FOR AGENDA

EBS/89/78

CONFDIENTIAL

April 19, 1989

To: Members of the Executive Board

From: The Acting Secretary

Subject: Fund Support for Debt Reduction Operations - Preliminary Considerations

Attached for consideration by the Executive Directors is a paper on preliminary considerations regarding Fund support for debt reduction operations. This paper, together with the paper on country circumstances and financing approaches related to the debt situation (EBS/89/77, 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. Stuart (ext. 4579) or Ms. Puckahtikom (ext. 8780) is available to answer technical or factual questions relating to this paper.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Fund Support For Debt Reduction Operations--Preliminary Considerations

Prepared by the Exchange and Trade Relations Department

(In consultation with other departments)

Approved by L.A. Whittome

April 19, 1989

At its April 1989 meeting, the Interim Committee agreed that the Fund should provide resources in appropriate amounts to facilitate debt reduction operations for countries undertaking sound economic reforms, by setting aside a portion of members' purchases under Fund arrangements. The Committee also agreed that the question of provision of Fund resources for limited interest support for transactions involving significant debt or debt service reduction be examined. It requested the Executive Board to consider as a matter of urgency the issues and actions involved in the proposals that had been put forward.

At the same time, the Committee reaffirmed the validity of the case-by-case approach and the central importance of sustained implementation of growth-oriented policy reforms, and improvement in the investment climate in debtor countries. It was also emphasized that new financing flows from private and official sources, and reflows of flight capital, would depend on appropriate debtor countries' policies.

This note is prepared as background for an initial and informal discussion by Executive Directors of the key operational issues of these proposals as they might affect the Fund. The paper does not seek to cover all the questions that arise nor does it propose specific details on the modalities of the Fund's participation in debt reduction operations. However, as individual cases come forward, these modalities may need to be developed quickly, in particular as regards the possible setting aside of part of Fund purchases to finance debt and debt service reduction. Thus, specific operational issues arising from Fund involvement in debt reduction will need to be brought to the Board's attention at an early date. Given the complexity of the issues involved and the importance of proceeding promptly with implementation in cases where members are embarking on strong adjustment programs, the specific details of the initial approach for the Fund will probably need to be experimental. A companion paper discusses general issues related to debt reduction and its relevance for countries facing different economic circumstances.

In cases where debt reduction will be important, it is probable that both the Fund and the World Bank will be involved in assisting the

countries in their adjustment efforts. Staffs of both institutions will need to work together closely to ensure consistency in the approach to policy adjustment. The specific modalities in support of debt reduction that will need to be adopted by the two institutions may give rise to additional operational questions which would be addressed as the individual cases come forward. The staffs of the two institutions have been in close contact on the broad range of issues that are covered in this paper.

1. Conditionality for the use of Fund resources in support of debt reduction

The basic principle underlying the debt strategy has been that sustained implementation of policy reforms in debtor countries is key to the restoration of external viability. With sound policies, greater financing can better support external adjustment with growth. This adjustment framework remains central as greater emphasis is placed, in the menu of financing options, on debt reduction. At the same time, it is essential that resources available from all sources for debt reduction be truly additional to those resources that would otherwise have been provided to developing countries.

For many heavily-indebted countries, access to external financing has been severely constrained, reflecting a heavy debt service burden and in some cases a considerable discount on debt in secondary markets. Debt reduction could help improve the medium-term financing prospects facing these countries, and help rebuild normal market access. This, in turn, could strengthen the member's ability to adopt and sustain sound policies and provide stronger assurances that external viability can be achieved with a more favorable growth performance. In these circumstances the Fund could, in its current policies and practices, play a role in support of debt reduction operations.

Through the analysis of and advice on medium-term economic and financial prospects of member countries, the Fund could assess the case for incorporating debt reduction as part of an adjustment program. The pursuit by members of a strong medium-term adjustment program supported by the Fund, and (as usually will be appropriate) by the World Bank, should provide evidence that the member's commitments relating to debt reduction operations would be met; such confidence will be necessary if debt reduction is to contribute to the regaining of normal market access. In addition, the Fund could help to catalyze resources from other creditors to finance debt reduction. The Fund might also, if this proved important to the securing of agreement, provide a channel for resources through trust or similar accounts for specific operations such as debt buybacks or securing debt service payments in the context of debt exchanges.

The Fund could also extend financial assistance in the context of a Fund-supported program in support of debt reduction. This would be consistent with the Fund's approach in paying due regard to special

circumstances of member countries, subject to the principle of uniformity of treatment. Traditionally, resources provided by the Fund are intended to meet general balance of payments needs of the country, which could include financing of debt reduction. A specific commitment of Fund resources for debt reduction could be justified as it would signal strong official support for such operations and help foster the appropriate degree of debt reduction.

But care must be taken to ensure that there are adequate safeguards for the temporary use of the Fund's resources and that the prime emphasis remains on the needed adjustment. Thus, the adjustment effort would need to provide reasonable assurances of the achievement of balance of payments viability (involving no further need for exceptional financing, including from the Fund) within an appropriate timeframe. The speed with which viability could be achieved would depend in part on the scope and speed at which debt reduction would take place. The members' programs would need to take account of the range of debt reduction that would be desirable and the external financing required to support it, indicate in broad terms the appropriate mix of debt reduction and new financing, and incorporate the possible range of domestic financial implications of debt reduction operations; reserve targets and performance criteria would be set accordingly. In the programs, there might be a need (as discussed below) to focus on policy adjustments that would directly enhance the credibility of debt reduction operations including steps to help stem capital outflows and encourage the return of flight capital.

In cases where debt reduction is considered essential, economic and financial imbalances facing the member are likely to be large, requiring--even with significant debt reduction--strong programs. Resource mobilization and efficient use of resources will be critical in these programs and sound macroeconomic policies including structural elements will remain central, particularly to improve the savings and investment climate. Thus, Fund financial support for debt reduction would be expected to be linked to medium-term adjustment programs adopted in the context of an extended arrangement or stand-by arrangements with a strong element of structural reform. Fund support for debt reduction operations might also be considered in the context of ESAF arrangements for low income developing countries but separate consideration would need to be given to the question whether the financing could or should be provided from the ESAF.

Given the large amount of financial resources from all sources that might be needed if there were to be debt reduction on a significant scale over a range of countries, particular importance would be attached to policies that would help reverse capital flight and attract private capital inflows. Experience indicates the sensitivity of such flows to the credibility of adjustment policies and the political environment. "Liquid capital" may return relatively quickly in response to shifts in interest and exchange rates, while capital that would be used to finance

fixed investment may be attracted only after a stable economic environment has been in place for some time.

Policies to rebuild the confidence of the private sector and to address the problem of capital outflows and encourage the return of flight capital are typically key elements of Fund-supported programs, and include fiscal, monetary, interest rate and exchange rate policies. In addition, greater emphasis might need to be given to structural and institutional measures to encourage savings and investment--for example, a strengthening of investment through enlarging private sector access to productive activities and liberalizing exchange and trade regulations. Expanded debt conversion programs and greater use of domestic capital markets could provide vehicles for the repatriation of funds, provided that the specific actions taken were consistent with the macroeconomic framework of the program.

Policy advice on removing institutional constraints on the mobilization and utilization of capital inflows, in particular for purposes of direct investment, would continue to be provided in close consultation with the World Bank. The staff intends to study this question in more detail paying particular attention to the lessons that can be drawn from the experience of countries, including those that have introduced schemes to attract workers and emigrants' remittances, as well as the possibilities of monitoring the return of capital more effectively. But it is to be noted that statistics in this area lack the precision that would, for instance, be required for the formulation of performance clauses.

The Fund's policy on financing assurances in the context of the evolving debt strategy is being examined in a separate forthcoming Board paper. In some circumstances, the Fund might want to consider withholding approval of arrangements providing for debt reduction until banks and the member had renegotiated existing contracts or negotiated the necessary waivers of restrictive clauses in commercial bank lending agreements that would make possible a broad range of voluntary debt reduction operations. However, this approach should not be allowed to prevent the Fund moving ahead quickly when countries are undertaking strong programs--particularly where not going ahead would jeopardize the country's economic program and potentially disrupt its balance of payments. Waivers might be granted contingent on the existence of a Fund arrangement and might remain in effect while the economic program is on track. Disbursements of Fund resources to support debt reduction operations might take place after the cash payments associated with debt reduction had actually been made.

In this context, creditor governments could facilitate debt reduction operations through a review of tax, regulatory, and accounting systems that might restrict the incentives for, or constrain the participation of banks in, debt reduction operations. At their April 1989 meeting, the Ministers and Governors of the Group of Seven agreed to review practices in these areas, consistent with maintaining the

safety and soundness of the financial system, with a view to eliminating unnecessary obstacles to debt and/or debt service reduction operations. These questions will be looked at by the staff in the context of the annual report on international capital market developments.

2. Possible avenues of Fund financial support for debt reduction

In the context of a strong medium-term adjustment program, resources provided by the Fund could be used to support cash buyback operations or principal enhancement. In addition, consideration might be given to providing resources for interest support to enhance the quality of new instruments in debt exchange operations. For both purposes, Fund support for debt reduction operations could be accommodated within the existing framework of stand-by and extended arrangements or be channeled through a special facility in the General Resources Account.

A special facility could have a number of advantages for financing debt reduction operations. In particular the financial terms for its use could be closely tailored to its purpose and they could be different from other terms and conditions for use of Fund resources, provided that the terms were applied uniformly for all eligible members. However, given that the underlying arrangement should be a sine qua non of the entire operation, and in view of the need to proceed quickly in individual cases and the advantages of simplicity, it may be preferable to provide Fund support as part of the underlying arrangement, rather than establishing a new, separate facility.

The impact of potential increases in demand for the Fund's resources on the Fund's liquidity position and borrowing requirements under the policy of enlarged access will be discussed in the context of an update of the Fund's liquidity position which would be issued in late May or early June.

a. Set-aside mechanisms for debt reduction

In cases where cash buybacks or principal enhancement for debt exchanges (e.g., through purchase of zero coupon bonds) are considered an important element of a country's medium-term financing plan, it would be appropriate to set aside a specified portion of the member's access under the Fund arrangement for these purposes. The proportion specified would need to be sufficient for Fund support to have a catalytic effect on the contribution of other creditors. At the same time, the set-aside must leave adequate margins to meet the member's general balance of payments needs. On balance, the set-aside proportion might be expected to be at the low end of the level of access; an indicative magnitude of 25 percent of access has been suggested, and a proportion of around this size might be considered to be a fair general guide to initial operations.

A commitment of Fund resources at the time of approval of the arrangement should provide assurances to the market that Fund resources will be available to finance debt reduction operations. As regards phasing, it would seem prudent to time Fund disbursements for support of debt reduction with program performance; the strength and credibility of economic performance will be key to the success of debt reduction operations, even though large upfront assistance might facilitate earlier and more substantial debt relief. In cases involving relatively large debt reduction operations or severe cash constraints, some frontloading of Fund support could be appropriate, provided that needed prior actions had been taken under the program.

At least three approaches might be considered in making the set-aside available to finance buybacks. (i) The Fund could commit resources to the member, to be made available to complete the buyback when it is negotiated, or to replenish the member's reserves following a buyback. (ii) Fund resources for the set aside could be placed in an account possibly administered by the Fund to be used by the member when a buyback had been negotiated; under this option, questions regarding investments and accrual of interest on investments would need to be addressed. (iii) The Fund's resources could be made available to the member to be held in reserves and used to finance a buyback once negotiations with bank creditors had been completed.

Under options (i) and (ii) above, it would be possible to make Fund resources available to finance the buyback only after completion of a review by the Executive Board to determine that the terms and amounts of the buyback met some specified or general requirements. One approach would be to assure that the size of the buyback was broadly within the range implied by the medium-term scenario underlying the economic program; however, the changing assumptions that need to be incorporated into medium-term scenarios put together at different dates as well as the difficulties of projecting accurately the effects of buybacks on investment and growth indicate the need for caution. An alternative approach would be to evaluate the buyback at the time Fund resources are released in less quantitative terms, with a view to ensuring that the amounts and terms of the buyback reflect in broad terms the impact of debt reduction needed for viability or at least represent a significant step toward viability. Depending on the option, the question of the use of resources that were committed for debt reduction but not actually used for debt reduction would have to be addressed.

b. Securing debt service payments

As noted above, in addition to agreeing that the Fund could set aside purchases to facilitate buybacks of debt, the Interim Committee asked at its April 1989 meeting for an examination of the possibility of providing resources for limited interest support. For debt reduction to succeed there must be confidence that the reduced stock of debt and the resources mobilized to support debt reduction will be serviced according to their agreed terms. Strong assurances would be provided by the

sustained implementation by the debtor country of its adjustment program. Additional safeguards could help to reduce further the market's perception of risk, particularly in the early stages of a medium-term program and before a strong track record of implementation has been established. This could lower debt service payments by encouraging creditors to accept a smaller amount of new claims for existing debt, or accept a lower rate of interest on the existing stock of debt.

Securing of debt service payments could be effected in the form of guarantees from a third party, i.e., in practice from the official sector, or through placing the debtor country's resources--owned or borrowed--as collateral for future debt service obligations. With a strong adjustment program, the use of guarantees might be an efficient way to secure debt service payments and encourage private creditors to reduce the debt burden of borrowing countries. However, undue focus on official guarantees could distract the attention of borrowing countries and their private creditors from the need for policy adjustment and a collaborative approach to debt reduction. There need to be deep concerns about an undue transfer of risks from the private sector to creditor governments, and guarantees could slip into being open-ended with respect to the ultimate magnitude of public resources that may be necessary.

The Fund's Articles do not permit the provision of guarantees through the General Resources Account, as this would involve no exchange of assets and could potentially deplete its resources. Also, a build-up of contingent liabilities, the realization of which is not made conditional upon policy performance, would not be consistent with the traditional approach for the use of the Fund's resources.

The engaging of the debtor country's resources--both owned and borrowed--to help secure debt service payments would avoid the complications associated with guarantees by a third party and keep the prime emphasis on the debtor's resolve to deal with its economic difficulties. To convince creditors further of the improved quality of their claims, the resources placed as collateral could be administered under a trust or similar administered account. Asset enhancement could also derive from provisions whereby creditors would share in any unexpected improvement of a country's debt service capacity, such as an unforeseen upswing in the terms of trade. The implications for negative pledge clauses of the securing of certain debt service payments would need to be considered.

Possible Fund support for the securing of debt service payments include (i) providing its services for the administration of resources devoted to asset enhancement; and (ii) supplementing the country's resource needs arising from such operations. The Fund has the authority, under Article V, Section 2(b), to administer contributions in an account for the benefit of a member, consistent with the Fund's purposes. The resources for the account could be contributed by the

debtor country from a variety of sources, including official reserves, other official assets that could be sold or used as collateral, reflow of flight capital, and borrowing.

If it were decided to support debt reduction operations through the securing of debt service payments as well as setting aside some Fund resources for buybacks, supplementary access to Fund resources as a contribution to an interest support account would need to be considered in light of the potential needs of debtors, appropriate Fund access limits, and other liquidity considerations of the Fund. Fund resources for the purpose of asset enhancement could be made available on the basis of a review by the Executive Board to ensure that the terms and amounts of debt reduction met certain specified requirements.

For such an approach to be effective in supporting adjustment and enhancing the country's debt, procedures under which resources would be transferred to and disbursed from the account would need to be designed carefully. Possible procedures might provide that the member would draw on the account following its failure to meet debt service obligations according to clear prespecified understandings, including appropriate sharing arrangements among creditors. The account's duration could match the repurchase period of Fund resources or the maturity of the instruments involved (in which case the account might still exist after completion of Fund repurchases). The account could be revolving: use of the account during the period of a Fund arrangement could trigger a review with the Fund on how the account could be reconstituted; use at other times could trigger consultation with the Fund.

Under an administered account approach, possible Fund disbursements would continue to be clearly distinct from the member's recourse to the account and would be made only when the program was on track and performance criteria were being observed. But it then follows that disbursements from the account on behalf of the member might be possible even if the program was off track or, at the extreme, if the member had overdue obligations to the Fund. More generally, a broad-based strengthening of claims in such a manner could have implications for the status of the Fund as a preferred creditor and the staff will need to give these matters further consideration.

The pooling of resources of individual debtor countries in a single account could provide a leveraging of resources for securing a larger amount of interest payments, and peer pressure from other participants in the account may help foster reconstitution of used amounts. However, such a pooling may require rules on sharing of the debt service burden and could complicate the attribution of responsibilities. In addition, a run on a pooled account, say because of a deterioration in the external economic environment common to many members, could lead to a transfer of uncovered risk to the Fund, other international financial institutions, or creditor governments.