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May 12, 1989

To: Members of the Executive Board

From: The Secretary

Subject: Fund Involvement in the Debt Strategy - Further Considerations

Attached for consideration by the Executive Directors is a paper on the role of the Fund in the debt strategy, which has been scheduled for discussion on Friday, May 19, 1989.

Mr. Stuart (ext. 4579) or Mr. Regling (ext. 7358) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Fund Involvement in the Debt Strategy--Further Considerations

Prepared by the Exchange and Trade Relations Department

(In consultation with other departments)

Approved by L.A. Whittome

May 12, 1989

Building on recent informal Executive Board discussions of papers relating to Fund support of debt reduction operations and financing assurances, the present paper attempts to provide a basis for the Board to set out guidelines in these areas. 1/ Section I addresses eligibility criteria for Fund support of debt and debt service reduction operations; the kinds of operations that could be supported by the Fund; access to Fund resources; modalities and monitoring procedures; and cooperation with the World Bank. Issues related to the Fund's approach to financing assurances are addressed in Section II.

I. Debt and Debt Service Reduction

Given the substantial uncertainties that exist regarding debt and debt service reduction operations and their impact in individual countries, the suggestions regarding the Fund's support for such operations are necessarily tentative and intended as a starting point; a number of aspects will continue to be studied by the staff and it is to be expected that the Fund's approach will evolve in the light of experience. As Executive Directors have stressed, it would be important to avoid the setting of rigid rules that could prove difficult to operate; the Fund's policy will evolve under the guidance of the Executive Board as individual cases come forward, and it is envisaged that the overall experience and procedures would be reviewed in one year's time, or earlier if the situation so required.

1/ The staff papers "The Debt Situation--Country Circumstances and Financing Approaches" (EBS/89/77, 4/19/89) and "Fund Support for Debt Reduction Operations--Preliminary Considerations" (EBS/89/78, 4/19/89) outlined the main issues related to debt and debt service reduction operations in member countries, and possible approaches for Fund support of such operations. The staff statement on "Preliminary Considerations Regarding Fund Support for Debt Reduction Operations" (89/70, 5/1/89) indicated the staff's further thoughts on these issues. In addition, the staff paper "The Fund's Policy on Financing Assurances" (EBS/89/79, 4/20/89) reviewed policies in this area and suggested adaptations that might be appropriate in current circumstances.

Sustained implementation of strong adjustment policies remains of fundamental importance if debtor countries are to achieve satisfactory economic growth and restore their access to credit markets. In addition, it has been increasingly recognized that, for some countries, the attainment of external viability with growth will require greater emphasis on debt and debt service reduction within the basic principles of the collaborative debt strategy. The support of the Fund and the World Bank in this area will be part of a general effort by all parties in the debt strategy. In this respect, it will be important that the resources provided by the Fund and the World Bank for debt and debt service reduction operations catalyze support from other sources, including the debtor countries themselves.

A preliminary survey of Area Departments regarding possible requests for use of Fund resources suggests that estimates of the demand for the Fund's resources would be substantially higher than those indicated in the March 1989 review of the Fund's liquidity position. (A brief update on the Fund's liquidity position will be circulated to Executive Directors before May 19). On the basis of the survey, the staff's preliminary conclusion is that the Fund's liquidity position remains satisfactory for the balance of 1989, and, with some uncertainties, through the early part of 1990. It is the judgment of the staff that the provisions for Fund support of debt and debt service reduction operations set out below could be accommodated without an undue deterioration in the Fund's liquidity position. As already indicated to the Board, the Fund's liquidity position will be kept under close review and the Board will be kept informed of these reviews. The implications of the Fund's involvement in support of debt and debt service reduction will need to be taken into account by Executive Directors in their consideration of the factors bearing on the need for an increase in quotas under the Ninth General Review of Quotas. This matter will be included in the forthcoming staff paper to be discussed on June 12.

1. Eligibility

Fund support of debt reduction operations would, in principle, be open to all members. 1/ It would be expected that requests would be considered on a case-by-case basis with particular reference to three points: (i) the strength of economic policies; (ii) a judgment that there is scope for voluntary, market-based debt reduction operations that would be beneficial to the country's regaining access to credit markets and attaining external payments viability with growth; and (iii) an assessment that debt and debt service reduction represents an efficient use of scarce resources based on the alternative opportunities

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1/ The discussion in this paper is in terms of the use of the Fund's general resources for support of debt and debt service reduction operations. Issues related to the possible use of ESAF resources for such operations need to be examined separately.

open to the member country. In general, Fund support for debt and debt service reduction, in the context of a Fund arrangement, would appear to be justified for countries experiencing debt servicing difficulties whose debt trades at a sufficiently deep discount, and where medium-term scenarios suggest that efforts to meet the country's financing needs only through new money and/or rescheduling at market interest rates might not be consistent with attaining external viability.

In cases where debt reduction is considered an essential element of the country's approach to its debt problem, the imbalances facing the member are likely to be large, requiring strong policies in a medium-term framework. Internal and external resource mobilization and efficient use of resources will be critical, and policies to improve the savings and investment climate will need to be given special emphasis. For these adjustment programs to be successful, they will in many cases need to be supported by continued financing from commercial bank creditors, including new money, in addition to the support of the official sector. Some countries with protracted difficulties 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.

Furthermore, particular importance should be attached in program design to policies aimed at reversing capital flight and attracting private capital inflows, especially foreign direct investment. Fiscal, monetary and exchange rate policies, which typically are key elements of Fund-supported programs, should generally be complemented by actions to foster a favorable climate for foreign direct investment, including the removal of constraints on the mobilization and utilization of capital inflows.

Given the difficulties of identifying and measuring particular capital flows, such as the reversal of flight capital, and also the general preference to avoid targeting of specific balance of payments items, it would seem appropriate to incorporate any assumed improvement in capital flows into the macroeconomic performance criteria of the program (for example, the net international reserves target) rather than developing separate criteria for monitoring such flows. Monitoring would also take place through the assessment of the adequacy of policy actions--including in the areas of financial and exchange rate policies--which aim at encouraging capital inflows.

The Interim Committee and Executive Directors have strongly emphasized the importance of ensuring continued support for countries that have succeeded in maintaining market access, often through difficult adjustment efforts. Such countries may 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. For the Fund, support will continue

to include making available policy advice and catalyzing financing from other sources, as well as providing its own resources to support growth-oriented adjustment. Fund support for debt reduction operations must not be allowed to reduce the Fund's ability to support members not engaging in such operations. This is a subject to which Executive Directors have agreed to return in due course.

2. Kinds of debt operations

When considering the use of Fund resources to support debt or debt service reduction operations, central importance should be attached to the efficient use of these resources to secure a reduction in the member's debt burden. Emphasis has been placed on the importance of principal reduction, and experience to date has underlined the role that can be played by such operations, not least because of their transparent and clearly permanent nature. However, the market may develop instruments that involve a combination of principal and interest reduction; it would be important for the Fund not to inhibit the development of efficient instruments by limiting its support to specific techniques.

A key will be to ensure that official resources are used only to support operations that imply a substantial market-related discount in the exchange of existing commercial bank claims for cash or collateralized instruments. It should be possible in all cases to compare the discount implicit in the various transactions to ensure the effective use of resources. 1/

The choice of particular techniques will depend on the country's prospective financing needs and the portfolio preference of creditors. While it may be possible in some circumstances to obtain more relief from a collateralized exchange than from a cash buyback, it would be prudent to start from conservative assumptions about the degree of leverage that can be obtained. In general, market participants seem to agree that different instruments involving the same commitment of official resources would secure similar amounts of effective debt relief. In light of these considerations, it is suggested that Fund support be provided on the basis of its clear expectation that the operations in question will imply a substantial discount and result in significant effective debt reduction.

3. Access

As regards access to Fund resources, there has been general support in the Board that in appropriate cases a proportion of access within an arrangement could be set aside for debt or debt service reduction. A commitment of Fund resources at the start of the arrangement would

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1/ Effective use is defined in terms of the reduction in the present value of future debt service payments.

provide a clear signal of official support for a member's economic program and external financing requirements, including debt reduction where appropriate. In principle, the set-aside would not represent an increase in Fund access. Access under these arrangements, as in other cases, will be determined on the basis of the strength of the program (including its debt reduction elements), the speed with which external viability would be attained, balance of payments need, and the member's ability to repay the Fund. In determining the proportion of access to be set aside, it would be important to be cautious, taking into account the member's other balance of payments requirements. The exact size of the set-aside for individual arrangements would be determined on a case-by-case basis, but initial cases could be considered on the basis of a figure of around 25 percent of access.

Executive Directors have not reached a consensus on the provision at the outset of arrangements of additional Fund resources to support debt or debt service reduction operations. It is suggested that the Fund should retain the option to consider a request from a member to increase the amount of an arrangement if the country were able to agree on further significant cost-effective debt or debt service reduction operations; if it was considered that additional Fund support would be a decisive factor in facilitating such operations; and if Fund resources would catalyze other resources in their support, including from the member country itself. Directors may wish to consider the possibility of allowing on a case-by-case basis for additional access of up to 40 percent of quota to support such operations.

Fund resources for debt reduction would be made available during the period of adjustment programs supported by extended or stand-by arrangements and only if the performance criteria had been met, or the Executive Board had agreed to any necessary waivers. Given the importance of ensuring the appropriate use of Fund resources, purchases (or rights to purchase) of set-aside amounts would be phased in line with program performance. Where appropriate, for example where programs incorporated sufficient prior actions, some frontloading of set-aside amounts could be considered, or purchases could be phased in accordance with the specific financing needs associated with the member's debt reduction program. It would also add to flexibility if it was agreed, for example, that the amount becoming available over a twelve-month period could be drawn in one sum, halfway through the period. These options would need to be considered on a case-by-case basis.

If additional Fund access were involved, the availability of these resources might also need to be tailored to the specific timing of significant debt operations; this amount could be phased evenly or concentrated in a few drawings, depending upon the nature of the debt or debt service reduction that had been agreed.

4. Accountability

Actual disbursements of Fund resources in support of debt reduction should only take place once the Board is satisfied that the debt reduction plan that the country is agreeing with commercial bank creditors is appropriate. At the same time, it will be important that the Fund avoid interference in the negotiations between members and their commercial bank creditors.

An approach that would balance these objectives would involve an initial release of Fund resources in support of debt reduction if the program is on track; if the Board is satisfied with the authorities' general description of the debt and debt service reduction elements of the financing program; and on the understanding that the operations will be market based and involve substantial discounts or, if administered, will take place at market-related prices. The operations would thus represent a significant measure of debt reduction for the resources employed and would be consistent with progress toward balance of payments viability. The targets of the program, including the net international reserves target, could be designed to accommodate the use of Fund resources for debt reduction and to ensure that the official resources made available for debt reduction were used for such operations. More generally, in cases where the debtor's own resources also support debt or debt service reductions, the program design will need to take account of the domestic financing implications of the menu items in the financing plan.

The set-aside could be made available from the outset of the arrangement in cases where the above conditions were met at the time the arrangement was approved. Otherwise, the member's rights to purchase the set-aside amounts would accumulate and the resources would be made available upon the completion of an Executive Board review of the member's debt reduction plan.

Periodic reviews would consider how debt reduction is actually developing, in particular how individual transactions compare to the Board's expectations and understandings and what their impact is on balance of payments prospects. In these reviews, the Board could reconsider the specific modalities of Fund support for the country's debt reduction plan, and subsequent purchases in support of debt reduction would depend on a satisfactory outcome of such reviews. Moreover, in considering a request for additional Fund resources to support debt operations, the Board would also need to be satisfied that a substantial reduction in the country's debt burden was being undertaken, consistent with significant progress toward external viability.

At present, considerable uncertainties remain about the level of total resources available for debt or debt service reduction operations in a particular case, and the impact that such operations could have on a country's balance of payments. Initial operations may build up

gradually and it may prove necessary to reconsider the approach as experience is gained. As the overall amount of Fund resources that have been made available for debt reduction--whether through the set-aside or through augmented access--increases, it will be important to see that the debt operations that these resources are supporting are leading to significant progress towards external viability.

5. Collaboration with the World Bank

In its support of debt and debt service reduction operations the Fund will collaborate closely with the World Bank to assist countries in securing effective debt reduction. Both institutions are likely to be involved in supporting debt reduction operations when these are important elements in a country's financial and development strategy. It would be important in such cases that the two institutions keep each other informed and that they consult closely along the lines envisaged in the recent Board paper on Bank-Fund collaboration. The management of both institutions believe it useful to go forward with these approaches.

II. Financing Assurances

For the Fund to be effective in supporting members' adjustment programs in current circumstances, adaptation in the Fund's policy on financing assurances would be needed to ensure that the basic objectives of this policy are met. These objectives remain valid, namely to ensure: that a program is fully financed, thus giving the member country the support it needs for its adjustment efforts; that the financing of the program is consistent with the member's return to external viability, thus providing assurances that the member will be able to repay the Fund; that a cooperative approach is maintained to address financing problems, with the burden shared fairly; and that orderly relations between the member and its creditors are maintained or re-established.

The financial environment in which members and their bank creditors negotiate financing packages has changed significantly in the recent past. The negotiating process has become much more complex, reflecting reduced bank cohesion and the incorporation of more complicated instruments in the menu; the inclusion of debt reduction in some financing packages will complicate this process further.

Given these developments, it would be appropriate to modify the Fund's policy on financing assurances, although in a cautious and prudent manner. Where circumstances permit, the practice of seeking a critical mass in cases of concerted financing will continue to be followed. The approval in principle of Fund-supported arrangements will remain a possibility.

However, in cases of adjustment programs where significant time may be needed for banks and the member to agree on an appropriate financing

package, the Fund would, on a case-by-case basis, approve an arrangement outright before the conclusion of such negotiations. This approach would be appropriate, however, only if prompt Fund support is judged to be essential for the successful implementation of a program; if negotiations between the member and its creditors are proceeding; and if it can reasonably be expected that a financing package will ultimately be agreed which would be consistent with medium-term balance of payments viability. As has been the practice with cases now coming forward, management would consult with Executive Directors at an early stage in such circumstances. Technical contacts between the staff and the bank advisory committee would be needed to understand the banks' position and to inform them about the member's program, its financing requirements and possible debt reduction needs.

In promoting orderly financial relations, every effort must be made to avoid the proliferation of arrears. Nevertheless, while the accumulation of arrears to banks cannot be condoned or anticipated by the Fund in the structure of programs, it may have to be tolerated on a temporary basis where negotiations continue and the country's financing situation does not allow their avoidance. In this event, appropriate safeguards would be incorporated into the monitoring procedures of the Fund arrangement, and the Fund would expect the member to continue to treat creditor banks on a nondiscriminatory basis. Arrears to creditor groups (bilateral creditors for example) that are contributing to the financing requirements of a program would not be tolerated. A comprehensive review of progress in the negotiations would be scheduled at a time appropriate to the circumstances of the case, and subsequent disbursements of Fund resources would depend on the satisfactory conclusion of this review.

Progress of the negotiations with the banks would be closely monitored by the staff and any unforeseen development would be brought to the Board's attention. Performance criteria under stand-by or extended arrangements would be quarterly while negotiations with creditors were continuing. Once an agreement was reached between the member and the banks, the immediate balance of payments impact of the package and its consistency with the country's medium-term viability would have to be assessed.