be estimated to the extent that such claims can be specified in terms of, e.g., commodity prices or interest rates, for which historical variability can be reliably measured.

It is important to note, however, that the debt strategy does not envisage that creditors would be forced to accept debt reduction instruments at exchange ratios that do not reflect the market values. The range of uncertainty about the amount of debt reduction possible with given resources is essentially a technical issue that requires further study. Estimates will vary because of uncertainty about portfolio preferences of banks and other investors.

Debt-equity conversion of public sector liabilities involves both an influence on flows of direct investment and a complex debt exchange. In essence, the government's external debt is refinanced by domestic debt, in proportions determined by the ratio at which the debt equity conversion takes place; while the funding cost of the private investment undertaken through these conversions is also cut. Countries with strong fiscal positions (and broad domestic financial markets) have been those least troubled by effecting appropriate offsets to the domestic debt and liquidity created; however, the underlying economics are the same in all cases. It is, of course, important to safeguard objectives of economic programs from the domestic debt and liquidity creation involved in such conversion operations by promoting stronger fiscal adjustments as necessary.

Since the key to debt reduction lies in creditor consent, both in a formal sense and because of potential diversion of available foreign exchange resources, the foundation of a debt reduction operation will lie in the negotiations over "waivers". Syndicated credits all carry provisions designed to protect individual creditors from being paid interest or principal on terms inferior to those obtained by other participants in the same credit. The restructuring of most sovereign debt in the past few years has had the effect of bringing most bank creditors under the same loan agreements. The first operational step in any debt reduction initiative is to alter existing contracts so that debt reduction is possible, and in particular to negotiate waivers to the sharing provisions in existing contracts.

It is in the interest of debtor countries to obtain waivers that are as wide as possible, including for the future use of reserves that arise from unexpectedly good economic performance. Experience has shown in Bolivia, Chile, Costa Rica and elsewhere that banks may want to limit the scope of waivers in terms of amounts and sources of funds for debt reduction as well as techniques for utilizing such funds. In essence, banks would prefer any available--or potentially available--resources to be devoted to contractual debt service. Negotiation of such waivers could, therefore, prove a protracted process. But negotiation is possible. In the case of Chile, for example, banks accepted that proceeds of an unanticipatedly high copper price could be used to buy back debt. This could be generalized, so that windfall increases in international reserves above targeted levels could be utilized for debt reduction. In light of the magnitude of official resources currently under discussion, if a significant number of countries came forward with appropriate debt or debt service reduction proposals, it would be important that countries secure additional sources of financing as well as broad waivers.

In most cases a debt reduction initiative may not reduce contractual interest payments to the level that can be serviced from the debtor's noninterest current account balance, and therefore the underlying economic program will still require significant foreign financing to support growth. Thus, as in recent years, existing

creditors are likely to continue to be called upon to refinance a portion of residual interest payments. The terms on which these "new money" packages are put together are likely to be close to the terms of existing debt--both debtors and creditors may see interest arrears as a fall-back if sharp divergence from such items is proposed.

It has to be expected that debtor countries and their creditors would reach quick agreement on financing packages including new money. "Good faith" on the part of the debtor country in seeking to conclude such negotiations is part and parcel of living up to its commitments under an internationally-supported adjustment program. To promote an orderly and voluntary evolution of debtor countries' relationship with both private and official creditors, it would appear important that the Fund keep abreast of the negotiations.

It will be especially important to be clear what is to be excluded debt in the case of debt reduction. Traditionally, many debtor countries have excluded from the rescheduling process certain categories of debt to private creditors, such as short-term trade related debt, interbank credit, and bonds (in addition to categories of debt to official sources including the international financial institutions).

There may be dangers that concentration on one set of countries detracts from other countries whose situation also merits strong official backing. The focus of the present debt discussions, including the issues mentioned above, is principally on the market-traded debt of the middle-income countries. Concern with debt and development, to state the obvious, is much broader. On the one hand, there are countries--many chiefly indebted to official creditors--whose difficulties have been protracted and whose balance of payments outlook may be judged unviable. Some are eligible for concessional Paris Club reschedulings under the options approach yet may need still stronger support; others may not be eligible for such exceptional debt relief, but may also need special treatment of various kinds. On the other hand there are examples of countries that have managed their economies prudently, but who see concerns of contagion in private markets--or relative diversion of official resources--as the debt problem continues. Vigilance in the creditor community, and readiness to move swiftly with needed support, are essential to meet these concerns.

The considerations set out in this paper are relevant to assessment of ways in which the Fund can support countries as they engage in debt reduction, and the nature of the financing assurances that the Fund could seek in this connection. Given this context, issues of particular importance would include the eligibility of countries, the effectiveness of different reduction approaches, and the relevance of medium-term scenarios as a framework in which to evaluate the implications of different financing scenarios.