FOR AGENDA

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February 24, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Issues in Managing the Debt Situation

Attached for consideration by the Executive Directors is a paper on issues in managing the debt situation, which is proposed to be brought to the agenda for discussion on Friday, March 17, 1989.

Mrs. Junz (ext. 8849) or Ms. Atkinson (ext. 7359) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

Issues in Managing the Debt Situation

Prepared by the Exchange and Trade Relations Department

(In consultation with other Departments)

Approved by L.A. Whittome

February 24, 1989

1. Introduction

In discussing this subject last August, Directors stressed that for countries to regain access to international capital markets on a spontaneous basis, there first must be restoration of confidence among both foreign and domestic savers. This, in turn, depended on strong and sustained adjustment policies on the part of debtors, and on creditor support of these efforts through the provision of financing appropriately adapted to the needs of each country. Reflecting the diversity of needs of both debtors and creditors, financing options had proliferated. It was recognized that within this broadening menu--while new financing to support investment and growth would remain predominant--debt reduction would need to play an increasingly important role to help rationalize both debtor and creditor balance sheets. Without this, in many cases the financing needed to support investment and growth would not be forthcoming in adequate amounts, the full support of the private sector would not be mobilized, and an increasing dependency on the official sector could become ingrained. With these considerations in mind, it is worth reviewing the key features of the present environment to see how, in the present circumstances, a renewed impetus could be given to the debt strategy.

2. The current state of the debt strategy

With regard to the low-income countries, whose creditors tend to be concentrated in the official sector, progress toward bringing their financing in better order has been made with the implementation of proposals to provide relief on bilateral debt; this has been of importance also in supporting the concessional resources that have become available through initiatives in the international financial institutions. However, problems remain; these are particularly pressing for those countries that, although they basically cannot afford to finance themselves on market terms, currently do not have access to exceptional terms from the official sector.

For countries with predominant financial market links, the broadening of menu options has been welcome. However, these have tended mainly to focus on short-term relief and have made little more than a marginal contribution to improving the debt structure in the medium term. Existing contract provisions in bank agreements impede the flexible use of debt reduction opportunities and negotiation of necessary waivers has generally been tortuous. The lack of more forceful movement toward a menu better adapted to countries' medium-term needs has contributed to lack of confidence and thus to the disappointing rates of growth, investment, and inflation in many developing countries--although by far the main reason for inadequate progress has been the difficulty of introducing and then sustaining sufficiently strong adjustment efforts; the latter have, in turn, been hampered by unfavorable developments in the terms of trade and by continued protectionism.

The failure to regenerate sustainable growth has led to an erosion of political support for the adjustment process in a number of countries, and has contributed to unevenness of policy implementation. To a certain extent, the erosion of support reflects an undue optimism about how quickly policy changes can lead to improved economic conditions, but it also reflects a perception that, if there is light at the end of the tunnel, this may yet be years away.

Debtors have increasingly acknowledged that restoring sustainable growth in living standards necessitates far-reaching economic reforms, often supported by institutional changes. A number of countries have begun to implement comprehensive structural adjustment programs, often supported by Fund and World Bank resources. However, the absence of financing arrangements that address the issue of medium-term viability generates uncertainties that can forestall success. Thus, there have been cases where governments have begun to implement politically difficult adjustment programs only to see them undermined by lack of confidence on the part of economic agents, who believe that the internal and external indebtedness of the government will continue to preempt returns on their investments. For the same reason, external private creditors also have been reluctant to provide financing to meet the cash flow needs of the program. This frequently has led to a slippage in--if not reversal of--policy, and resulted in a squandering of all or most of the initial gain. Consequently, scarce external resources have not been put to their best possible use; and, as governments again muster the political energy to put their economic policies back on track, they start from a considerably more difficult domestic situation, coupled with higher external indebtedness. Recognition of the need for comprehensive adjustment policies is nevertheless widespread. This is underlined by the approach now being adopted by several newly elected governments.

To reduce the likelihood of new cycles of policy reform and slippage and to generate early mobilization of domestic resources, adjustment efforts must be backed at the outset by financing that

promises to shorten the path to viability. This implies in general a multi-year commitment of creditors' funds. Such a commitment is also needed to break the pattern whereby debtors have come to rely on repeated renegotiation of contracts as the means to secure cash relief; and on a growing resort to interest arrears when new loans, effectively to refinance interest payments, are not readily forthcoming.

However, there remains a question whether adequate financing will be forthcoming. Creditors' doubts that contracts will be maintained and debt fully serviced are indicated by banks' reluctance to participate in adequate concerted lending packages and, more broadly, by deep discounts in the secondary market for loan claims. To the extent that such discounts persist, they provide an indication that financing to support the adjustment process will not be forthcoming on a spontaneous basis unless there is a considerable shift in prospects regarding a country's ability to service its debt.

In this connection, the market has increasingly accepted the need for debt reduction, and various options--beginning with debt equity swaps--began to be incorporated in the menu as early as 1984/85. However, countries have become concerned that these options have tended to cater unduly, in their scale and design, to the interests of banks and have often involved significant costs; for example, by complicating policy implementation when domestic borrowing has financed retirement of external debt. Broader debt reduction operations (DROPs), especially in view of the market situation, would in many cases be a reasonable approach, deserving explicit support.

3. Debt reduction operations

An important success of the debt strategy has been that banks, in aggregate, have strengthened their balance sheets to a point where they could afford to take losses associated with their developing country portfolios. Banks are increasingly concentrating their attention on assets that reflect their evolving business interests, at a time when profit opportunities elsewhere have proliferated. These changes have complicated the mustering of funds needed to support ongoing adjustment policies, but have also opened the door to DROPs. Nonetheless, debt reduction itself requires financing from participants in the strategy, since generally it involves the early repayment of external debt--albeit at a discount. Most debtors seeking to use DROPs are "cash constrained," which raises the question how to determine the appropriate division of scarce foreign exchange resources between debt service and DROPs.

In agreeing to incorporate debt reduction more broadly into the menu, creditors will need to be assured that the resources mobilized to support debtors' efforts to deal with the debt overhang will not finance capital flight, but rather will promote a reflow of private capital. Moreover, some techniques of debt reduction--in particular buybacks and debt exchanges--utilize market pricing to determine the value of the

claims to be extinguished: creditors may fear that the debtor country, by its own actions or statements, could drive this price down artificially. While many countries, concerned to establish or re-establish their reputations as reliable market participants, may strenuously avoid this, the temptation is there.

These considerations imply that creditors need some safeguards as they move to facilitate greater debt reduction. Clearly, the strongest safeguard against such concerns is the pursuit by a country of a strong medium-term adjustment program. This can give creditors the assurance that a country is strengthening its payments capacity and creating the incentives for a return of flight capital. Thus DROPs, if linked to Fund-supported medium-term programs, are likely to be more readily acceptable to creditors. For some creditors, instruments that would allow them to share in the upside potential that should result from the adjustment process would also facilitate rationalization of balance sheets (for instance, an asset-exchange could incorporate a contingent claim which would be activated once debt service capacity had been restored. This would make some DROPs potentially temporary--akin to creditors' contributions to a corporate workout situation).

4. The return to normal market access

Changes are now under way that attempt to balance the needs of debtors and creditors better than in the past. Both parties aim at returning to normal market relations. In the case of creditors with a long-term business interest in debtor countries, this involves basing lending decisions on such underlying interests and moving beyond negotiations in lockstep with other creditors whose basic objective is to disengage or to capitalize on others' efforts to improve the value of claims. But to trigger spontaneous capital flows, creditors with a potential longer term commitment will need to obtain greater assurance that restructured debt and new contracts will indeed be serviced according to their agreed terms. In this regard, countries' sustained implementation of medium-term policy reforms, often with the support of the Fund and the World Bank, will be of key importance.

On the part of the debtor, a return to normal market access means achieving secure funding for normal trade and investment purposes, albeit at costs that involve a normal risk premium. Currently, interest rates on restructurings are well below what the market would otherwise exact. Progress toward normalization also involves reversing the concentration of obligations in the public sector that has been a feature of the debt problem, and allowing a return to privatization of liabilities.

Thus, normal market access implies moves toward decentralization on the side of both creditor and debtor, as concerted lending is phased out and final users of funds also become the obligors. Menu options should be assessed to determine to what extent they genuinely bring market relationships back toward what could be considered normal. Further

moves to concentrate risks in the public sector or to secure funds at below market rates would probably ease a number of immediate problems, but in essence they would be deviations from the path toward normalization.

Similarly, moves toward guarantees by the official sector appear at odds with a return to normal market access. There is, of course, likely to be increasing pressure for such guarantees, given banks' concern about the quality of their claims on debtor countries, but there are some serious questions. One is whether--in addition to its contributions through the Paris Club, bilateral transfers, and the international financial institutions--the official sector should contribute in a form that co-mingles its own claims with commercial bank assets or, if it does, whether such contributions would be additional. Another is whether creating a preferential category of claims in this way would help or impede progress toward a flow of unguaranteed foreign resources and a return of flight capital.

5. The role of creditor governments

As the search for positive market solutions to improve creditor portfolios and debtor balance sheets continues, creditor governments need to signal clearly their full support of the development of a broad range of menu options, including adequate additional financing in support of growth-oriented adjustment programs. In view of the difficulties in obtaining new money, and given that new money will continue to be necessary, more openness to interest capitalization would be in order. In many cases, both debtors and creditors may be prepared to entertain innovations that are in their mutual longer term interest, but are held back by short-term considerations. In these cases, some prodding to cross the threshold could be wise, but would need to be provided by the official community. In particular, it is difficult for a bank both to provide new money and to facilitate DROPs without changes in the structure of incentives and disincentives. In the same vein, the ability of some banks to reap windfall profits at the expense of others--i.e., to be free riders--needs to be curtailed. With regard to the latter, the banking community is beginning to find ways of minimizing the ability to ride free, particularly as the disengagement of some participants continues to reduce the membership of restructuring groups to banks with a longer term interest in commercial relations with a country, or with commitments of a size where refusal to lend or exit is in effect unacceptable to the lending banks.

Creditor governments, beyond providing clear political support to the proliferation of market options to deal with debt problems in general and the debt overhang in particular, would need to move positively to remove legal, tax, and regulatory impediments that unduly hamper such a development.

In the area of legal impediments:

--proposals that would allow domestic approaches pertaining to private sector workouts to apply to sovereign debt as well, e.g., allowing the majority of claim holders to set terms and conditions of such a workout, could provide a promising avenue for dealing both with the threshold and the free rider problems.

As regards tax policy, banks' losses, to the extent that they have been realized, have been shared by the taxpayer in most countries, as has provisioning against losses in some. But, to the extent possible, such public monies should serve the dual purpose of cushioning the banks' losses while, at the same time, helping to rationalize the debtor's financial position. Changes in this area are clearly difficult and vary across countries. Key options might be:

--to limit over time the tax deductibility of unrealized losses on sovereign debt held by banks in order to increase the supply of tradeable debt and, thereby, the possibilities for buybacks and asset exchanges to the benefit of the debtor country;

--to disallow favorable tax treatment for "wash" transactions where banks swap debt among themselves mainly to establish tax losses (or avoid new money obligations) on a portfolio on which they continue--or expect to continue--to receive income at face value; and

--to examine the scope for eliminating tax (and regulatory) benefits available to participants in restructuring packages that do not provide a broad range of waivers to allow debt reduction.

As regards prudential and accounting approaches:

--where banks continue to hold loan claims without substantial provisioning, but avoid participation in financing packages on the grounds that the country is not creditworthy, regulators could ensure that this sentiment is reflected in the valuation of such claims on the banks' books; and

--to support broad participation by banks in financing packages, it would be desirable to make clear as a matter of principle that banks will not be penalized for tendering debt in buybacks or debt exchanges: where these banks are otherwise able to hold such claims closer to face value, the fact of tendering at market prices should not of itself result in a marking down of the banks' entire portfolio.

Furthermore, the official sector, in providing direct financial support for countries' adjustment efforts, could thereby also indirectly support their efforts to rationalize their underlying financial position. Thus funding provided in support of far-reaching adjustment programs can free up resources for debt reduction, or replenish official reserves to adequate levels. The resources of the Fund, the World Bank,

and other multilateral development banks, as well as bilateral financing, all can make important contributions to the success of such programs. With regard to official debt restructuring, the agreement in the Paris Club on concessional terms for the poorest countries is a first step toward debt relief appropriately focused on the medium term.

As the international community opens doors more widely to rationalization of debtors' financial positions, realization of such opportunities depends in the first instance on the debtor countries themselves. The question arises to what extent foreign savers should be engaged in the work-out of financial situations in countries that, through their own policies, have discouraged domestic savers and in the process have accumulated a debt burden that interferes with the sustained execution of good policies. This is in contrast to meeting the financial needs of those countries that have struggled to avoid such a situation. It is, however, surely right to support the efforts of countries to correct past misjudgments, although creditors would need to be assured in providing relief that they are joined by re-engagement of domestic resource mobilization, including the repatriation of flight capital.

6. The role of the Fund

In this, as well as in helping to establish a convincing medium-term framework, the Fund has a key role to play. The Fund's policy advice to member countries and its support for strong adjustment programs remain central to this role. Given the medium-term nature of the debt problem, and the need for broader DROPs, it is also important that the Fund be in a position to provide in its medium-term assessments a realistic view of countries' debt servicing prospects--a function that can help inform negotiations between debtor and creditor on the type and terms of financing that would be appropriate. In the discussion of the debt situation last September, Directors agreed that--while the devising of financing instruments is strictly a matter for debtor and creditors to initiate--the Fund might assist in preparing financing scenarios on which a country's debt management policy and negotiations with creditors could be based. Indeed, the financing scenarios on which Fund arrangements are based already have the potential for serving this need.

In constructing such scenarios, there needs to be greater emphasis on the dynamic evolution of a country's financing position associated with progress on adjustment. Scenarios should thus take into account the impact of a resumption of private capital flows, including reflows of flight capital, as sustained implementation regains credibility for adjustment policies. Such schemes must, however, not be rigid. As it is frequently difficult to determine a country's immediate balance of payments situation, let alone to project its medium-term prospects, it would be necessary to adapt both adjustment and debt management policies of any individual country in accordance with evolving circumstances. The CCFF can provide valuable support to the underlying medium-term strategy.

It would not be possible, even on the basis of improved medium-term projections, to say with precision where the point of viability would be for each country. But careful consideration on a case-by-case basis should provide the background for making judgments about whether:

--DROPs are essential to achieve any measure of financial viability over the medium term;

--DROPs are important to support higher investment and a growth rate that can absorb additions to the labor force;

--DROPs would help countries to cross the threshold to voluntary financing.

Debt reduction in all cases will need to be phased in accordance with the implementation of internationally credible economic programs.

Fund programs aimed at setting debtor countries on the path to viability need to take into account the financing required to support DROPs, whether these are direct buybacks or asset exchanges with credit enhancement. Reserve targets and other performance criteria would have to be set so as to allow for the use of reserves for a cash buyback, purchase of collateral for an asset exchange, or to secure interest. Attention in the Fund's lending should be given to a borrower's prudent debt management operations, including hedging of interest rate exposure, where appropriate, and risk-reducing asset and liability management.

The Fund's own financial involvement, be it through a series of annual programs or through extended arrangements, must largely be catalytic. Nevertheless, this function, through its contribution to the design, adoption and support of strong policies in debtor countries is basic. More specifically, the Fund could catalyze financing for DROPs, and help--through trust or similar accounts--to channel such financing for buybacks or for the putting aside of resources to secure interest on debt exchanges. With a significant contribution from the repatriation of private capital and bilateral official financing in parallel with adjustment programs, such Fund-supported operations could be the best way to speed up the return to the market. Engaging a country's own resources, together with the support of the international community, would be more likely to lead to renewed market access than would be the passing of risk straight to the official community through official guarantees. In general, resources freed through DROPs must not be used to divert funding to creditors that are not part of the process. Another signal of debtor countries' willingness to play their part in the cooperative strategy will be their readiness to engage outside investors in the adjustment and reform process. This would need to include a hospitable environment for direct foreign investment.

The Fund will continue to need to judge the nature, extent, and timing of the commitment of its own resources in light of the commitment of the other parties to the strategy. This judgment would relate

especially to the adequacy of policy design and implementation in the debtor country. Indeed, there will always be uncertainties both on the sustained nature of the adjustment effort and regarding how much and how quickly domestic resources can be re-engaged. In view of all this, DROPs should be phased, in general in conjunction with multiyear Fund involvement. For low-income countries, where debt to official creditors is particularly important, DROPs could be developed in conjunction with ESAF arrangements.

The above considerations have important implications for the Fund's policy on financing assurances. Financing assurances have been anchored to the commitment of a "critical mass" of new money. But the increasingly protracted process of assembling adequate bank financing has delayed other financing as well, and increasingly endangered the adjustment process. As a more medium-term view of a country's financial circumstances becomes dominant, the quality and composition of the financing packages will become as important as their quantity. For countries where debt reduction approaches are of major importance alongside the assembly of adequate cash financing, financing assurances should include the up-front availability of waivers. Such waivers would need to permit the country to undertake DROPs of adequate scope and magnitude in light of its financing situation and economic policy program.

For its part, and given the greater complexity and the growing medium-term orientation of financing packages, the Fund may also need to adapt its approach to financing assurances. Such adaptation may be needed to allow the Fund to react quickly to support and monitor good programs where these are being implemented, and promote agreement on financing packages that will help medium-term viability as well as immediate cash flow. The Interim Committee agreed last April that "with strong adjustment programs, more Fund resources should, where appropriate, be made available by increasing actual access within current limits and that, in exceptional circumstances, access might extend beyond these limits."

With a medium-term approach that incorporates increased reliance on repatriation of capital and a broadening of the menu of options, in particular to include the DROP items, both the timing and the precise amount of cash flow that would be generated from a financing package become inherently more uncertain. These uncertainties need to be accommodated within the strategy in order to secure the more fundamental objectives of rebuilding debtor-creditor relations on a market basis, and underpinning the restoration of growth in a viable medium-term setting.

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To sum up, the potential elements for a constructive medium-term strategy are coming together as all parties have increasingly begun to orient their actions toward medium-term viability:

--debtor governments are moving to adopt appropriate medium-term adjustment programs as the center of their strategy;

--creditors are increasingly recognizing the need for a medium-term focus to their strategy;

--the official sector is coming forward with bilateral financing to support these medium-term efforts, as well as with exceptional debt relief for the poorest;

--the World Bank's capital increase and the negotiations on IDA 9 strengthen its ability to support development and structural adjustment;

--the Fund now has in place the necessary instruments to help design and support multi-year adjustment programs with consecutive SBAs, extended arrangements, and ESAF, all strengthened by the CCFF;

Would Directors, therefore, agree with the following general propositions?

What is needed now is to capitalize on this progress. The principal challenge is to regenerate domestic and international support for debtors' adjustment programs. The Fund can play a key role in supporting countries' efforts to adjust their economic policies and to rebuild their financial market relations: through providing policy analysis and advice, through assisting in the analysis of countries' medium-term economic and external financing prospects, through providing its own resources, and through catalyzing additional resources. In its financing assurances policy, the Fund needs to pay regard to the quality as well as the quantity of financing packages, and to strengthen its ability to support strong adjustment programs in a timely manner. In the current environment, there will be cases where it will be essential to integrate DROPs in countries' medium-term financing plans. Moreover, there should be the swift consideration and adoption of measures to provide the necessary regulatory, tax, and accounting incentives and disincentives to support debtor-creditor negotiations of DROPs; and, given the importance of these measures, the Fund should be in a position to report progress in these areas to Ministers by the Annual Meeting.

For the highly indebted middle-income countries, the approach outlined in this paper can hasten a return to the market--whereas a strategy based on the assumption of risk by the official sector would tend to delay it. At the same time, there is an urgent need to develop better support for the adjustment efforts of countries that are not benefiting from access to exceptional official debt relief and that cannot afford to finance themselves on market terms. More broadly, it is of the essence that the debt strategy be pursued in a medium-term framework and on a cooperative and case-by-case basis, and that it engage both national savers and the international community.