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Approaches to Third World Debt Reduction

Editors Mike Faber and Stephany Griffith-Jones

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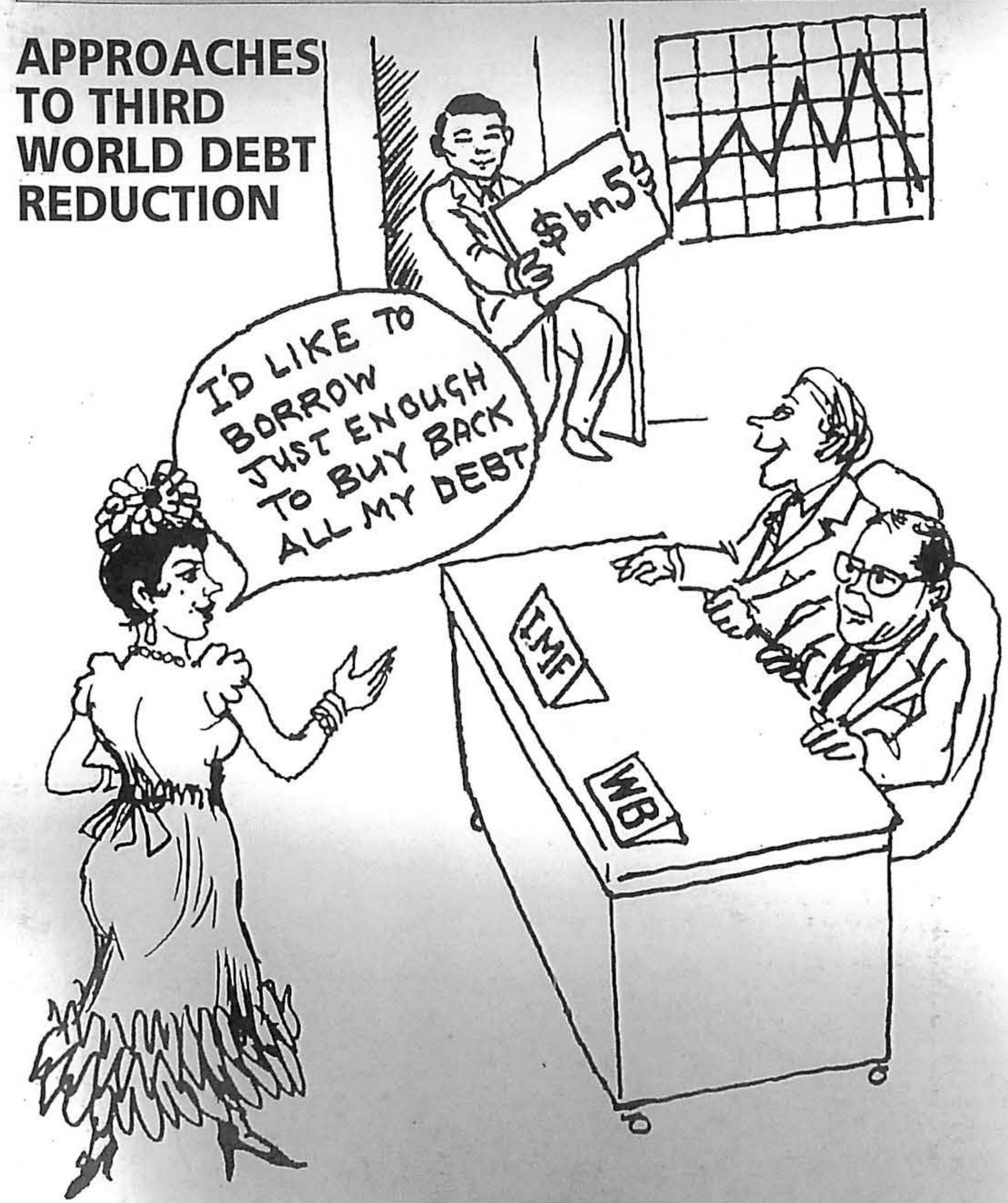
APPROACHES TO THIRD WORLD DEBT REDUCTION



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Summary

The Debt Crisis at the Turn of the Decade
John Williamson

John Williamson's paper examines the Brady Plan and its implementation, in the context of debt management since the early 1980's. It makes several proposals to improve the effectiveness of the Brady Plan, so that it can lead to more debt reduction. These include proposals to modify Paris Club rescheduling and to change banking regulations.

Development vs Debt: Past and Future
Richard Portes

Richard Portes' article examines the lessons which the debt crises of the 1930's have for the 1980's. The article also examines a recent event — changes in Eastern Europe — and analyses the possible likely effects it can have on Latin American countries in the next decade.

The Menu Approach
Robert Devlin

Robert Devlin's article looks in some detail at the stage before the Brady Plan was implemented, (the market menu approach), in which the concept of debt reduction was informally gradually ushered in. Amongst others, it describes and evaluates in some detail the 1988 Mexican Aztec bond scheme, the Bolivian buyback, the Brazilian 1988 financial package — that included an 'exit' option — and the more limited Chilean buyback.

The Shaping of the Brady Proposals
Mike Faber

Mike Faber's article examines the reasons for the timing of the Brady proposals. It then looks at both the similarities and differences between the Brady strategy and the previous phases of debt management, emphasising the significance of debt reduction in the new phase. It evaluates the likely overall magnitude of the impact of the Brady Plan. Finally, it examines the evolving structure of the debt, emphasising the declining importance of private bank debt.

The Renegotiation of Mexico's External Debt
Pedro Aspe Armella

Pedro Aspe's article examines in detail the recent Mexican deal under Brady. It stresses the net savings in interest payments achieved as well as the reduction of the total debt. The article also examines projected indirect benefits of the Brady agreement, in forms of renewed confidence in the Mexican economy. The paper includes official Mexican government figures and projections on the impact of the Brady agreement.

Brady and the Philippines: What Progress?
Reginald Herbold Green

Reginald Green's paper examines the Philippines deal in the context of the Brady Plan, emphasising that debt reduction in the Philippines package — though positive in itself — needs to be assessed against the financing gap, with 'new money' inadequate to cover the gap.

The Costa Rican Debt Deal: Is Small Beautiful?
Stephany Griffith-Jones

Stephany Griffith-Jones' paper examines the Costa Rican deal, reached in the context of the Brady Plan; this package has substantive debt and debt service reduction elements, with no 'new money' from the private banks. The paper examines the particular features of Costa Rica, (such as the total small size of its debt and its geo-political importance to the US), which, together with the government's bargaining skills, seems to explain the high quality of the package.

The New Roles and Facilities of the IMF
Robert Russell

Robert Russell's article examines the International Monetary Fund's role in the debt management strategy. It further describes the broad functions performed by the IMF, particularly in relation to developing countries.

The New Roles and Facilities of the World Bank
Anthony Toft

Anthony Toft's article explains the participation of the World Bank in debt management, and puts it in the context of the World Bank's broader role to encourage structural adjustment in developing countries.

The Paris Club and African Debt
Peter Mountfield

Peter Mountfield's article provides an insider's historical account of how working procedures evolved in the Paris Club. It also describes the main features of a Paris Club agreement, as well as the proceedings of how the Paris Club currently operates. Some suggestions follow on current issues and on proposals to deal with them.

The Debt Problem at the Crossroads
William Rhodes

William Rhodes' article gives a positive evaluation of the Brady proposals; it puts forward the Mexican package as an example of the gains to be made by the implementation of the Brady Plan.

How a Major Creditor Views the New Proposals
Jolyon Larkman

Joint Memorandum to the Treasury and Civil Service Committee
Sir Kit McMahon and Sir Jeremy Morse

The articles by Jolyon Larkman, Sir Kit McMahon and Sir Jeremy Morse all evaluate critically the Brady proposals.

The Time is Ripe
Alfred Herrhausen

Alfred Herrhausen's article emphasises the need for important changes to the debt strategy. It also presents his own proposal for dealing with the debt problem.

Supervisory Attitudes in the USA
E. Gerald Corrigan

Gerald Corrigan's article presents the changes already implemented by the US regulatory authorities and makes further proposals to facilitate the implementation of the Brady proposals.

The New Bank of England Rules for Provisioning
Stephany Griffith-Jones

Stephany Griffith-Jones' article presents in some detail the new 1990 Bank of England matrix, which provides detailed rules for British banks' provisioning against possible Third World losses.

Some Accounting and Tax Aspects of LDC Debt
Mitchell Hogg

Mitchell Hogg's article takes a detailed look at tax and

rovisioning requirements from the point of view of an ccountant and bank auditor.

he Role of Export Credit Insurance

erald Breach

erald Breach's article discusses the effect of the debt crisis n Britain's ECGD and gives a detailed account of how the CGD is responding.

apan's Attitude Towards External Debts of eveloping Countries

Aasahiko Agata

Aasahiko Agata's article discusses Japan's rapidly growing ole in facilitating and helping fund schemes of debt eduction, particularly in the context of the Brady Plan.

he Changing Secondary Market

ordon Wood

ordon Wood's article describes the operation of the econdary market for trading Third World debt. It analyses ome of the main determinants for the levels of prices in hose markets.

ebt Relief for Child Development

tephany Griffith-Jones

tephany Griffith-Jones' article examines the donations of udanese debts to UNICEF by Midland and other banks, nd their use by UNICEF to expand its spending on clean vater and reforestation projects in Sudan. The article also xamines a new Inter-American Development Bank/UNICEF scheme for swaps in Latin America.

he NGO Attitude to Debt Reduction

ohn Denham

ohn Denham's article describes why European non-governmental organisations (NGO's) give so much ttention to the debt problem and its negative effects on overty in developing countries. It also describes the uropean NGO's campaign on debt.

Resumé

La crise déficitaire au tournant de la décennie

John Williamson

L'article de John Williamson fait l'étude du Plan Brady et de ses applications dans le contexte de la gestion des dettes depuis le début des années 1980. Ce plan fait plusieurs propositions pour améliorer l'efficacité du Plan Brady, afin d'arriver à une plus grande réduction des dettes. Ces propositions comprennent des propositions de modification du Club de Paris et de changements des règlements bancaires.

Le développement contre le déficit: le passé et le futur

Richard Portes

L'article de Richard Portes fait l'étude des leçons à retenir de la crise des années 1930 et à utiliser pour les années 1980. L'article fait également l'étude d'un évènement récent — les bouleversements dans l'Europe de l'Est — et fait l'analyse des conséquences possibles pour l'Amérique Latine durant la prochaine décennie.

L'approche "Menu"

Robert Devlin

L'article de Robert Devlin étudie en détails la période précédant l'implantation du Plan Brady (l'approche de marché "à la carte"), durant laquelle le concept de réduction des dettes a été introduit progressivement et de façon non-officielle. Entre autres, il décrit et étudie en détail le projet de liaison Mexicain Aztèque de 1988, le rachat bolivien, le marché financier brésilien de 1988 — qui avait une possibilité de "sortie" — et le rachat du Chili plus limité.

La formation des propositions Brady

Mike Faber

L'article de Mike Faber étudie les raisons de choix de temps des propositions Brady. Il étudie ensuite à la fois les similarités et les différences entre la stratégie Brady et les périodes précédentes de gestion des dettes, en insistant sur l'importance de la réduction des dettes durant la nouvelle phase. Il évalue l'étendue possible des conséquences du Plan Brady. Enfin, il étudie l'évolution de la structuration du déficit, en insistant sur l'importance réduite des dettes dans les banques privées.

Trois descriptions de transactions de forme Brady

Pedro Aspe Armella

L'article de Pedro Aspe étudie en détail les récentes transactions mexicaines sous le Plan Brady. Il souligne les économies nettes obtenues dans les payments à intérêts, ainsi que la réduction du déficit total. L'article étudie aussi les bénéfices indirects de l'accord Brady, sous forme de confiance renouvelée dans l'économie mexicaine. L'article inclue les chiffres officiels du gouvernement mexicain et les prédictions sur les conséquences de l'accord Brady.

Reginald Herbold Green

L'article de Reginald Green étudie le marché des Philippines dans le contexte du Plan Brady, insistant sur le fait que la réduction des dettes aux Philippines — bien que constructif en soi — est d'un ordre pratiquement négligeable en comparaison du déficit financier, avec de "nouvelles finances" incapables de combler ce déficit.

Stephany Griffith-Jones

L'article de Stephany Griffith-Jones étudie le marché de Costa Rica, dans le contexte du Plan Brady; ce marché a des dettes importantes et comprend des éléments d'un système de réduction de dettes, sans "nouvelles finances" provenant des banques privées. L'article étudie les caractéristiques particulières de Costa Rica (telles que la petite taille de son déficit et son importance géo-politique pour les Etats-Unis), qui, avec les talents du gouvernements en matière de négotiations semblent expliquer la haute qualité de ce marché.

Le rôle du IMF

Robert Russell

L'article de Robert Russell étudie le rôle des Fonds Monétaires Internationaux dans la structure de gestion du déficit — il décrit aussi les fonctions générales du IMF, particulièrement en rapport avec les pays en voie de développement.

Le rôle de la Banque Mondiale

Anthony Toft

L'article d'Anthony Toft explique la participation de la Banque Mondiale dans la gestion des dettes, et replace cette participation dans le contexte du rôle plus général de la Banque Mondiale qui encourage une adaptation structurelle dans les pays en voie de développement.

Le club de Paris

Peter Mountfield

L'article de Peter Mountfield présente un compte-rendu historique vu de l'intérieur sur l'évolution des procédures actuellement en cours dans le Club de Paris. Il décrit également les principales caractéristiques d'un accord avec le Club de Paris, ainsi que les procédés employés et la façon dont le Club de Paris fonctionne. Des suggestions sont proposées pour les problèmes actuels et sur la façon de les aborder.

Le point de vue des banquiers

William Rhodes

L'article de William Rhodes présente une évaluation positive des propositions Brady; il présente le marché mexicain comme étant un exemple des avantages que l'on peut obtenir grâce à l'application du Plan Brady.

Jolyon Larkman, Sir Kit McMahon and Sir Jeremy Morse

Les articles de Jolyon Larkman, Sir Kit McMahon et Sir Jeremy Morse font tous une évaluation critique des propositions Brady.

Alfred Herrhausen

L'article d'Alfred Herrhausen insiste sur le besoin de changements importants dans la gestion des dettes. Il présente également des propositions personnelles pour aborder le problème du déficit.

Le point de vue des contrôleurs bancaires

Gerald Corrigan

L'article de Gerald Corrigan présente les changements déjà effectués par les autorités de contrôle des Etats-Unis (et présente d'autres propositions) pour faciliter la mise en pratique du Plan Brady.

Stephany Griffith-Jones

L'article de Stephany Griffith-Jones présente en détail la nouvelle matrice de 1990 de la Banque d'Angleterre, qui fournit des règlements détaillés en ce qui concerne l'approvisionnement de capitaux utilisés en cas de pertes financières éventuelles du Tiers Monde.

De nouvelles directives pour l'approvisionnement

Mitchell Hogg

L'article de Mitchell Hogg examine en détail les demandes de taxes et d'approvisionnement, vu par un comptable et expert-comptable.

Le rôle des assurances de crédit exporté

Gerald Breach

L'article de Gerald Breach examine les conséquences de la crise du déficit sur le ECGD Britannique et donne un compte-rendu détaillé des réactions de ECGD.

La contribution japonaise

Masahiko Agata

L'article de Mashahiko Agata examine le rôle grandissant de facilitation et d'aide aux projets de réductions du déficit, en particulier dans le contexte du Plan Brady.

Le marché secondaire en mouvement

Gordon Wood

L'article de Gordon Wood décrit la façon dont opère le marché secondaire pour négotier le déficit du Tiers Monde. Il analyse certains des principaux aspects déterminants pour les niveaux de prix dans ces marchés.

Une baisse du déficit pour le développement des enfants

Stephany Griffith-Jones

L'article de Stephany Griffith-Jones examine les donations faites à l'UNICEF par la Banque "Midland" et d'autres banques au Soudan, et l'utilisation qu'en fait l'UNICEF pour élargir sa participation à installer l'eau potable et à des projets de reboisement au Soudan. L'article fait également l'étude d'un projet de développement inter-Americain banque/UNICEF pour un échange de dettes contre développement en Amérique Latine.

L'attitude des NGO envers la réduction du déficit

John Denham

L'article de John Denham décrit les raisons pour lesquelles les organisations non-gouvernementales (NGO) donnent autant d'importance au problème du déficit et à des conséquences négatives sur la pauvreté dans les pays en voie de développement. Il décrit également la campagne européenne des NGO pour la réduction du déficit.

Resumen

La crisis de la deuda al terminar la década

John Williamson

Este artículo examina el Plan Brady y su implementación en el contexto del manejo de la deuda desde comienzos de la década de 1980. Hace una serie de proposiciones para mejorar la efectividad de este plan, de modo que pueda conducir a una mayor reducción de la deuda. Las proposiciones incluyen modificaciones del calendario de pagos y de las regulaciones bancarias.

Desarrollo versus deuda. Pasado y futuro

Richard Portes

Este artículo examina las lecciones que pueden obtenerse de la crisis de la década de 1930 para enfrentar la de 1980. También analiza los cambios recientes ocurridos en Europa del Este y sus posibles efectos en los países de América Latina en la década siguiente.

El enfoque menú

Robert Devlin

Este artículo considera con algún grado de detalle la etapa anterior a la implementación del Plan Brady (enfoque menú de mercado), en la que informalmente el concepto de reducción de la deuda se constituyó gradualmente en un guía. Entre otros, describe y evalúa el esquema de bonos Azteca de México de 1988, el de recompra de Bolivia, el paquete financiero brasileño de 1988 con su opción de salida y, el chileno de recompra, más limitado.

El perfil de la propuesta Brady

Mike Faber

Este artículo examina las razones del cronograma de la propuesta Brady. Luego considera las similitudes y diferencias de la estrategia Brady, así como las fases previas del manejo de la deuda, enfatizando el significado de la reducción de la deuda en la nueva etapa. Evalúa la magnitud global probable del impacto del Plan Brady y finaliza con un análisis de la evolución de la estructura de la deuda, destacando la declinación de la importancia de la deuda con la banca privada.

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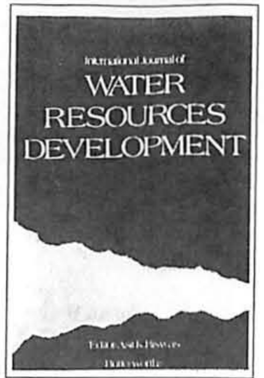

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JBEX1

Editorial

Mike Faber and Stephany Griffith-Jones

It has been said that 'the liberty of the subject is secreted in the interstices of procedure'. In other words, resounding proclamations about the rights and freedoms of citizens are worthless unless procedures exist that are known, accessible and affordable which will enable the individual to exercise those rights through due process of a court of law.

This dictum came sharply to mind a year ago when reading an account of the speech which US Secretary of the Treasury Nicholas Brady had given to a conference of the Brookings Institution and the Bretton Woods Committee in Washington on 10 March 1989. What struck us immediately about Secretary Brady's proposals was the extent to which their success or failure in achieving their declared object of LDC debt reduction would depend upon the decisions and actions of parties outside the US government's control. Those decisions and actions by foreign and US bank regulators, tax authorities, company auditors and legal advisers will establish 'the interstices of procedure' which must determine whether individual banks in different jurisdictions will or will not participate in Brady-type schemes in a manner that would achieve Brady's declared objective. One of us predicted, based on a first tentative analysis, that 'the Plan's early results will probably give rise to frustration and disappointment' and 'the amount of debt extinguished in exchange for their accepting new obligations towards the World Bank and the IMF is likely to seem to debtors disappointingly small'.[1]

It was that line of thought, namely that the success of any scheme of debt reduction would depend upon an accurate assessment of the reactions and initiatives of many types of actors in the Third World debt drama, that gave rise to the idea behind this *Bulletin*. The *Bulletin's* purpose is to enable readers to learn something of the considerations which will determine how such actors are likely to respond not just to Brady, but to other forms of debt reduction initiatives. For that understanding to be complete, we have thought it necessary to enable our contributors not just to talk about their reaction to the Brady proposals, but also to explain their perception of the role of their own institutions and their interpretation of what it was that gave rise to the problems of excessive LDC indebtedness in the first place.

Our scheme of presentation proceeds as follows:

We start with a general overview of the LDC debt situation ('The Debt Crisis at the Turn of the Decade' by John Williamson) and then follow it with a chapter ('Development vs Debt: Past and Future' by Richard Portes) which both looks back to the repudiations of the 1930's and forward to the effects changes in Eastern Europe may have upon the position of Latin American debtors in the 1990's.

Robert Devlin's chapter ('The Menu Approach') traces the introduction of various forms of voluntary debt reduction during the second phase of the Baker Plan while the following chapter ('The Shaping of the Brady Proposals' by Mike Faber) attempts to explain how the Brady proposals evolved out of the widely shared perception that the Baker Plan had simply run out of credibility, and what the similarities and differences are between the two approaches.

In Chapter Six the first three deals to give effect to the Brady approach are analysed. The Mexican Finance Minister, Pedro Aspe Armella, describes the Mexican deal in terms that are markedly more positive than those quoted later in this *Bulletin* from the McMahon-Morse memorandum. Reginald Green assesses the Philippine deal in the broader context of the country's overall foreign exchange needs if target growth rates are to be met. Stephany Griffith-Jones describes the Costa Rica deal and readers may be tempted to conclude that, in its way, it is the sweetest of the lot.

In the following two chapters Robert Russell ('The New Roles and Facilities of the IMF') and Anthony Toft ('The New Roles and Facilities of the World Bank') explain the participation of their two institutions in schemes of debt or debt service reduction, but both do so in the broader context of the full range of measures that the multilateral financial institutions can employ to encourage policy reform and to finance stabilisation, adjustment and development.

Peter Mountfield's chapter ('The Paris Club and African Debt') provides a historical account of how working procedures evolved, informally but very effectively, in that very influential but still slightly mysterious association of officials. 'English practices run by Frenchmen' is how one diplomat has described it.

[1] This quotation is by Mike Faber from 'Success of Debt Plan is beyond Brady's Control' (The Independent, 28 March 1989).

The Debt Crisis at the Turn of the Decade*

John Williamson

So far as Latin America is concerned,[1] the dominant economic happening of the 1980s was the debt crisis. Commercial bank lending came to an abrupt halt when Mexico was forced by reserve depletion to declare a temporary moratorium in August 1982. Without a flow of new bank loans, continued servicing of debt on the original contractual terms proved impossible everywhere except Colombia. The attempt to maintain debt service dictated fiscal deflation, devaluation, and the diversion of savings from investment into export surpluses. The result has been the 'lost decade': a decline in per capita income of almost 10 per cent (in place of a 40 per cent rise in the 1970s), a one-third fall in gross investment, and true hyperinflation for the first time anywhere since the aftermath of World War II.

The original debt strategy was based on a diagnosis of temporary illiquidity and sought to maintain debt service while providing partial interest recycling (euphemistically termed 'new money') so as to limit the need for peremptory adjustment. The implicit premise was that little was fundamentally wrong with the economic model that had produced quite reasonable growth from the end of World War II to the early 1980s: once the traditional levers of fiscal and exchange-rate policy had been re-set appropriately, Latin America would be able to generate a negative transfer, which would restore bankers' confidence, whereupon lending would recommence and growth could revert to its previous rate.

By 1985 it was obvious that matters were not working out that way, and so a new plan, the 'Baker Plan' was introduced. This contained no significant change in the financing provisions for debtor countries: they were still expected to pay interest service in full while principal was rescheduled and involuntary 'new money packages' provided partial interest recycling. What was new was the change in rhetoric, which now spoke of restoring growth, and the conditionality, which began to focus on supply-side policies like deregulation and privatisation. It was not evident to me at the time (and I have no idea whether it was clear to the plan's authors), but in retrospect one can see the Baker Plan as challenging the traditional statist model of Latin American development. Policy reform had to go far deeper than raising taxes and restoring a realistic exchange rate.

Just over three years later, in early 1989, a new administration conceded that the Baker Plan had not worked. Its successor, the Brady Plan, changed the financing part of the strategy, to encompass debt relief (which again had to be described euphemistically to make it acceptable to bankers' ears, as 'debt reduction and debt service reduction'). The condition for debt relief remained policy reform on the lines developed under the Baker Plan, the logic being that policy reform needed financial support to succeed, while financial support without policy reform amounted to throwing good money after bad.

The key question is, of course, whether the Brady Plan is going to work — in the sense of alllowing the debtor countries to resume robust growth — where its predecessors failed. It is already clear that it is unlikely to make a dramatic difference to the amount of debt service that debtors will need to pay to avoid confrontation with their creditors. In the outline agreement reached with its creditors, Mexico seems to have gained relief (i.e. a reduction in the present value of its contractual future obligations) of about one-third of its bank debt. But a substantial part of this relief will arise only as the debt is paid off in the distant future, and Mexico's negative transfer to the banks will decline by less than 20 per cent in the short run. The Philippines, the second country to settle, expects to get even less relief. Costa Rica, the third country to reach agreement, should get debt relief of about two-thirds as compared to its contractual obligations, but this will actually bring it no easing to its cash flow at all in the short run: indeed, the restructuring will require some *increase* in the negative transfer in the medium run (assuming that the economy continues to perform well, so that the contingent payments obligations are activated). Hence, if one believes that the debt problem has damaged the debtors primarily by siphoning away funds that would otherwise have been invested productively at home, one has little reason to be optimistic about the prospects of the Brady Plan.

The alternative view is that debt is important primarily because it is thwarting the entrepreneurial response that policy reform is intended to elicit. Mexico, for example, has undertaken an impressive range of policy reforms during the 1980s, in terms of curbing its fiscal deficit, achieving a competitive exchange rate (and hence a rapid growth of nontraditional exports), liberalising trade and foreign direct investment, privatising and in other ways rationalising the public sector, and deregulating [Williamson 1990]. Yet per capita income and real wages have, at least until recently, continued to fall. Mexican entrepreneurs have quite enough flight capital parked abroad to finance an investment boom, once they are convinced that Mexico has indeed turned the corner and that the policy reforms are going to stick. Catch-22 is that they will not draw that conclusion until *either* they see that other entrepreneurs have already drawn that conclusion *or* until they conclude that Mexico can get by in the medium run even without capital repatriation. In other words in order to succeed, the Brady Plan needed to provide enough debt relief to give assurance that repatriation of flight capital was unnecessary, whereupon repatriation could happen.

In fact, announcement of the agreement between Mexico and the banks last July stimulated enough capital repatriation to allow the authorities to reduce the domestic interest rate by over 20 percentage points, which would have given them the chance to redirect something like 5 per cent of GDP from internal debt service to restoring some of the public expenditures that have been savagely squeezed in recent years (including infrastructure, health, and education). This was the best news since the debt crisis started. It is a tragedy that subsequent foot-dragging by the banks has jeopardised the momentum that seemed to be building up, and sent interest rates in Mexico inching up again. At this stage one just has to hope that final agreement will soon be reached and that it will turn out that the damage is reversible.

The case of Costa Rica is even clearer, inasmuch as the agreement offers Costa Rica no cash flow relief at all. It cuts contractual obligations to the level that Costa Rica can afford to pay, which is the same as the level that it has been paying. The hope is that this will remove the threat of future disruption and so restore confidence.

Mexico and Costa Rica are not the only countries in Latin America that have implemented policy reforms sweeping enough to merit support through the Brady Plan. Bolivia and Chile have, in fact, gone even further in modernising their economic model. Colombia, Jamaica and Uruguay are also serious candidates. Venezuela too has made major reforms, though it started only a year ago. Policy reform is even more recent in Argentina, and its success can even less be taken for granted. But the best way to help policy reform there, as well as in countries that have not yet started, is to show that agreed debt restructurings that offer debt relief are available to countries that persist with policy reform. Limiting debt relief to those countries with an established record of policy reform is one key element of the Brady Plan that makes good sense.

Another key feature of the Brady Plan, which arises from its historical background as an attempt to buy debt relief from the banks on a voluntary basis, is its retention of an important element of choice for each bank, notably a choice between furnishing debt relief and continuing to recycle a part of the interest (e.g. by 'new money'). One can argue that it might have been better to develop sanctions to force banks to fall in line with official decisions on the magnitude of debt relief that a country needs. If the Brady Plan fails, that issue will doubtless be reopened in another two or three years time. But in the interim it is vastly more constructive to ask what changes might help the Brady Plan to succeed.

The simplest change would be to enlarge the sums available from the IMF and World Bank to support debt relief operations, but this also appears to be a lost, or at least an unpromising, cause. Three alternative, evolutionary changes look more hopeful.

(1) At the moment only the commercial banks are being asked to provide debt relief. There are good reasons for continuing to exempt the multilateral development banks. But a lot of debt is also owed to export credit agencies of the developed countries, and there is no very convincing reason as to why this should be treated more leniently than the bank debt. The simplest approach would be to forgive the same proportion of this debt as banks choosing debt reduction are required to forgive. Alternatively, a similar proportion of the debt could be converted into local currency terms, to be spent in future years on projects in the environmental, educational or social fields agreed to be of mutual interest to creditor and debtor.

(2) At present the IMF and World Bank are earmarking separate funds for debt reduction (buybacks or principal collateralisation) and for interest support (interest collateralisation). Like most earmarking, this is leading to inefficiency: most immediately, the Philippines is being thwarted in its desire to use the full funds that it has been voted in the way that seems mutually most advantageous to it and its creditors, which happens to be buybacks. This earmarking should be quietly abandoned forthwith.

(3) There is still a problem of getting potential free-riding banks to participate in Brady-style debt restructurings. The most potent incentive to a bank to participate is eligibility for tax relief. At present European banks are generally eligible for tax relief on provisions whether or not these are used to grant relief to the debtor, while American banks get tax relief only

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[1] While debt is an important problem in other parts of the world too (notably in Africa, the Philippines, and part of Eastern Europe), this paper is restricted to Latin America.

when debt relief is granted. The European practice encourages provisioning but gives no incentive to translate this into debt relief, while the American practice gives no incentive to provision and therefore leaves banks in a less favourable position to grant debt relief. Stephany Griffith-Jones (1989) suggests getting the best of both worlds by granting contingent tax relief on provisions, the relief being withdrawn retroactively if a bank fails to participate in an agreed debt restructuring.

Those of us who have concluded that profound policy reforms were needed to change the traditional Latin model of development can take heart from the reform movement sweeping Latin America. But well-intentioned reform programmes often come to nought unless they can show some clear results fairly early. The sort of definitive resolution of the festering debt crisis offered by a Brady-style restructuring buttressed by the three suggestions advanced above appears precisely the sort of result that is needed to encourage reformers to persist.

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Development vs Debt: Past and Future

Richard Portes

This paper will deal in turn with the past, the present and the future. My research on the past concerns, in part, how Latin America got out of the mess the last time around, in the 1930s and 1940s. My research on the present deals with the secondary market for LDC debt, in particular the information conveyed by the market prices and its relevance for policy.

For the future, aside from these lessons, I shall discuss the impact of recent events in Eastern Europe on the prospects for Latin America. Here I have been involved since September in chairing a group of academic advisers to the European Commission on the programme of aid for the restructuring of the Hungarian and Polish economies.

Dealing with Debt in the 1930s

A few months ago, I completed a research project for the World Bank, jointly with Barry Eichengreen of Berkeley and CEPR, on dealing with debt in the 1930s and 1980s. Perhaps some of our conclusions should have influenced policy in the 1980s but were too late — nevertheless, I think they are still relevant.

First, we found that countries which interrupted service on their external debts in the 1930s recovered more quickly from the Great Depression than did countries that resisted default. It is of course difficult to isolate how debt management strategy affects subsequent macroeconomic performance. In the 1930s as in the 1980s, maintaining debt service was often associated with fiscal austerity, import compression, and export subsidies. Conversely, the decision to suspend payments was often accompanied by the currently unfashionable policies of fiscal expansion, monetary reflation, and import-substituting industrialisation.

This comprehensive reorientation of macroeconomic stance makes it hard to distinguish the effects of external debt management from the entire set of policies. And we would certainly not recommend that countries now considering debt service reduction should couple it with irresponsible fiscal and monetary policies or inward-looking trade strategies.

Nevertheless, history does suggest that default may be good for you. If creditors are not going to grant outright debt relief, despite the excellent advice they get from middleweights like me and indeed Mr Brady (Mr Volcker is evidently a heavyweight), perhaps the debtors will finally draw the necessary conclusions.

Such conclusions are reinforced by the evidence that countries that defaulted in the 1930s did not suffer inferior access to the capital markets after the war. The important condition was to conclude negotiated settlements with the creditors. Once they had done that, countries which previously had suspended debt service were treated by the capital market just as countries that had maintained debt service without interruption.

Unlike experience since 1982, interwar default in some cases led to a substantial reduction of transfers from debtor to creditor. We might call this 'selective debt relief'. It was in fact compatible with a reasonable overall rate of return for creditors. The risk premium they had charged *ex ante* was enough to give them average realised rates of return in excess of yields on British and US Treasury bonds.

Now, we observe that the banks have made very substantial provisions for losses and nevertheless survive. This suggests that ex post, they too might find that their 1970s lending to LDCs was not unprofitable, even if there were major defaults tomorrow.

Our historical research shows that readjustment of defaulted debts in the 1930s and 1940s typically involved long, complex negotiations. We often hear the analogy with Chapter 11 corporate bankruptcy proceedings in the United States, under which default and readjustment permit a clean break with the past. This analogy is not more applicable to the 1930s than to the 1980s and 1990s. In many cases, interruptions to debt service were sporadic, and uncertainty over transfers lingered for decades. So in this regard, looking to the 1930s for more effective procedures will not help.

On the other hand, we did learn something potentially useful about government behaviour. The standard story of the 1930s is that creditor governments then refrained from involvement in the crisis much more than governments and the international financial institutions do today. We found, however, that creditor-country governments were often intimately involved in interwar debt readjustment. The difference is that in recent years creditor-country governments and their agents have exerted continuous pressure on the debtors to maintain debt service. In the 1930s and 1940s, by contrast, they pressured debtors and reditors alike.

History offers no encouragement to those who may still believe that some comprehensive plan will sort out he debt crisis in the 1980s. Global schemes to short-ircuit protracted bilateral negotiations proved ruitless in the 1930s. Nearly every element of the global plans advocated in the 1980s was first suggested nd discussed in international meetings over 50 years go: a special international lending facility, matched njections of private and public funds, conversion of xisting assets into new ones featuring different ontingencies. Ultimately none of the global schemes ould solve the issues of who should fund and control heir administration.

inally, unlike global plans, market-based debt eduction did make a useful contribution to resolving he debt crisis of the 1930s. Debt buybacks by the lebtors reduced the debt overhang and eliminated narginal creditors. Secondary market prices were nfluenced mainly by changes in the prospects for a egotiated settlement. Buybacks did raise market rices, but nowhere near enough to nullify their effects n reducing the market value of outstanding debt. Aoreover, despite their public statements of dis-pproval, creditors were willing privately to welcome uybacks out of reserves as a part of the readjustment rocess.

he Secondary Market for Debt

hese remarks on buybacks in the 1930s lead me irectly to the secondary market for LDC debt today nd its relevance for policy. Does the market offer a ensible way out from under the burden of debt?

he fundamental question here is what the market rices mean, what information they contain. It is clear hat the discounts in the secondary market represent n inefficiency. Any discrepancy between the market nd the nominal value of the debt is in itself a source of efficiency.

Iy collaborator Daniel Cohen has put it this way: to ll investors in the world, except one, purchasing one ollar of nominal claims on Chile costs (right now) 3 cents. The exception is Chile itself. When Chile pays its debt it has to pay a full dollar for one dollar f principal or one dollar of interest falling due. Basic onomics tells us that any price discrepancy like this inefficient and distorts incentives.

second source of inefficiency arising from an cessive nominal debt burden is reflected in the condary market price. This is the 'debt overhang' lustrated by the so-called 'debt Laffer curve'. When e nominal value of the debt is zero, the lenders pect to receive nothing. When the debt approaches finity, they will expect to receive nothing too: either e debtor will default or the domestic economy will ollapse totally and the return on the debt will be negligible.

So we can suppose there is a smooth curve relating the total present value of expected repayments to the nominal value of the debt: it starts at zero, first increases with the nominal value to some maximum, then starts to fall, ultimately to zero — just as the Laffer curve is supposed to relate total tax revenue to the tax rate.

The debt Laffer curve is in fact reflected in the secondary market price, if the market prices debt efficiently. For in that case, the price is just the present value of expected repayments divided by the nominal value outstanding. So it is the average value of a dollar of nominal debt. If the elasticity of the market price with respect to the face value of the debt exceeds unity, then lenders will actually increase the market value of their claims by writing off some of the debt. If the elasticity is less than unity, then debtors can reduce the market value of their debt through buybacks.

This is an empirical question of great practical relevance. For example, buybacks such as those endorsed by the Brady initiative have been called a 'boondoggle' for creditors. The argument is that they will just transfer resources from the World Bank or the IMF, or from debtor country reserves, to the banks selling debt, without any effective reduction in the aggregate market value of debt outstanding.

Other policy questions also revolve around what information is conveyed by the secondary market price and how it reacts to behaviour by the debtor and creditors. For example, does the market price give an appropriate benchmark for the price at which banks should concede debt reduction? Or for the price at which the debtor or an international agency should be willing to purchase the debt? Is the price for a given country's debt determined mainly by its own economic performance, or is it dominated by overall market conditions and contagion effects?

Work that I have been doing with Daniel Cohen throws some light on these key issues. Our preliminary results relate to monthly market price quotations for the debt of 24 countries, from February 1986 to November 1989. First, we find that the price of debt in the secondary market does not behave like the price of other assets, such as equity shares. In particular, the returns to a holder of debt do not appear to be significantly correlated to any measure of risk. One inference is that the market does not price efficiently.

Second, the prices are very closely correlated — indeed, with unit elasticity — to LIBOR. This suggests that the market price does embody information about the net present value of expected returns to holders of the debt.

Third, the prices for a large debtor, such as Mexico, are very significantly correlated to the weighted mean of prices for other countries and not significantly correlated to the price of its main export, petroleum. This suggests there is an important systemic risk that is poorly correlated to a country's wealth. On the other hand, for smaller debtors such as Ecuador, the price of oil is a major determinant of the secondary market price.

This indicates a hierarchy of debtors. The large ones determine systemic risks, while for the small debtors, the market price depends on their wealth.

This last set of results illuminates the potential role of buybacks in getting out from under the debt overhang. To the extent that systemic risk is an important determinant of the price, buybacks that reduce the total nominal value will not significantly affect the average value, that is, the market price. Equivalently, the marginal price may be much closer to the average price than critics of buybacks have maintained. The case for buybacks by the debtors in the market is then much stronger.

Latin America and Eastern Europe

But the future for highly indebted Latin American countries will depend not only on what they can do for themselves, whether in their debt strategies or in changing the fundamentals that determine economic performance. The East European revolutions of 1989 may have a major impact.

Debt is important because growth depends on investment. Debt service depresses domestic investment and discourages foreign direct investment. The transformation of Eastern Europe might weaken industrial country efforts to reduce the debt burden on Latin America, and it might also divert foreign direct investment that would have come to Latin America.

Poland of course preceded Mexico in launching the debt crisis with a moratorium just over nine years ago. In writing about East European debt in 1977, I had predicted this and also the danger for Hungary, which then also had to seek assistance in early 1982.

Now these countries are among the most heavily indebted in the world — \$20 bn for Hungary's 10 mn people, \$40 bn against Poland's less than \$8 bn of convertible currency exports. By the end of 1989, Poland's annual inflation rate had reached about 1000 per cent, a respectable level even by Latin American standards. Bulgaria, Czechoslovakia, East Germany and Romania are not heavily indebted, but as in Hungary and Poland, much of their capital stock is hopelessly uneconomic.

Many billions of dollars will be needed for reconstruction in Eastern Europe. Some will doubtless come from domestic savings. But the demand for a net inflow of resources is already strong and vocal. This could come from grants, debt reduction for Hungary and Poland, new lending, or foreign direct investment. There will be some grant element in aid, and given the budgetary constraints of which all industrial countries are only too conscious, this must partly divert resources from aid to Latin America.

The position on debt relief is by no means so clear. Although Hungary has so far resisted rescheduling, at great cost, the market discount is finally beginning to open up. Hungary is likely to be a candidate for Brady treatment after the elections of 24 March, and Poland is already. The political pressure to grant them debt relief may become overwhelming.

This could benefit Latin America. The banks' emphasis on the case-by-case approach reflects resistance to setting precedents; thus Mexico is claimed to be unique. A few more, like Hungary and Poland, could break down that barrier.

The Paris Club has ruled out debt reduction except for the poorest countries. Here again, pressure to help Poland might eventually bring the exception that could become the rule.

This is the optimistic side. The negative aspect is that Eastern Europe is drawing the attention and the resources of the international lending agencies as well as of private investors. Latin American countries may well envy the amounts of official assistance already promised or said to be likely. True, the banks are unlikely to lend significantly, and even official sources should hesitate to put substantial new money into overindebted countries like Hungary and Poland. But the World Bank will clearly lend heavily and also seek co-financing with private investors.

Everyone is calling for foreign direct investment in Eastern Europe, partly to reinforce the movement towards capitalist market economies there. But FDI to the LDCs from OECD countries has been running at a rate less than \$15 bn annually for the past few years — only 10 per cent of total OECD FDI. So Eastern Europe will be more competition for a rather small pot, which it is unlikely to enlarge significantly.

Moreover, the East Europeans may increase the pressure of 'tax competition' for FDI. Mexico now claims to offer the best conditions for foreign private investors in the world. East European countries may try to match the tax breaks, and they will compete favourably in regard to skilled labour at low real wages.

They will also compete in goods markets with the industrialising Latin American countries. Both in patterns of actual and potential trade, and in what they offer to FDI, the East European countries will look to Western Europe, the US and Japan like middle-income developing countries. Incidentally, this is also likely to be uncomfortable for Southern Europe — in particular the Southern tier of the European Community. If Eastern Europe does turn out to be the 'boom town', the 'gold rush' that some ıave called it, the Latin American countries will not be he only ones to lose out.

)verall, the balance does not look favourable for -atin America. The way forward is thus somewhat nore difficult. My own view is that progress will equire more aggressive action to achieve debt relief, including more active use of the secondary market. But this must go hand in hand with more widespread, determined efforts for domestic economic reforms, of which Mexico is for the most part a good example. After Brady, the initiative must be taken by the Latin American countries themselves.

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The Menu Approach*

Robert Devlin

The Brady Plan's proposals represent an important advance in the conception of how to manage the problems of the highly indebted countries (HICs). The positive aspects of the proposal can be best appreciated by first examining the scope and limitations of the Brady Plan's predecessor, the Baker Plan, and more specifically, the second stage of that Plan, the so-called Market Menu Approach.

The Market Menu Approach emerged in 1987 on account of the shortcomings of the Baker Plan's original formula for restoring growth in the highly indebted developing countries, which involved intensification of economic reforms in the debtor countries, coupled with a redoubled effort to mobilise concerted loans for them from commercial banks and official lenders.[1] As it became evident that the commercial banks were unwilling to support the Baker Plan's lending commitments, the official focus shifted to the so-called Menu Approach as a way to overcome the problem of developing countries' growing financing constraint.[2]

The Menu concept essentially supplemented new concerted lending packages by the banks with other financing options. On the one hand, the Menu proposed the use of alternative new money instruments such as trade and project loans, international bond placements and limited capitalisation of interest payments. On the other, it introduced for the first time in the management of the debt problem the possibility of financing the debtor countries through debt reduction techniques such as debt-equity swaps, debt-bond exchanges, and buybacks. In the official scheme, the items on the Menu had to emerge voluntarily from the market on a case-by-case basis in negotiations between the debtor country and its creditor banks. Moreover, the creditor governments made it emphatically clear that their support of the Menu could *not* involve costs for their taxpayers, i.e., public guarantees and the like to enhance financing packages were explicity excluded from the official management strategy.

Although appearing in 1987, the Menu did not gain concrete form until 1988 when an array of its market-based options actually emerged from the negotiations between debtors and creditors. Moreover, financing schemes tended to stress debt reduction techniques, in part because net lending by the banks had become practically impossible to mobilise. Indeed, according to World Bank estimates net bank financing to the highly indebted countries, after adjustment for the net movement of arrears, was only US$500 mn in 1988, compared to an already low figure of US$7 bn in 1987.[3]

Events in Latin America, where the bulk of the highly indebted countries are located, were indicative of the general situation in 1988. Indeed, new money operations were a rare event. Brazil secured a US$5.2 bn loan in June as part of a package that rescheduled US$62 bn of outstanding debt. The terms were a 12-year maturity and an interest rate of 0.81 per cent over LIBOR. Venezuela also secured some new money, but by exploiting a non-conventional option in the menu: bond placements. During the year the country emitted four bonds worth approximately US$350 mn. The notes typically had a maturity of five years and interest rates ranging from 11.13 per cent fixed, to 1.13-1.88 per cent over LIBOR.[4] Finally, in early 1989 Colombia — the only HIC to avoid a rescheduling — secured a new money commitment

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[1] The Baker Plan was announced in September 1985 and 'promised' to mobilise US$29 bn over three years for 15 heavily indebted developing countries (Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia). Later Jamaica and Costa Rica were added to the list. US$20 bn was to come from commercial banks and US$9 bn from official lenders. However, programmed bank financing — which represented a modest 2½ per cent annual expansion of exposure — proved difficult to mobilise, in part because by 1986 commercial banks had substantially reduced their vulnerability to default and therefore had less incentive to lend in concerted fashion to problem borrowers. Indeed, World Bank data suggest that net lending by banks totalled only US$6 bn over 1986-88, in contrast to US$15 bn for official lenders. Source: World Bank, *Quarterly Review*, Washington DC, March 1989, p. 3.

[2] For a more completed analysis of the evolution of the official debt management strategy and the emergence of the Market Menu Approach, see CEPAL, *La Evolución del Problema de la Deuda Externa en América Latina y el Caribe*, Estudios e Informes de la CEPAL No. 72, Santiago, Chile, 1988 and Robert Devlin, *Debt and Crisis in Latin America: The Supply Side of the Story* (Princeton: Princeton University Press, Chapters 5 and 6).

[3] World Bank, *op.cit.*, p. 3.

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involving a US$1.5 bn loan from its bank creditors with a $12\frac{1}{2}$ year maturity and a 0.88 per cent spread over LIBOR, coupled with a US$0.2 bn bond placement carrying an eight year maturity and a spread of 1.5 per cent over LIBOR.

Aside from the small number of HICs which were able to secure new bank credit, the volume of loans for those privileged few countries was disappointing also. In the Brazilian operation, nearly two-thirds of the loan was earmarked to liquidate interest arrears accumulated a year earlier. Meanwhile, the two-year financing package for Colombia, in addition to being extremely difficult to organise, fell short of the cost of upcoming amortisation. That means that the creditor banks actually will reduce their exposure in a country that by most any standard is quite creditworthy. Finally, the Venezuelan issues were both small and extremely expensive. Moreover, much of the money was reportedly subscribed by Venezuelan residents, making the bonds more of a vehicle for repatriating capital flight than an international bond placement as such.

As for the debt reduction items in the Menu, 1988 began with an interesting operation in Mexico in which the government proposed to trade up to US$20 bn of restructured public debt for US$10 bn of bonds with a single maturity of 20 years and an annual interest rate of 1.63 per cent over LIBOR (compared to 0.81 per cent over LIBOR for the restructured debt). To enhance the new government bond, Mexico indicated a willingness to guarantee its principal by using the country's foreign exchange reserves to make a parallel purchase of a specially issued US Treasury zero-coupon bond with a face value and a maturity identical to that of the Mexican instrument.[5]

The proposed scheme at the time was hailed in some circles as the solution to the problem of the HICs.[6] However, the launching of the operation ran into a number of unexpected difficulties. Gaining the necessary waivers from the banks to initiate the conversion operation was not as difficult as it might have been because protracted negotiations over a March 1987 rescheduling agreement had already exempted public debt from the sharing clause, which required approval of 100 per cent of the banks. The remaining obstacle was the negative pledge clause which had to be waived to collateralise the new bonds. Since this waiver required the consent of only 51 per cent of the banks, it was secured within two months. The major problems arose on other fronts.

First, Mexico's collateral was for principal only, which represented just 18 per cent of the discounted/present value of the 20 year Mexican bond. In other words, the banks perceived that 80 per cent of the income stream on the bond was unsecured Mexican risk. The Mexican authorities tried to overcome this problem by asserting that the new bond would be senior to existing loans, but most banks were apparently unconvinced about seniority being created by fiat. Second, the attractiveness of the offer was reduced by a ruling of the United States Securities and Exchange Commission which stated that US banks would have to write down all loans tendered for the exchange, even if ultimately they were not accepted by the Mexican government. Third, the announcement of an offer to exchange up to US$20 bn of debt for US$10 bn of bonds implied a discount of 50 per cent on outstanding bank loans; yet many institutions in the US had loan loss reserves sufficient to cover discounts of only 25-30 per cent,[7] while the Japanese banks were formally even less covered for loan losses.[8] Fourth, national tax codes were such that for many European banks there was little or no advantage to recognising the lower value of their assets in an exchange. Fifth, the placement confronted inherent free rider problems since certain banks would be tempted to withhold their participation in anticipation of having the value of their loans rise as the absolute amount of Mexican debt fell. Finally, the exchange offer was a very novel twist in the official debt management strategy; it is well known that the market reacts cautiously to new instruments and therefore conversions of this type might normally be expected to start quite small even under the best of circumstances.[9]

The reaction of the market to the Mexican offer indeed fell far short of initial expectations. In the auction Mexico received 320 bids from about a quarter of the country's nearly 500 creditor banks for a total value of US$6.7 bn. The government accepted just 95 of those bids valued at US$3.7 bn and traded them for US$2.6 bn of Mexican bonds. Thus the average discount on the operation was 30 per cent and bank debt was reduced by US$1.1 bn. The government had to expend about US$490 mn of foreign exchange reserves to collateralise the new bonds, plus, in order to avoid discrimination, at least another US$100 mn had to be drawn upon to collateralise the country's outstanding bonds already in circulation.

The results of the Mexican exchange offer clearly disappointed creditors and debtors alike. Nevertheless, even the most optimistic scenario of a US$10 bn debt reduction would not have produced dramatic relief for Mexico's harried balance of payments. This is because the principal on the debt was not being paid and there was little prospect of it being paid in the foreseeable future. (Hence the 50 per cent discount on Mexican debt trading in secondary markets in early 1988.) In these circumstances, and with an interest rate on rescheduled debt of LIBOR +0.81 per cent, every dollar of debt reduction brought with it at that time only 8.8 cents of cash flow relief in the form of lower interest payments.[10] However, this interest savings was partially offset by the fact that Mexico attempted to enhance the new bond with a higher spread over LIBOR than found on the old debt and also had to disburse upfront liquid interest-earning foreign exchange reserve to purchase collateral that would not yield a cash flow for 20 years. Indeed, in these circumstances a US$10 bn exchange would have produced only slightly more than US$650 thousand annually in net interest savings, compared to an annual interest bill on the debt of nearly US$9 bn. Moreover, in view of the need to disburse for collateral, the net cash balance on that hypothetical operation would have been negative for Mexico for the first three years. With Mexico's actual voluntary conversion being realised at a relatively low discount and low volume, net annual interest savings will be tiny and the net cash flow balance of the transaction will be negative for Mexico for most of the 20 year life of the agreement.[11]

Another important debt reduction operation was launched in March 1988 by Bolivia. Because of economic and political problems, this nation unilaterally suspended its debt service in mid-1984. After rescheduling its Paris Club debt in July 1986, Bolivia began to actively negotiate a buyback of its bank debt, worth about US$670 mn (excluding interest on arrears), or 15 per cent of the country's total public foreign debt. The country's bank debt had been circulating in secondary markets at about 6 cents on the dollar, but with news of a potential buyback, secondary market prices quickly rose to 11-12 cents.

A year after initial contacts, in July 1987, Bolivia won waivers of the already mentioned restrictive clauses which were contained in a 1981 rescheduling agreement. Among the conditions established for the buyback were that the resources for the purchase had to come from third party donors; the contributions had to be placed in an IMF Trust Fund, and an identical price would have to be offered to all the country's bank creditors. The banks also won the option to accept, in lieu of cash, 25-year collateralised peso denominated zero-coupon bonds, which were indexed to the US dollar and eligible for conversion into local equity at a 50 per cent premium over their face value.[12]

The buyback was formally announced in January 1988 with an offer price of 11 cents on the dollar. In March Bolivia announced that 53 of its 131 creditor banks had made bids; nearly US$270 mn of debt was exchanged for cash and US$64 mn for notes. The outstanding debt was reduced by nearly half.

The buyback clearly illustrated how assistance from the international public sector can accelerate a reduction of outstanding bank debt. Indeed, the entire operation would not have been feasible without the resources provided by government donors and the IMF's good offices. Nevertheless, the operation was far from an unqualified success and revealed shortcomings of the Market Menu Approach as then conceived.

It is rather striking that facing an unquestionable state of insolvency in Bolivia; an offer price that nearly doubled that prevailing in the secondary market before the announcement of a buyback, and the availability of third party to finance a full scale repurchase, only 40 per cent of the country's creditor banks 'volunteered' to participate in the operation. The reasons for this sluggish response are varied. Some banks clearly preferred to free ride, evaluating that with a reduced debt Bolivia might eventually be willing to settle the remaining outstanding obligations on terms more favourable to them. Other banks which were fully reserved against Bolivian portfolio risk estimated little immediate tax or accounting benefits from a formal recognition of a loss; indeed, by sitting tight a bank might achieve a windfall benefit from an unexpected sharp rise in the country's terms of trade.

[4] Venezuela undertook four operations in 1988: (i) a US$100 mn note in February which carried a five-year maturity and a fixed rate of $11\frac{1}{8}$ per cent; (ii) another US$100 mn issue in August carrying a five-year maturity and a spread over LIBOR of $1\frac{7}{8}$ per cent; (iii) a DM$100 mn issue in November carrying a five year maturity and a $8\frac{1}{4}$ per cent fixed interest rate and finally; (iv) a US$500 mn issue in December, of which only US$100 mn was in cash, the rest being composed of restructured private sector debt. This latter operation carried maturities of six, ten and 15 years and an interest rate of $1\frac{1}{8}$ per cent over LIBOR.

[5] For more detail on the Mexican proposal, see Ruben Lamdany, June 1988, 'Voluntary Debt Reduction Operations: Bolivia, Mexico and Beyond . . .', Washington DC, World Bank.

[6] 'Mexico's New Bond Scheme Points to Long Term Solution to Region's Debt Crisis', 11 January 1988, *Business Latin America*, p. 9.

[7] See CEPAL, 28 February 1989, 'Estudio Económico de los Estados Unidos 1987', Santiago, Chile, LC/G.1477, table 32.

[8] Bouchet, M. and Hay, J. 'The Rise of the Market-Based Menu Approach and Its Limitations', Washington DC, World Bank, 1989, p. 19.

[9] Keneth Telljohann, June 1987, 'Analytical Framework', *Prospects for Securitization of Less Developed Country Loans*, New York, Salomon Brothers, p. 11.

[10] At that time LIBOR was about 8 per cent.

[11] Since LIBOR at that time was 8 per cent, the hypothetical reduction of US$10 bn of restructured debt would have reduced annual interest payments by US$880 mn. On the other hand, the new US$10 bn Mexican bond would have carried an interest rate that was 0.82 per cent higher than the rate on restructured debt, generating additional interest costs of US$82 mn per annum for the country. Liquid foreign exchange reserves of US$2 bn would have had to be used to purchase collateral that would have no cash return for 20 years; hence, if those deposited reserves were earning a very conservatively estimated 7 per annum, cash interest income of US$140 mn per annum would have had to be foregone. Thus net interest savings from the exchange would have been US$658 thousand annually. But since US$2 bn would have to be disbursed for collateral, the cumulative net cash flow would have been negative for Mexico for the first three years. The interest savings and cash flow benefits, of course, fall as the exchange ratio worsens for the debtor. Using the same assumptions about interest rates, Mexico's actual exchange at a 30 per cent discount generated at that time net annual interest savings of about US$35 mn and an overall negative cash flow balance that would not be rectified for 17 years.

[12] For a more detailed summary of the Bolivian operation see Lamdany, *op.cit.*

Other banks, with inadequate reserves against their LDC exposure, would have wanted to avoid the losses implied by participation in a buyback and thereby keep their loans at book value. Finally, some institutions undoubtedly preferred to avoid the precedent of debt forgiveness.

Another problem was the rise in the secondary market price itself. At 6 cents on the dollar the secondary market had been valuing the country's US$670 mn debt at US$40 mn. However, anticipating the buyback the market price rose to roughly 11 cents, meaning that the remaining unpurchased debt of US$336 mn gained a market value of US$37 mn. Thus slightly less than US$37 mn of cash and Bolivian notes bought only a US$3 mn reduction in the market value of outstanding obligations; in other words Bolivia paid 11 cents on the dollar for a debt with a marginal value of less than one cent.[13]

Buying back a debt with a low marginal value is not unequivocally the best alternative use of resources for a country with a foreign exchange constraint; indeed resources could conceivably be deployed more productively for reforms, imports, investment, and economic growth. Moreover, the allocation of resources for a partial buyback even as large as that of the Bolivian case does not necessarily alter dramatically private investors' perception of risk; since after the buyback the country was unable to service its remaining bank debt, and those outstanding obligations traded in secondary markets at a heavy 89 per cent discount, potential new investors would undoubtedly still have their decisions affected by perceptions of a long embattled queue for available foreign exchange. Nevertheless, what perhaps made the Bolivian operation attractive was that donor resources were earmarked solely for the purpose of a buyback and the country already had a significant pipeline of commitments of foreign loans and grants which it could absorb only gradually.

Perhaps the fullest expression of the Menu Approach emerged in June 1988 when Brazil announced a new financial package with its creditor banks that would lead the country out of the moratorium which it had declared in February 1987. As mentioned earlier, the agreement included the traditional rescheduling of principal on commercial terms and a new money commitment. However, what was notable about the agreement was the impressive array of menu items incorporated into the financing.

As part of new money package of US$5.2 bn, Brazil offered to issue, in lieu of new loans from the banks, up to US$1 bn of bonds in bearer form which would carry the same terms as the loans. Moreover, US$2.9 bn of the new money subscribed in the form of loans would become eligible over 1989-1991 for conversion into local equity at par, up to a limit of US$50 mn per month.

Brazil also offered the banks an 'exit' option on the restructured debt. In lieu of a rescheduling, the creditors could exchange public sector medium term debt for exit bonds valued at par with a 25-year maturity and a fixed, below market interest rate of 6 per cent. The bonds were designed to offer those banks which wished to avoid future reschedulings and requests for new money a chance to 'exit' from the process, but at the cost of accepting financial instruments with lower interest rates and longer maturities. To further enhance the instruments, Brazil allowed the banks to convert the exit bonds at par into cruzado denominated Brazilian Treasury notes indexed, at the choice of the bank, to domestic inflation or to the dollar exchange rate.

The entire new money package, as well as the exit bonds, were additionally eligible to participate in Brazil's newly inaugurated debt-equity swap auctions, which began in February 1988. Other menu items in the agreement involved a retiming of interest payments from a quarterly to semi-annual basis and relending provisions for restructured debt.[14]

The Brazilian agreement was clearly innovative and the best expression to date of the Menu Approach. But again, as a vehicle for debt relief it was only a qualified success. The subscription to the new money package was indeed unusually quick, about one month. Yet only 308 of Brazil's 500 commercial banks entered into the agreement. Moreover, the participating banks' chief motivation for the loans was Brazil's agreement to liquidate more than US$3 bn of arrears and the resulting very favourable interest receipts/new loan ratio of four to one over the programme period 1987-1989.[15] Indeed, the signing of the new loan pact in Brazil by itself was expected to increase US money centre banks' 1988 earning per share by between 10 and 40 per cent.[16]

The subscription to the exit bond, while much more successful than a similar instrument promoted by Argentina in 1987,[17] nevertheless only attracted 108 banks for a total value of US$1 bn, or 20 per cent of the amount which Brazil had originally offered to exchange. At that time the conversion implied savings of about US$30 mn per annum in interest payments, which was far less than a bonanza in view of the then US$11 bn annual interest burden on the debt.[18]

In addition, considering that the new money eligible for conversion into equity at face value corresponded closely to the amount of interest payments in arrears, and that the market then valued Brazilian obligations at 50 cents on the dollar, a swap at par was an unusually generous concession to the creditor banks. Moreover, the conversions — which are to be additional to the official debt-equity swap programme — could make management of the country's severe inflationary problem more difficult.

In April 1988 Chile had begun negotiations with its creditors to amend loan contracts in order to introduce more flexibility into the country's debt management. Six months later, in September, the requested amendments were approved by the banks to allow: (i) direct buybacks of the debt at a discount for an amount not to exceed US$500 mn and to be funded exclusively from the country's foreign exchange reserves; (ii) debt exchange offers for up to US$2 bn; (iii) prepayments in pesos in cases where receipts are re-lent to new investment projects and (iv) the awarding of preferencial guarantees on new debt up to an amount of US$500 mn. The pre-payment provision was used during 1988 to extend US$35 mn in financing to a local mining project, and in November Chile deployed US$168 mn of its reserves to purchase US$299 mn of debt, capturing a discount of 44 per cent.[19]

The Chilean initiative certainly did introduce needed flexibility into the loan agreements. Yet the banks, fearing moral hazard — put severe limits on the volume of resources that could be managed in this new way. Moreover, like any buyback operation, there is the question of efficient allocation of resources. At that time the repurchase bought about US$16 mn per annum in net interest savings; however, since the country was required to make an outlay of US$168 mn in reserves, the cumulative net cash flow on the operation would remain negative for the next ten years.[20]

Undoubtedly the most dynamic source of debt reduction in developing countries in 1988 involved formal debt-equity swap programmes as well as informal swaps, which are operations that do not directly involve a country's monetary authorities. The World Bank estimates total swaps of some US$14 bn in 1988, compared to US$7 bn in 1987 and US$1.5 bn in 1986.[21] Most of the swaps occurred in four countries: Brazil, Mexico, Chile and Argentina. Brazil carried out by far the greatest volume of swaps; estimates place them at US$8 bn, of which about US$3.6 billion were in the country's formal programme. Mexico also had a large number of informal swaps, estimated at US$3 billion in 1988. Meanwhile, Chile converted about US$2 billion of external debt into peso-denominated assets under its formal Chapter 18 and 19 programmes. Finally Argentina registered US$1 bn in formal swaps, plus an undisclosed amount of informal transactions.

While the volume of debt-equity swaps has risen markedly in recent years, so have the polemics surrounding them.[22] One of the major concerns raised by the debtor countries has been related to their weak fiscal situation and the inflationary effects of converting foreign debt into currency and notes. These and other problems with swaps caused Mexico to halt its formal programme in 1987, while both Brazil and Argentina temporarily suspended their operations in early 1989. On the other hand, Chile, with a relatively sound fiscal situation, continued to aggressively promote its swap programme.

Finally, another important, but informal and less publicised process for reducing debt in 1988, was the accumulation of arrears. This process not only reduces the immediate outlays for debt service, but also tends to drive down secondary market prices for the debt and opens up opportunities for eventual settlements at less than face value. During the course of 1988 a surprisingly large number of highly indebted countries found themselves deploying this non-menu option to reduce debt-servicing burdens.[23]

The review of some of the major financial operations in heavily indebted countries highlights some of the shortcomings of the Menu. First, the voluntary response of the banks to the debt reduction schemes was very poor. This was due to a complex constellation of factors: free riding, sharp differences in the ability of the banks to absorb losses, disincentives arising from bank regulatory and tax codes, fears of precedent, and difficulties in creating preferential status for new debt instruments.

[13] That is, one dollar in reduction of the face value of the debt lowered the market value by only 0.009 cents. This problem has led some analysts to declare buyback and conversions a 'boondoggle'. See Jeremy Bulow and Kenneth Rogoff, 1988, 'The Buyback Boondoggle', *Brookings Papers on Economic Activity* No. 2, pp. 675-704.

[14] For an analytical review of the retiming and relending provisions see Ruben Lamdany, December 1988, 'The Market Based Menu Approach in Action: The 1988 Brazil Financing Package', Washington DC, World Bank.

[15] Bouchet and Hay, *op.cit.*, p. 7.

[16] Peter Truell, 23 June 1988, 'Brazil's Proposed Debt Pact is Expected to Boost '88 Earnings of Big US Banks', *Wall Street Journal*.

[17] In 1987 Argentina offered exit bonds with a 25-year maturity and a fixed 4 per cent rate of interest. Only two banks subscribed. See Lamdany, 'Market Based Menu Approach . . .', *op.cit.*, p. 36.

[18] Evaluated at the LIBOR in mid-1988 (8 per cent) and a spread of 0.81 per cent on restructured debt.

[19] Ricardo Ffrench-Davis, September 1988, 'Recompra de la Deuda de Chile', Santiago, Chile, CIEPLAN.

[20] To calculate net interest savings I applied November's LIBOR of 9 per cent plus a spread of 0.81 per cent for restructured debt and very conservatively estimated interest earnings of 8 per cent per annum on the foreign exchange reserves.

[21] World Bank, *op.cit.*, table 8.

[22] For an evaluation of some of the potential negative effects of swaps see Group of Thirty, 1987, *Finance for Developing Countries*, New York; Ricardo Ffrench-Davis, December 1987, 'Conversión de Pagarés de la Deuda Externa en Chile, *Colección Estudios CIEPLAN 22*, pp. 41-62 and Eugenio Lahera, September 1987, 'La Conversión de la Deuda Externa: Antecedentes, Evaluación y Perspectivas', Santiago, Chile, CEPAL, LC/R.614.

[23] In Latin America alone more than half of the countries with bank debt were in arrears in 1988. See CEPAL, December 1988, 'Balance Preliminar de la Economía Latinoamericana 1988', *Notas Sobre la Economía y el Desarrollo*, No. 470/471, Santiago, Chile, p. 11.

Second, the ability of the problem debtors to undertake direct buybacks, or to enhance exchange offers was limited by the scarcity of their own foreign exchange resources, legitimate questions about the best alternative use of those resources, and in the particular case of debt-equity swaps, the implications of those conversions on expanded domestic money supply and inflation.

Third, negotiations with the banks for voluntary debt reduction were usually protracted, due in part to the need to gain waivers on restrictive clauses in loan contracts. This, coupled with the uncertain response of the banks to exchange offers even when they were approved, created great uncertainties regarding the volume and timing of external financing via voluntary debt reduction techniques.

Fourth, the time path of effective cash flow relief granted by market-based voluntary debt reduction techniques tended to be exactly the inverse of what was needed for programme debtors with a very high social rate of discount for foreign exchange. In effect, most of the techniques stressed reduced principal, the payment of which had already been pushed off into the distant future by restructurings or moratoria, and which at the margin had an extremely low expected value. The effective balance of payments relief therefore was limited to lower interest payments; however these fell by only a tenth or less of every dollar of debt reduction.

When financial instruments that act more directly on interest payments were deployed by the debtors, such as exit bonds, interest savings tended to be marginal. This was because of the factors just cited in point one above, and the fact that the uncertain return of exit bonds had to compete with the certain return of an exit via a cash sale in secondary markets (which has no direct benefits for the debtor). When countries tried to enhance the response to their exchange offers through self-financed collaterisation, the net balance between the use of scarce foreign exchange and the savings of foreign exchange was initially unfavourable for the debtor and not rectified for many years.

Fifth, new money was increasingly difficult to raise from the banks as they became more reserved against loans losses and more engaged in exposure reduction.

Sixth, the Menu's options, whether in the form of new resources or debt reduction, tended to be applied very unevenly across the debtor countries, with its limited benefits being concentrated in only a handful of countries.

In sum, as CEPAL observed in 1988, the operation of the Menu revealed some interesting appetisers for some debtor countries, but the 'main entrees' simply were not there.[24] When left to their own devices, private markets typically unwind from a debt overhang only very slowly. Hence the Menu Approach as then conceived could only chip away at the corners of the debtors' financing constraint. Indeed, the debt management strategy clearly did not address a central macroeconomic problem: how to finance in a sustained and predictable way the economic reforms and new investments that the highly indebted countries will need to initiate growth now and begin to restore their capacity to service debts.

[24] CEPAL, *Evolución del Problema de la Deuda Externa en América*, *op.cit.*, p. 49.

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Food Security in Developing Countries

Edited by Simon Maxwell

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Food security' is becoming to the 1990s what 'basic needs' was to the 1970s: a conceptual focus for academic analysis and an organising principle for country policy and donor programmes. This timely **Bulletin** takes a critical look at the concepts, methods and results of food security planning in developing countries. The ten papers report on the latest research in countries as diverse as Ethiopia, Sudan, India and Indonesia. They include conceptual and methodological overviews as well as policy reviews by the main aid agencies. This **Bulletin** will be essential reading for academics, practitioners and students with an interest in food security.

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The Shaping of the Brady Proposals

Mike Faber

Ten Reasons for the Timing

A variety of reasons have been advanced as to why the Brady proposals came when they did and why they incorporated for the first time official US backing for schemes of debt reduction that would involve enhancements from the international financial institutions.

First, the extant 'Baker Plan' strategy had run out of credibility. It is important to say that rather than that the plan had failed, because an accusation of failure involves an assumption about what the underlying objectives of the strategy actually were. Some blamed the failure of the commercial banks to come up with the amount of new funding which the strategy had required; some argued that the banks had done their bit but the response of the IFIs had fallen short;[1] some believed that the major part of the failure lay at the door of the LDC debtors themselves for not adjusting their internal policies rapidly and rigorously enough. But wherever the blame lay it was clear by mid-1988 that the strategy was not enabling most severely indebted countries to grow out of their problems and that the critical ratios of creditworthiness were not generally improving.

Second, the international financial system was no longer felt to be vulnerable to whatever actions the debtors might take or, by 1990, to a more radical approach to the entire problem than had been manifest in the previous procedures for repetitive reschedulings.

Third, most of the major lending banks had succeeded in making substantial provisions against loss of part of the principal owed or failure to receive prompt payment of interest as well as in strengthening their capital ratios.

Fourth, the performance of the secondary market where LDC loans were being traded at deep and generally growing discounts was assuming increasing significance — debtors were asking 'why are we attempting to service our loans in full when the market considers them to be worth less than half their face value?' and 'what can be done to enable us to capture the discounts?'

Fifth, a sense of the lack of parity of sacrifice between creditor banks and the populations of debtor countries in the treatment of the problem since 1982 was spreading; this uneven impact of the prevailing strategy was even causing disquiet amongst some of the staff of the IFIs.

Sixth, contributing to that feeling of disquiet was the evidence that IFI-designed structural adjustment programmes had much less chance of working if resources needed for investment had to be continually diverted fully to service the ever growing burden of commercial bank debt.

Seventh, in a period of high interest rates and weak commodity prices the underlying quality of IMF advances and of World Bank loans might themselves be damaged unless the burgeoning and ultimately competing claims of the commercial banks could be reduced.

Eighth, certain political considerations had assumed more immediate importance for the US administration, for example the need to come to terms with a new President of Mexico as orthodox in his financial policies as any Mexican President was likely to be; the desire to preserve democracy in Argentina; the need to respond to the anti-debt, anti-adjustment riots in Venezuela; and the wish to bolster Mrs. Cory Aquino's popularity in the Philippines.

Ninth, the possibility of getting the IFIs and the Japanese Government indirectly to help out the more exposed US banks (and the US Treasury) was not in itself unattractive.

Tenth and finally, Mr. Brady's installation as US Secretary of the Treasury gave his Assistant Secretary scope to introduce a new policy that would differentiate him from his predecessor and at the same time fit in with the more comprehensive and flexible approach to the countries of Latin America favoured by President Bush.

Similarities and Differences

The announcement of a new policy, like a death in the family, however expected it may be always comes as a bit of a shock when it actually happens. The contents of the Brady proposals, as presented on March 10 1989 should not however have occasioned any great surprise. They had been circulated in draft form and

[1] See William Cline 'From Baker to Brady: Managing International Debt', Amex Bank Review, Marjolin Prize Essays, 1989.

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subjected to considerable criticism including some from institutions which found it necessary to welcome the proposals when they later became official US policy. All the main ingredients in the Brady mixture can be found in earlier publications or statements by commentators on the Third World debt situation. Amongst the most influential of these were 'Voluntary Approaches to Debt Relief' by John Williamson,[2] 'Six Principles for a Revitalised Debt Strategy' by Moeen Qureshi,[3] and the statement put out by Horst Schulmann of the Institute of International Finance (IIF).[4]

It can thus be argued that one part of the impact of the Brady proposals was mainly psychological — the explicit recognition that the external debt of many developing countries had grown so large that it could not possibly be fully serviced and that forms of debt relief were therefore unavoidable. It was not the truth of this proposition, which had been evident to many people for a considerable time, that mattered; it was the significance of a Secretary of the US Treasury for the first time publicly acknowledging it.

US Government officials like to refer to the Brady proposals as 'the strengthened strategy' for dealing with LDC debt and it is a useful touchstone for seeing whether individuals (or institutions) feel themselves beholden to US influence to detect whether or not they use this same nomenclature. In this article it is suggested that there are four significant similarities between the Baker and the Brady strategies and four significant points of difference.

The similarities are these:

1. The Case-by-Case approach in dealing with individual sovereign debtors is to be preserved although within a different framework of options.

2. Agreement by the debtor to a programme of adjustment with the IMF remains a pre-condition of eligibility for the new facilities and full conditionalities are to be maintained.

3. Participation by commercial banks in one or other of the options is to remain on a supposedly voluntary basis, the use of the word 'voluntary' in this context not being intended to inhibit government authorities from a certain amount of necessary 'arm-twisting'.

4. As with earlier phases of the strategy, the proposals were worked out and introduced by US officials and were heavily influenced by regional geo-political considerations.[5]

The differences are these:

1. The negative pledge and sharing clauses in the original syndicated loan agreements should be waived so as to allow different banks to select different options in converting out of those loans.

2. Governments are urged to induce their tax and regulatory authorities to amend or to interpret their tax treatment and banking regulations so as to facilitate (or even encourage) the participation of banks in schemes of debt or interest rate reduction.

3. The IMF and the World Bank would henceforth be willing to disburse their advances and loans in certain circumstances even if the sovereign debtor concerned had not reached a conclusive agreement with its commercial bank creditors — thus of course weakening the power of those creditors in holding out for what they would regard as an appropriate rescheduling deal.

4. Finance would be made available by the IFIs and, it was hoped, by other sympathetic agencies (especially from the balance of payments surplus countries) to fund schemes of debt and debt service reduction.

It was this last measure, the instrumentation for which will be described next, which has attracted most of the attention. But the other three differences in their own way could be just as important in determining the actual impact of the new strategy.

The Meaning of 'Credit Enhancement'

The most spectacular innovation in Brady was the proposal for debt reduction to be achieved within a framework of voluntary actions by the commercial banks. The key that was to make such voluntary lowering of their claims acceptable to the banks was the prospect of 'credit enhancement' which would mean that a lower nominal claim against a debtor could be of equal or greater value than the previous higher claim because it would be collateralised or guaranteed with the money for the guarantees and the collateralisation or, in some cases, to finance debtor government buy-backs of their loans for cash, coming from the IMF, the World Bank and other well disposed governments.

It has been argued, most cogently by Lomax,[6] that it is an anachronism to include within the same scheme for a single country proposals for debt and debt service reduction with proposals that some banks should simultaneously supply what is euphemistically called 'new money'.[7] Either a country should be regarded as insolvent, the argument goes, in which case it requires debt or debt service reduction, or it is only temporarily illiquid, in which case its need is for 'new money' (or temporary capitalisation of part of the interest due) until it can get over a short- to medium-term difficulty in its balance of payments. A view needs to be taken as to whether or not the country should be regarded as effectively insolvent; if it is not, debt reduction is inappropriate and, if it is, 'new money' will simply make the position worse.

Whatever sympathy one may feel for this line of argument, it is clear that those who designed the Brady proposals could not afford to admit its logic. The reason they could not do so was because it was not anticipated that sufficient financing would be available to fund schemes of debt reduction and/or that the discounts achieved in a voluntary negotiation between debtor governments and bank advisory committees would be sufficiently deep to offer the required balance of payments relief unless a proportion of commercial bank creditors were willing and indeed preferred to increase their exposure to the sovereign debtor by the provision of 'new money'. There may also have been an apprehension that some banks, particularly in the US, still could not afford to take some of the losses resulting from taking one of the debt reduction options even by the year 1990.

This diagnosis, if correct, would explain the emergence of the three main options between which creditor banks would be expected to choose in their next rescheduling negotiations with eligible sovereign debtors. The three options are by now famous but will be summarised here. They were: (1) a given bank could commit itself to a 'new money' package that would involve re-lending a proportion of the interest due on its existing loans thus increasing its exposure to the country by an agreed proportion over an agreed number of years; or (2) it could convert its existing loans into bonds that would have a lower face value but the same rate of interest; or (3) it could convert its existing loans into bonds that would have the same face value but a lower rate of interest. In the event of the bank selecting either the new reduced face value or reduced interest bonds it would benefit from the fact that the eventual repayment of the principal would be collateralised and the interest payments would be secured for a certain period of time on a roll-forward basis by one of the international financial institutions.

It should be stressed that these three options were still to be accompanied by other measures such as 'cash buy-backs up to a maximum amount', 'viable debt-equity swap programmes', provisions that would encourage domestic nationals to repatriate their flight capital, 'concerted lending, club loans by a group of banks, or a range of trade, investment or other credits from individual banks'.[8]

The role of the IMF and the World Bank, in the view of the US Treasury, would continue to be to encourage and require debtor policy reforms, to supply finance for stabilisation and adjustment programmes and to catalyse other forms of financial support. But under the new strategy they would also be asked to 'redirect and increase resources to support debt and debt service reduction transactions agreed upon by commercial banks and debtor nations as an additional spur to growth in debtor nations.'[9]

The Size of the Initiative

It is a feature of the Brady proposals that the quantum of debt and debt service reduction that will result from their implentation is unknown and unknowable. It is unknowable because neither the amount of resources to be devoted to debt reduction, nor the distribution of their application between different forms of debt reduction, nor the outcome of deals to be struck between individual debtors and their creditors can be known. Furthermore there are a variety of different ways in which the extent of debt relief can be measured. In these circumstances it is hardly surprising that estimates range from the optimistic to the pessimistic with any individual position in that range being determined by factors as diverse as a personal interest in the scheme's success, the effect of the proposals on a bank's declared profits, or animosity toward some officials at the US Treasury.

Most commentators however seem to be agreed on three things. First, that the psychological climate in which future debt rescheduling negotiations will be conducted has been profoundly changed; second, that the scheme will have a significant effect in some countries in bringing about debt service relief; and third, that the proposals by themselves with their present level of funding will not get rid of more than part of the debt overhang.

What is the anticipated level of funding? Early indications were that the IMF and World Bank were each thinking in terms of $12 bn or so per institution over the first three years. Of that total of $24 bn, roughly $10 bn would be additional resources with the remaining $14 bn being detoured from already programmed policy lending. Another $4.5 bn in parallel lending for import support has been programmed by Japan.

Robert Devlin has commented:

[2] John Williamson 'Voluntary Approaches to Debt Relief', Institute for International Economics, September, 1988.

[3] Moeen Qureshi 'Six Principles for a Revitalised Debt Strategy' in Adrian Hewitt and Bowen Wells 'Growing Out of Debt' published by the Overseas Development Institute for the All Party Parliamentary Group on Overseas Development, 1989.

[4] H. Schulmann 'The Way Forward for the Middle-Income Countries', IIF, Washington DC, January, 1989.

[5] This part of the analysis draws heavily on Robert Devlin 'The New International Management of the Latin American Debt Problem', a paper prepared for the seminar 'Raul Prebisch's Intellectual Heritage and the Development Problems of Latin America', Santa Fe, Argentina, June 1989.

[6] See D. F. Lomax 'International Monetary Arrangements — Recent Proposals for Third World Debt', a paper submitted in evidence to the House of Commons Treasury and Civil Service Committee, July 1989.

[7] For an investigation of the use and abuse of language in the Third World debt debate, see Mike Faber 'Beware of Debtspeak' IDS Discussion Paper, No. 251.

[8] David C. Mulford 'The Brady Plan: strengthening the current international debt strategy' in *Third World Debt: Managing the Consequences* edited by S. Griffith-Jones, IFR Books, 1989.

[9] ibid.

'By just taking into account the Baker 17 countries, where there is some $375 bn of obligations with commercial creditors, it is clear that the $29 bn already committed to the Brady Plan could support no more than a very partial reduction on the debt overhang. For example if used in straight buy-back of the Baker 17 debt at April's weighted average secondary market price of 36 cents, the above mentioned public funding could reduce commercial debt by some $80 bn. Even this magnitude of debt reduction — which incidentally is highly improbable in a voluntary scheme because it assumes no rise in secondary market prices — would bring a fall in the interest payments on the commercial debt of these countries of only 21 per cent; meanwhile, the reduction in total interest payments would be just 16 per cent.'[10]

Devlin also points out that to the extent that debt reduction is financed through new loans, cash flow relief will be less than the reduction in interest payments to the banks. Indeed loans from the IFIs or for that matter grants from bilaterals that are used to reduce or extinguish debt but which otherwise would have been available for general balance of payments support will have a strongly negative foreign exchange flow impact in the initial year followed by a positive net foreign exchange flow impact in all subsequent years. To that extent, as I have argued elsewhere, debt reduction expenditures can be subjected to a form of cost benefit analysis and their projected rates of return compared with what could be anticipated by alternative aid-financed projects.

Devlin concludes 'In any event, the resources committed to the Brady Plan suggest a debt reduction that will be piecemeal and which will fall far short of achieving the 50 per cent or greater cut in interest burdens that many heavily indebted countries seem to feel they need now to begin to grow and develop. Indeed, even the Plan's illustrative example of achieving a 20 per cent reduction in the interest burden of 39 developing countries over the next three years would seem to require more resources than are currently available. Moreover such a modest reduction would not even compensate for the 40 per cent rise in LIBOR over the last 18 months.'[11]

The Evolving Composition of LDC Debt

However successful the Brady strategy turns out to be, it must still be set within the organic composition of LDC indebtedness as a whole. The structure of creditors is dynamic and changing quite rapidly and yet much less attention is normally paid to it than to the list of debtors and the extent of their individual indebtedness. Table 1 illustrates what is meant by 'the evolving composition of LDC Debt'; several points that emerge from it deserve comment.

Lines 1, 2 and 3 show the long-term external debt of all severely indebted developing countries expanding at a compound rate of 21.25 per cent a year over the 12 year period terminating in 1982, and at a rate of 9 per cent in the six years following. Of that earlier period, one is tempted to ask 'What *did* the bankers think they were doing?' Part of the answer is 'They did not know'. Or rather, each knew how fast his own business was expanding but was unaware that borrowing from others was expanding even faster. If the Brady proposals succeed and interest rates fall, we may postulate that the successor figure to that in line 3 for the period 1988-1994 may indeed become negative.

Line 4 demonstrates how, partly on the insistence of creditors, a higher and higher portion of each country's indebtedness has either become government debt, or has had to be guaranteed by government.

Lines 5, 6 and 7 show how quickly the proportion of Severely Indebted Countries' debt owed to the multilaterals (IFIs) and bilaterally to other governments has been increasing — namely by more than 2 per cent a year as a percentage of all such debt since 1982. The reasons for this are clear. While most commercial banks have been doing all that they can to reduce their exposure to LDC debtors, the World Bank has continued to make positive net transfers and the Paris Club has continued to do the equivalent of advancing 'new money' through its own extensive rescheduling arrangements. But the implications of this process continuing should be equally clear. Already, as line 8 and 10 show, all developing countries together owe more medium- and long-term debt to the bilaterals and to the IFIs than they do to the commercial banks. If the Brady proposals succeed this trend can do nothing but accelerate so that by 1994 it is quite conceivable that up to three-quarters of all medium- and long-term sovereign debt of all developing countries will be owed to official creditors.

A number of disturbing conclusions follow from that prediction, of which I shall mention just three: First conclusion: it is clear that the debt overhang cannot be removed simply by reducing LDC indebtedness to the commercial banks however large the discount they can be induced to accept in loan-bond conversions. Second conclusion (vide line 6): an early priority is going to be a solution to 'the Free-Rider Problem between Governments' which at the moment is gravely impeding the introduction of significant debt reduction to the proceedings of the Paris Club. Third conclusion: The next plan after Brady is going to have to incorporate more extensive and more open procedures for those whose indebtedness to the IFIs themselves (including arrears) has grown to a size that clearly cannot be serviced on the original contractual terms.

[10] R. Devlin, ibid.

[11] ibid.

Table 1

Long-Term Debt Outstanding
All Severely Indebted Developing Countries, except lines 8 and 10
(all figures and calculations based on US$, current)

	1970		*1982*		*1988*
1. Long-term External Debt ($bn)	31.2		313.5		529.0
2. Average annual increase, 1970-1982		+21.25%			
3. Average annual increase, 1982-1988				+9.00%[b]	
4. Percentage public and publicly guaranteed	61.3%		78.5%		93.1%
5. Percentage owed to multilaterals	10.1%		8.5%		14.0%[a]
6. Percentage owed to bilaterals	23.2%		14.6%		23.7%[a]
7. Percentage all official creditors	33.3%		23.3%		37.7%[a]
8. Line 7 for *all* developing countries	n.a.		35.4%		45.2%[a]
9. Percentage of both public and private debt owed to commercial banks	48.4%		62.9%		50.5%[b]
10. Line 9 for *all* developing countries	31.6%		50.4%		40.4%[b]

Sources: WB World Debt Tables 1989-90, Vol 1, pp 122-3 and 78-9.

Notes: a These figures will continue to rise
b These figures will continue to fall

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THREE BRADY DEALS DESCRIBED

1. The Renegotiation of Mexico's External Debt

Pedro Aspe Armella

1. Background

When President Salinas gave his inaugural speech on December 1, 1988, the Mexican economy faced a state of prolonged recession, high levels of inflation and a serious deterioration of standards of living for the population. One of the main causes of this situation was the net external transfer of resources, due to an excessively high external debt. In effect, between 1983 and 1988 these transfers averaged 6 per cent of GDP and, in the latter year, the total stock of debt reached $100.384 bn; that is, 57 per cent of what the country produced in that year.

In view of the situation, the President instructed the Ministry of Finance to immediately open negotiations with the international financial community with the following four objectives in mind:

1. reduce the historical stock of debt;
2. reduce the flow of net external resource transfers;
3. obtain a multi-annual agreement in order to reduce the uncertainty caused by recurrent negotiations; and
4. reduce the stock of debt in real terms and its proportion to GDP.

Consequently, in December 1988 talks were initiated with Mexico's various external creditors in order to fulfil the Presidential instructions. The negotiations took place in two stages. The first was with the international financial institutions and the Paris Club, where two objectives were set out: firstly, to reduce to zero or to slightly positive levels net external transfers with these institutions by contracting new resources on a multi-annual basis; secondly, to count on their technical and political support for the Mexican thesis that only by eliminating the debt overhang could we resume economic growth. In the second stage, with the commercial banks, the goal was to diminish resource transfers through reduction of debt and its service.

2. Agreements with Official and International Financial Institutions

Among the agreements subsequently reached, the one with the International Monetary Fund will mean resources totalling $4.135 bn over three years, extendible to a fourth at Mexico's option.

The Main Points of the IMF Agreement of (May 26, 1989) are:

1. Recognition that external financing requirements are derived from growth objectives;
2. Acknowledgement that the debt overhang is an obstacle to sustained growth with price stability;
3. Reduction of net external transfers to a level consistent with Mexico's growth objectives established in the National Development Plan;
4. Financial support for debt reduction operations;
5. Financing totalling US$4,135 mn over a period of 3 years, which eliminates uncertainty and therefore allows productive investment to be reactivated.

Concurrently, the World Bank agreed to provide resources for investment amounting to $1.96 bn in 1989 and an average of $2 bn per year for the period 1990-92 to support structural change and modernisation in key sectors of the economy.

Both institutions supported Mexico's position with respect to the necessity of reducing the debt burden as a precondition for recovering growth and, in a decision without precedent, accepted that part of the resources they would extend to Mexico, plus the provision of an additional one-time sum, would be used to support debt reduction operations with commercial banks.

An accord was reached with the Paris Club under which principal and interest payments originally falling due between June 1989 and May 1992, totalling $2.6 bn, were restructured. Access to financing for at least $2 bn per year until 1994 was also confirmed to cover imports from the member countries.

Paris Club Agreement (May 30, 1989):

1. Restructuring of US$2,600 mn of principal and interest payments over 10 years with six of grace, on the following basis:
   - A) Between June 1, 1989 and March 31, 1990 100 per cent of principal and 100 per cent of interest payments;
   - B) Between April 1, 1990 and March 31, 1991 100 per cent of principal and 90 per cent of interest payments;
   - C) Between April 1, 1991 and May 25, 1992 100 per cent of principal and 80 per cent of interest payments.
2. Credit coverage of at least US$2.0 bn per year to finance Mexican imports from the Paris Club countries.

In the meantime, in an act of great solidarity, the Government of Japan through the Export-Import Bank, offered financial support to Mexico of $2.5 bn, also to be utilised in the debt reduction package with commercial banks.

3. Agreement with the Commercial Banks

Talks were begun in April with the Bank Advisory Committee for Mexico in order to make known to them our economic programme and our objectives in terms of relief from the debt burden. After more than three months of intense negotiations, an agreement in principle was reached on July 23, 1989. The characteristics of the Agreement were made known to Congress and to public opinion through the media and through the Term Sheet.

The fundamentals of the Agreement consist of three options among which the nearly 500 creditor banks represented by the Committee can choose. Under the first option, banks exchange existing debt for new bonds at a 35 per cent reduction; under the second, the exchange is for bonds with the same principal amount but bearing a rate of interest fixed at 6.25 per cent — or its equivalent in other currencies. In both cases, the final maturity of the debt was extended from 20 years with seven of grace to a single payment in 30 years, thus eliminating the pressure caused on the economy by annual amortisations. The third option consists of providing new loans over the period 1989-92 in an amount equal to 25 per cent of a bank's existing loans not committed to either of the first two options.

The special funds from the World Bank ($2.06 bn), the IMF ($1.644 bn), the Government of Japan ($2.05 bn), plus a direct commitment by Mexico ($1.296 bn), which total $7 bn, will be destined to guarantee the payment of the principal of the new bonds as well as 18 months of interest, thus improving the credit quality of the bonds. With a part of these funds, Mexico will purchase zero coupon bonds from the US Treasury (and from other countries) that will constitute an asset of our country and which, reinvested at a rate of 7.925 per cent per year for 30 years, will grow to an amount sufficient to fully cover the principal payments on the new bonds at the end of period. The rest of the funds, which, again, also constitute an asset of Mexico, will be destined to the guarantee of interest payments. Consequently, these resources do not imply an additional net cost nor do they represent net indebtedness, since they generate interest in favour of Mexico roughly equal to their expense by virtue of being invested.

At the start of the discussions with the commercial banks, the stock of debt that was subject to negotiation (eligible debt) amounted to approximately $52.6 bn. During 1989, various operations were carried out which reduced this total to $48.5 bn, namely:

- a) cancellations of public sector debt which certain public sector institutions received in payment for the sale of government-owned enterprises being divested;
- b) debt-for-equity conversions (swaps) authorised before November 1987;
- c) net amortisations by the public sector during 1989; and
- d) movements of exchange rates with respect to the dollar. The foregoing elements all contributed to the reduction in the stock of debt.

The distribution selected by the banks regarding the $48.5 bn of eligible debt was as follows:

- a) 41 per cent of the total will be subject to principal reduction;
- b) 47 per cent to interest rate reduction; and
- c) the remaining 12 per cent will be base for new money.

The banks' choices have the following consequences: first, the exchange of debt for bonds bearing a 35 per cent discount will lead to a reduction in nominal debt of approximately $7 bn. Second, about $22.5 bn of debt will be subject to a fixed rate of 6.25 per cent instead of the 9 to 10 per cent that Mexico has been paying. This is equivalent, economically, to a further reduction in the nominal stock of debt of around $7.75 bn. Expressed in another manner, the interest payments made at a rate below current rates are the same as those resulting from reducing the debt by $7.75 bn and paying market rates. Thirdly, with regard to new money, the banks' choices mean that Mexico will receive around $1.5 bn of additional credits between 1990 and 1992.

4. Effects of the Various Agreements with External Creditors

As a result of the various agreements with Mexico's external creditors and once the Financing Package is instrumented, the total nominal external debt on March 31, 1990 is estimated to be $93.599 bn. Now, if from this figure are excluded a) approximately $7.75 bn of implicit principal reduction derived from the reduction in interest rates described above and b) the credits destined for guarantees on the new bonds (by virtue of the fact that they are offset by a like amount of financial assets that are the property of Mexico), the total net adjusted economic stock of external debt will have been reduced to an equivalent of $79.889 bn at

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the interest rate levels prevailing prior to this Agreement. This means that the stock will have been reduced by $20.495 bn with respect to that outstanding in December of 1988, when the current Administration took office, and $27.581 bn when compared to the outstanding in 1987 ($107.470 bn), which was the highest in Mexico's history.

With regard to the public sector, the economic stock of debt in March 1990 will have been reduced by almost $21.4 bn with respect to that outstanding in December 1988.

The reduction in net external resource transfers resulting solely from the Agreement with the commercial banks will be $4.071 bn each year on average over the period 1990-94. This figure is composed of the following elements:

a) annual average interest savings of $1.629 bn due to principal and interest reduction;

b) new loans averaging $288 mn per year; and

c) the deferal of $2.154 bn of principal amortisations per year falling due in this period.

With respect to this last point, it is important to emphasise that another benefit stemming from the Agreement with the commercial banks is the dramatic change in the profile of principal amortisations of public sector debt. Mexico had $2.154 bn on average in principal amortisations falling due each year between 1990 and 1994 and $3.5 bn on average between 1995 and 2006. Now, the total amount of principal payments on the new bonds of around $35 bn, after the reductions resulting from this exercise, have now been deferred to a single payment in 30 years and, as mentioned previously, will be liquidated at maturity through the investment in zero coupon bonds today.

If to the sums above are added the benefits in terms of external transfers from Mexico's negotiations with the International Monetary Fund, the World Bank, the Inter-American Development Bank and the Paris Club, we have as a global result of Mexico's agreements with all of its external creditors that net external resource transfers are reduced to around 2 per cent of GDP on average between 1989 and 1994. Thus, those resources which previously were channelled abroad will now be used to stimulate productive investment.

As a consequence of the agreements obtained with the international financial institutions and with the Paris Club, Mexico has assured itself of funds on an annual basis until 1992, with an average amortisation period of 10 years with five of grace, which will permit Mexico to have greater flexibility in its balance of payments. With commercial banks, apart from new loans totalling $1.5 bn between 1990 and 1992, the amortisation of principal on the restructured debt has been deferred to 2019 and, as mentioned above, is guaranteed through the acquisition by Mexico of zero coupon bonds.

At the end of March 1990, the estimated net economic total stock of debt will represent only 40 per cent of GDP, which compares very favourably with 60 per cent in December 1987 and 57 per cent at the end of 1988.

Another important element of the Agreement is the flexibility provided to Mexico to undertake more debt-reducing transactions in the future, including direct buy-backs. Additionally, the package envisages, following Mexico's criteria, debt-for-equity conversions exclusively for privatisation of public enterprises and infrastructure projects totalling $3.5 bn over three and a half years, which will further reduce external debt by the same amount.

5. Perspectives for the Mexican Economy

The benefits derived from the Agreement are not limited to the direct impact on the balance of payments. Indirect effects of great significance are also expected and have already begun to be observed. Among these we can point to the bolstered confidence of economic agents. This has led to a gradual decline, on average, of real domestic interest rates which, combined with the permanent austerity of the public finances and the continued effort towards structural change and economic modernisation, will lead to a reduction of the public sector financial deficit to levels of around 2 per cent of GDP. This reduction of the deficit is consistent with a reduction of inflation to international levels and with an improvement of our external commercial accounts.

All of this should generate an increase in productive investment, both internal and foreign, as well as capital repatriation, which reached over $2.5 bn in 1989.

At the same time, it will be necessary to encourage domestic savings and facilitate the financial intermediation process in order to increase investment to levels consistent with reaching our objective of 6 per cent GDP growth rates by the end of this Administration. The Agreement, by freeing resources, will translate into the creation of new sources of employment and the gradual recovery of the purchasing power of workers, while allowing increased public spending in basic services such as education, health, social security and infrastructure.

Mexico faces a great opportunity to regain the path towards growth and stability. The groundwork has been laid for consolidating the recovery and strengthening the economy, thus allowing all sectors of the population to benefit from growth. We are also committed to maintaining strict fiscal discipline, to persevere with and deepen our efforts of structural change, of modernisation of the economy and of the Reform of the State, while learning from our own recent history that we should act with prudence and not incur again such excessive deficit spending or external indebtedness.

Table 1

Sources of Variations in the Total Foreign Debt Outstanding
(millions of dollars)

	Total	*Public Sector*	*Private Sector*	*Banks*[4]	*Bank of Mexico*
Outstanding at 31/12/1988	100384	81003	6498	8097	4786
— Net Borrowing	-877	-323	-1720	863	303
— Variations due to Exchange Rates[1]	-1872	-2061	0	0	189
— Cancellations[2]	-1830	-1830	0	0	0
— Swaps[3]	-730	-730	0	0	0
Estimated Outstanding at 31/12/1989	95075	76059	4778	8960	5278
— Net Borrowing	1231	0	0	-229	1460
— Principal Reduction from Debt Package	-6820	-6820	0	0	0
— New Money	576	576	0	0	0
— Bilaterals	1511	1511	0	0	0
— World Bank/IADB	2169	2169	0	0	0
— Bonds and Other	-143	-143	0	0	0
Estimated Outstanding at 31/03/1990	93599	73352	4778	8731	6738
— Implicit Principal Reduction Derived from Interest Rate Reduction	-7750	-7750	0	0	0
— Guarantees[5]	-5960	-5960	0	0	0
Estimated Outstanding at 31/03/1990[6]	79889	59642	4778	8731	6738

[1] This refers to the impact on the stock of debt of movements in currency rates vis a vis the dollar. Since approximately 25 per cent of the external debt is denominated in currencies other than the dollar, an appreciation of the latter causes the stock of non-dollar debt to fall when expressed in dollars. This volatility will practically disappear since a by-product of the Financing Package is that 90 per cent of the new debt will be denominated in dollars.

[2] These operations are a consequence of reconciling the positions of Nacional Financiera and Banco Nacional de Comercio Exterior as both debtors and creditors with respect to the public sector.

[3] These refer to operations approved before November 1987, where public sector debt is exchanged for equity investments.

[4] This includes interbank lines extended to Mexican banks by foreign banks before 1982. They are mostly short term and are renewed during the year. Also included are credits obtained from the CCC (Commodity Credit Corporation).

[5] The total amount of guarantees is $7,000 mn. However, only $5,960 mn are registered as assets since the remaining $1,040 mn are in the form of a standby credit facility with commercial banks, which will be gradually taken out by resources from the IMF and Exim Bank of Japan.

[6] This figure includes $7,750 mn of the principal reduction-equivalent of debt subject to below-market fixed rates. It also excludes $5,960 mn of funds constituting guarantees, as follows: World Bank $2,060 mn, Exim-Bank of Japan $1,400 mn, and International Reserves $1,300 mn, they are excluded because these resources earn interests in favour of Mexico similar to their contractual cost.

Benefits from the Renegotiation with Commercial Banks

I. Direct Benefits

— External debt is reduced by US$14,670 bn:
  — $6,820 through principal reduction
  — $7,760 through implicit principal reduction due to a lower interest rate.

— Annual interest payments are reduced by US$1,629 mn on average between 1990 and 1994.

— US$1,440 mn of new money to be received between 1990 and 1992.

— Annual principal payments of US$2,154 mn over the period 1990-94 are deferred to 30 years.

— The debt will be paid for at maturity through the acquisition of zero coupon bonds.

— Annual net external transfers are reduced by US$4,071 mn on average between 1990 and 1994.

II. Indirect Benefits

— Increase in domestic savings.

— Reduction of real domestic interest rates.

— Increase in investment.

— Capital repatriation.

— Strengthening of confidence.

Table 2 **Cash Flow Savings from the 1989-92 Financing Package**

Terms		Terms	
1. Principal Discount	35.00%	1. New Money Participation	12.00%
2. Reduced Rate	6.25%	Principal Reduction Participation	41.00%
3. New Money		Rate Reduction Participation	47.00%
1989	7.00%		
1990	6.00%		
1991	6.00%	2. Base ($ mn)	48044[1]
1992	6.00%		
		Assumptions:	
		3. Libor 1990-94	9.000%
		4. Spread over Par Bonds, Outstanding New Money and New Money commitments of 1989-92 Financing Package	.0825% (13/16%)

(in millions of dollars)	*1990*[2]	*1991*	*1992*	*1993*	*1994*	*Average 1990-94*
Interest savings from principal reduction	1014.8	676.5	676.5	676.5	676.5	744.2
Interest savings from rate reduction	1206.7	804.4	804.4	804.4	804.4	884.9
New money cash flows	749.5	345.9	345.9	0.0	0.0	288.3
Savings from restructuring of amortisations[3]	2545.0	1873.0	2431.0	2430.0	1492.0	2154.2
Total Cash Flow Savings	5515.9	3699.9	4257.9	3910.9	2972.9	4071.5

[1] The difference between $48,044 and $48,483 mn of eligible base debt is due to a portion of the base debt which is guaranteed by the World Bank and is not subject to the restructuring options.

[2] This includes retroactive savings from July 1, 1989, applicable in 1990.

[3] This includes the deferment of amortisations originally falling due in this period to 2019.

2. Brady and the Philippines: What Progress?

Reginald Herbold Green

'Pacta Sunt Servanda' ('The Contract Must be Honoured')
Medieval Domestic Private Commercial Law Doctrine

Overview

The Philippine public sector medium and long-term commercial bank debt renegotiations concluding in September-October 1989 were intended to be the centre piece of closing a 1989 external resource gap of $1.3 to 1.5 bn and a 1990 gap of $0.1 to 0.4 bn. They took place in the context of a reaffirmation by President Aquino and her Central Bank Governor and Secretary of Finance that the whole external debt could, should and would be paid.

The outcome of the negotiations was two agreed targets:

a. $1 bn of 'new money' either as medium and long-term (MLT) loans or as 15 year non-reschedulable bonds at 13/16 per cent over Libor to be taken up by June 30, 1991;

b. $1.3 bn buyback of public sector MLT (20 per cent of outstanding) at 50 per cent discount financed by the IMF, the World Bank and the Ex-Im Bank of Japan to take place during the course of 1990.

Background

Philippine external debt is in the $27.5 to $29 bn range as of early 1990. Of this $13 bn is commercial bank including $10 bn MLT of which $6.6 bn is public sector debt.

Over 1986-88 annual net transfers of debt interest and principal averaged $1.7 bn or 5 per cent of GDP — after a variety of partial commercial bank (CB) and Paris Club rescheduling negotiations. 1989-92 projections are for $1.5 bn annually assuming no new borrowings or renegotiations.

The 1988 growth rate was 6.5 per cent. Official 1989 projections were: with closing of the finance gap 6 per cent and without 4.6 per cent. In the event total Paris Club and regular rollover CB savings on outflow and limited increases in trade credit may have totalled $0.3 to $0.4 bn implying growth of about 5.0 per cent. However growth in tourism and direct foreign investment (likely to be reversed in 1990 following the November 1989 nearly successful coup attempt) plus some use of reserves allowed 5.8 per cent (tentative first estimate) growth.

The 'pay at all costs and borrow/get ODA/bargain on US payments for bases in order to do so' strategy of the President, Secretaries of Finance and Central Bank Governors (including those appointed in the January 1990 reshuffle) has kept Philippine external debt's secondary market value to 50 per cent of face and been welcomed by creditors — commercial, bilateral and official. It has probably played some role in mobilising ODA and encouraging direct investment inflows, both of which are significant. It has not secured new funds in the sense of net inflows of overall external resources nor has it closed the financing gap.

The strategy and the negotiations have been the object of sustained, widely based criticism in the press and by an umbrella Freedom from Debt Coalition, which groups academics, business organisations, church groups, labour and peasant bodies and support groups. Their main proposals have turned on gross debt service capping (at 10 per cent to 20 per cent of gross visible exports or one quarter to one half of 1986-88 average gross payments), selective repudiation (of up to $6 bn of loans inherently flawed by corruption the lenders knew of or should have known of), bond swaps or secondary market purchases at a high discount and Paris Club renegotiations on a multi year, long grace period (interest and principal) plus long payback basis. Legislation on debt service capping as a means to force satisfactory debt renegotiation terms was passed by an overwhelming majority in the Senate and has majority support in the House, but the President has made clear she would veto it. Some Cabinet Ministers (now largely ex-Ministers) favour debt capping and going into selective partial arrears on debt service.

A Debt Council including some critics of the 1986-89 strategy has been appointed by the President, but has few powers and exhibits something very close to a built in 'pacta sunt servanda' majority. Some fairly imaginative but small debt buybacks (nominally by government owned financial institutions, not by the State) have been carried out. Beyond that pre-1989 approaches and results were very much like early post-1982 Latin American London and Paris Club models.

Financing Requirement and Timing

The initial National Economic Development Authority estimate of the 1989-90 external resource gap was

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$2.2 bn. The reduction to $1.7 bn accepted in the 1989 IMF 'Letter of Intent' was on assumptions as to trade deficits and growth rates inconsistent with the NEDA model (and on trade, at least, with reality). That figure was cut to $1.4 bn by Paris Club reschedulings $0.1 bn above estimate (100 per cent not 70 per cent of interest rescheduled) and by £0.2 bn on CB rescheduling of 1990 principal payments. The division — on the IMF estimate — was $1.3 bn in 1989 and $0.14 bn in 1990.

Concerning the outcome of the CB negotiation, two points stand out:

a. $1.0 bn of 'new money' (if achieved) and $0.078 bn of net interest saving (for one year as no funds were drawable in 1989) on buyback does not add up to $1.4 bn (much less $1.9 bn on the NEDA estimate adjusted for other reschedulings);

b. the timing of flows is inconsistent with that of the projected gap. On reasonable projections, as of October, $0 would come in 1989; $250 mn might come in the first half of 1990; $400 mn in the second half of 1990 and $425 mn in the first half of 1991.

'New Money'

The 'new money' component of the negotiated targets is $0.9 bn for major banks and $0.1 bn for those with smaller exposures. This can be in normal MLTs or in 15 year non-rescheduled bonds at the option of the banks. Each bank can pick the form it prefers and the amount of its additional exposure, i.e. the target is a ceiling with no guarantee it will be met or even approximated.

As of mid-January 1990, only $0.62 bn had been pledged or semi pledged. The new Secretary of Finance was on a four nation tour to try to drum up the balance by a deadline extended from January to the end of February.

As the 'new money' is significantly less than principal repayments on old debt, is too late for 1989, at 13/16 per cent over Libor is not concessional and under the bond option would bar rescheduling, it is hard to see this leg of the arrangements as a great success even if $1.0 bn is raised.

Secondary Market Purchases

It appears that a 50 per cent discount has been agreed with the banks (under pressure from the IMF and World Bank who indicated their reluctance to finance buybacks at the 30 per cent discount proposed by the CBs). Voluntary offers of the order of $1.5 bn face value, exceeded the purchasing power of the $0.650 bn raised from a Fund-Bank-Bilateral consortium of lenders who financed the January 1990 repurchase.

World Bank approval of $0.2 bn exclusively for repurchase is the first tranche of what the outgoing Central Bank Governor described as a pledged package of $1.55 bn to retire $3 bn more of debt at 50 per cent of face value by the end of 1991.

The problem with this approach — which does mark a breakthrough in using IFI and bilateral loans to a government to repurchase its own debt at a discount — is that it does little for the short term financing gap. In that respect the debate on the relative merits of discounted debt buybacks versus collateralised, discounted bond swaps is very much secondary to the point that the main gains come primarily on future obligations — especially for repayment of principal — rather than on present interest payments, so they cannot be the main source of plugging the short run financing gap. Further if these approaches are limited to CB channelled MLT loans to the public sector they would cover only about a fifth of total debt. At a 50 per cent discount they would therefore reduce the debt burden only by 10 per cent plus the amount by which interest on Fund-Bank-Bilateral loans used was below that on the retired debt — perhaps 12 per cent in total.

Where Next?

In including debt reduction (apparently only because it was stressed in the Brady Plan), the Philippines has altered its macro renegotiation strategy in a way which increases potential long-term gains. However the amount is marginal and the short-term gains almost negligible when set against the financing gap.

It is hard to avoid concluding that the present Philippine strategy is unlikely to be adequate. The basic target should be to reduce net debt service either to zero (treating grants as well as new loans as offsets) or at worst to 10 per cent of visible exports. That would free 5 per cent of GDP and 20 per cent of the recurrent budget for investment, would extinguish the financing gap and be roughly consistent with 6 per cent growth. This in turn would allow 1980 GNP/capita levels to be restored in the first half of the 1990s. It would also give some stability to debt service net outflow projections and force longer term, more realistic negotiations.

'Pacta nul servanda sunt' might — as the Freedom From Debt Coalition and Congress believe — be a better approach than the present one. It would force negotiations aimed at reducing present gross debt service by an average of 50 per cent and *de facto* put the focus on debt reduction, as it would be clear that present debts could not be fully serviced within a 10 per cent of visible export earnings net service ceiling. CB debt burden would need to go down by 50 per cent, i.e. substitution of 50 per cent reduced principal amount of loans (whether by collateralised swap or buyback) at interest rates no higher than the present ones. Action analogous in results, albeit not necessarily form, would be needed on the Paris Club front. Conversion of all IMF drawings to ESAF (which is beginning) and agreements with the World Bank and ADB to lend at least as much as repayments plus interest are a third component with selective debt repudiation of loans in which corruption went to the heart of the transaction a fourth.

The 1989 CB agreement does not represent significant movement in that direction, as well as not meeting the immediate need for closing the external resource gap. It is more likely to act as a further impediment to sustained rapid growth and to require further rounds of interminable negotiations with the prospect of further delays in debt service payments but no adequate reduction in the overall burden of external debt.

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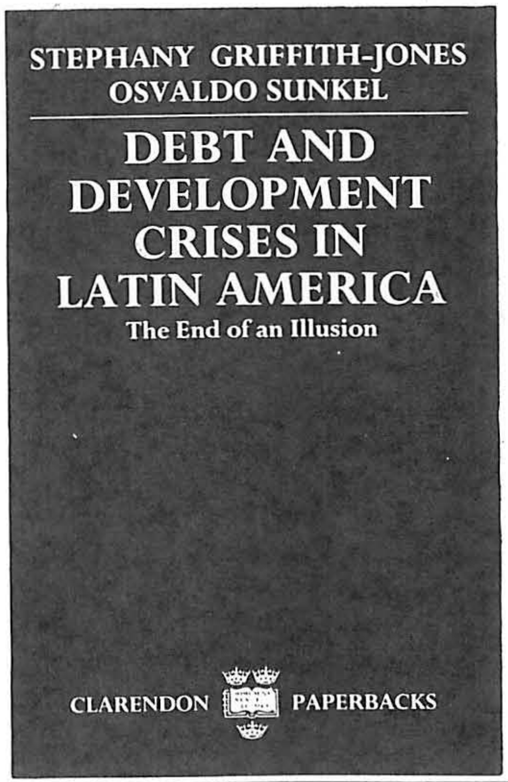

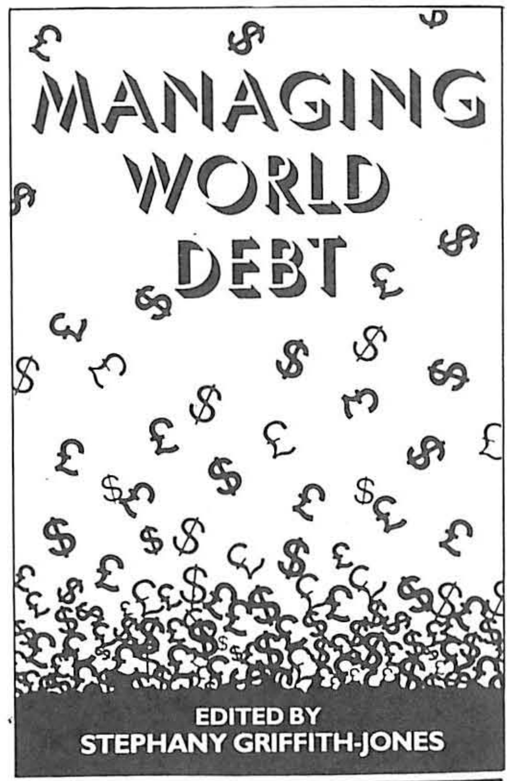

3. The Costa Rican Debt Deal: Is Small Beautiful?

Stephany Griffith-Jones

A. Introduction

One of the most interesting deals agreed in principle within the Brady Plan is the Costa Rican one. Its two main features are: a) the deal has only the options of debt/debt service reduction (and *not* a new money option) and b) the level of debt/debt service reduction agreed is very large, being estimated at around two-thirds of contractual obligations. As regards the latter point it should be stressed that the deal will bring Costa Rica no easing of its cash flow in the short run, because the country has *not* been servicing its commercial debt in full for several years. However, the agreement of such a deal will imply that Costa Rica has — to an important extent — overcome the serious debt overhang problem, with which it has been struggling since 1981. (The Costa Rican debt crisis started a year earlier than that of the rest of Latin America!) A major reduction of Costa Rica's debt overhang — if quickly finalised — should have a beneficial effect on private sector expectations and confidence, as the danger arising from disruptions and continuous negotiations disappears. Costa Rican senior policy-makers would also see a highly demanding and time-consuming activity such as payment debt negotiations disappear from their busy agenda with more time and energy available for them to concentrate on national economic management.[1]

B. The Background

Costa Rica has several distinctive features which affect its debt position. It is a small country; therefore, though its debt is large in proportion to its own economy (with its per capita ratio amongst the highest in the world, and with a debt/export ratio that peaked at around 300 per cent in the mid-1980s), the total sum of its debt is relatively small for its creditors; therefore, the potential damage of arrears or even losses on banks' balance sheets is infinitely smaller than similar steps taken by Mexico or Brazil. This is one of the ways in which Costa Rica's smallness is advantageous to it.

Furthermore, Costa Rica has other special features. It has a democratic regime (being unique in this sense in Central America); it neighbours with Nicaragua and Panama, which implies that the US government had particular motives to maintain friendly relations. Costa Rica also has a highly skilled debt bargaining team. At the same time the Costa Rican government has implemented fairly successfully an acceptable adjustment programme; the budget deficit has been sharply reduced, inflation declined from above 80 per cent in 1981 to a rate between 10 and 20 per cent in recent years, the exchange rate has become competitive, leading to a strong expansion of non-traditional exports. In the last four years GDP growth has been relatively good, though per capita GDP is still below its 1981 level. These features have allowed the Costa Rican government to obtain valuable concessions from the international financial institutions. For example, Costa Rica was the first country in Latin America to get credit from the IMF (under a stand-by) while having quite large arrears with the commercial banks. The diplomatic way in which arrears were accumulated (without any use of radical rhetoric, and, on the contrary, with permanent emphasis by the Costa Rican authorities on their wish to reach an agreement with the commercial banks) was noteworthy. Indeed Costa Rica followed the strategy of 'conciliatory default', — or perhaps a more mild form of 'conciliatory debt arrears' — advocated by people like Anatole Kaletsky, without shouting it from the roof-tops. As a result, it was able to continue attracting fairly significant new flows from bilateral aid agencies and multilateral agencies while limiting service payments on its bank debt. Partly also because of the smallness of its economy, such official flows were not interrupted as a result of commercial debt arrears.

The fact that Costa Rica was in partial arrears to the commercial banks led to the sharp decline in the price of its debt in the secondary market (to a level below 20 per cent since December 1987). In turn this made it easier for Costa Rica to obtain such a favourable deal within the Brady context.

C. The Costa Rica Deal in the Context of the Brady Plan

The agreement reached between Costa Rica and its Banks' Advisory Committee in November 1989 covered US$1.5 bn of medium-term bank debt and US$325 mn of arrears dating back as far as 1986. As pointed out, this agreement provides for only two options: reduction of the debt or of the service thereon; no provision is made for fresh funds without a write-down. In essence, this agreement gives the banks the opportunity to sell their debt back to Costa Rica at a price of about US$0.16 on the dollar. Banks choosing to sell 60 per cent or more of their portfolio will receive an offer to exchange the remainder of the debt for a 20-year bond (including a 10-year grace period) at a fixed below-market interest rate of 6.25 per cent. As an incentive for commitments to undertake large-scale buy-backs, these bonds will include a renewable guarantee of at least 12 months on interest payments. In contrast, banks selling less than 60 per cent of their loans will receive longer-term bonds (25 years, with 15 years grace) at a fixed interest rate of 6.25 per cent with no such guarantee as that provided for in the former case.

Arrears in respect of the debt remaining after the repurchase operation are to be settled by means of a 20 per cent cash payments and the reprogramming of the balance over 15 years (with no grace period) at 0.81 per cent over Libor. Again, in order to encourage the banks to undertake large buy-backs, banks selling 60 per cent or more of their portfolio will receive a renewable guarantee on three years of interest payments.

The Costa Rican bonds will also contain a contingency clause whereby the banks will be entitled to additional payments if Costa Rica's GDP exceeds 120 per cent of its 1989 level in real terms. However, such additional payments may under no circumstances be in excess of 4 per cent of the aggregate value of the bonds and the loans involved in the rescheduling of arrears in interest. Once these latter loans have been paid, the ceiling for additional payments will drop to 2 per cent.

As part of this package, Costa Rica will also set up a debt/equity conversion programme involving a minimum of US$20 mn per annum for the next five years.

About US$253 mn will be needed to finance the Costa Rican agreement, of which over US$100 mn will come from the World Bank and the IMF in the form of loans. The remainder is to be obtained from bilateral sources, such as Japan, Taiwan and the USA.

D. A Brief Assessment

The special features of the country and the negotiating skill of the Costa Rican authorities have been combined for this country to get the best deal in the context of the Brady Plan. Furthermore, the fact that the country was already in rather substantial arrears for several years with the commercial banks *and* that it did *not* insist on new money as part of the package clearly seems to have contributed to it being able to negotiate such a large discount on its debt. There are clear lessons here for other debtors, even though some account needs to be taken of Costa Rica's special features, such as its smallness and its geo-political importance to the US. However, other governments should also learn from the Costa Rican government the skill to argue that theirs is a 'special case'.

[1] For an interesting account of how time-consuming and distracting debt negotiations could be for a small debtor, see an account by the former Debt Minister of Costa Rica; E. Rodriguez, 'Costa Rica: A Quest for Survival' in S. Griffith-Jones (ed) *Managing World Debt*, Wheatsheaf (UK) and St. Martin's Press (USA).

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The New Roles and Facilities of the IMF*

Robert Russell

The international debt problem has been an evolving phenomenon, involving a number of actors. A constructive approach to the matter requires a positive response from all the actors, in a cooperative effort. The IMF's role in tackling the international debt problem must therefore be viewed as a central element in a wider international strategy to address the issues involved.

During 1989 the focus shifted somewhat from an approach relying mainly upon debt reschuduling, to one including possible debt and debt service reduction in support of adjustment. In this process of debt workout, there are four parties responsible for generating a cooperative approach to the problem: the creditor countries, the indebted countries, the commercial banks, and the international finance institutions. Each one has a specific role to play in the process.

First, there are the governments of the creditor countries. Their role is three-fold. They must adopt policies to achieve 'maximum sustainable high quality growth',[1] and to reduce trade protectionism. Additionally, there is a need for them to provide appropriate financing, both multilateral and bilateral, and relief initiatives (as formulated at the Toronto summit) for official debt.

Second, the over-indebted countries bear a responsibility to pursue strong growth-oriented adjustment policies, and to negotiate and fulfil the terms of appropriate financing or debt restructuring arrangements with creditors and donors.

Third, there are the commercial banks. Their responsibility includes rescheduling debt, and agreeing to debt and debt service reduction where appropriate. However, they should continue lending in moderate amounts to countries which are embarking on, or already making steady progress on, serious adjustment programmes.

Fourth, there is the role of the international financial institutions, and in particular, the Fund's specific responsibilities. These are to provide sound policy advice, and to play a part in financing, by making resources available to any member correcting its balance of payments difficulties, within prescribed limits and subject to conditionality. There is also the important catalytic effect which support from the Fund can have, and the Fund's ongoing collaboration with the World Bank. By contributing in these ways, the Fund can further strengthen the international debt strategy.

The Operation of the International Monetary Fund

The prime functions of the Fund are to provide the machinery for advice and collaboration on international monetary problems; to supervise the overall functioning of the international monetary system, by promoting a proper balance between adjustment and financing in all member countries; and to make resources available to members, in order to support the measures they are taking to correct temporary maladjustments in their balance of payments.

Each member country is assigned a quota in relation to its economic strength. The size of the quota determines the member's voting powers and the amount of foreign exchange or SDRs which it can 'purchase' from the Fund as well as its financial contribution to the Fund. Special Drawing Rights (SDRs) are allocated to members in proportion to their quotas. SDRs have become accepted reserve assets and can be exchanged for convertible currencies from other members, but require payment of interest. The calculation of the value of SDRs is made daily on the basis of a basket of currencies of the USA, the UK, the Federal Republic of Germany, France and Japan.

The drawings of funds to support balance of payments adjustment are limited by provisions which govern the total amount of the Fund's holdings of the member's currency, expressed as a percentage of its quota. Those purchases that do not bring the Fund's holdings of the member's currency above its quota, known as reserve tranche purchases, are allowed without special arrangement. Purchases are paid back by 'repurchases', in SDRs or currencies usable by the Fund.

The Fund's Policy Advisory Role

The Fund is required to oversee both the international monetary system to ensure its effective operation, and the observance by each member of its obligations under the Articles of Agreement. To do the latter, the Fund must 'exercise firm surveillance over the exchange rate policies of members', who are required to provide it with the necessary information and to consult with it on their exchange rate policies when the Fund requests them to do so. The objective of surveillance is to encourage members to follow economic policies conducive to sustained economic growth with low inflation in an open world economy, and to avoid payments and exchange policies harmful to other members.

Surveillance applies to all members, but extra attention is given to the large industrial economies. Fund surveillance can help to reduce the incidence of reschedulings of external debt of developing countries in two ways: first, by contributing to a more stable expanding global economic environment which raises the prospects for all countries to meet external obligations and enhance their creditworthiness; and, second, by inducing indebted countries to adopt more appropriate policies than they might otherwise pursue.

Article IV Consultations

Article IV of the Articles of Agreement charges the Fund with reviewing the policies of its members affecting exchange rates. This in practice has been interpreted to include a wide array of economic policies. Consultations are held pursuant to Article IV, with each of the 152 members, in most cases annually. The Fund staff generally collect information required for surveillance during regular consultations with each member and during special consultations with certain members in connection with the Fund's world economic outlook exercises. Moreover, the Fund may also decide that developments in a member's exchange market or its exchange rate policies indicate a need for discussions with that member.

In appraising the member's policies, the Fund staff evaluate developments in the member's balance of payments, in light of the latter's reserves and external debt positions. This evaluation takes into account the contribution that domestic as well as external policies are making to balance of payments adjustment, and the extent to which the member's policies are fostering the conditions required for stability, sustained economic growth, and high employment. The staff's report is submitted with the approval of the Managing Director to the Executive Board, which reviews it before determining whether the member's policies are consistent with the principles of surveillance and its obligations under Article IV. The Managing Director's 'summing up' of the Board discussion is then transmitted to the authorities of the country.

Multilateral Surveillance

The Fund has also been called upon to play a crucial role in multilateral surveillance. Following the Louvre and Venice agreements the Fund has been developing indicators as well as economic analyses to assist the major industrial countries in evaluating their economic policies. It has been found that the medium-term scenarios, involving key indicators, are helpful in highlighting the international interaction of economic policies and developments. The Fund continues to explore the development of criteria that would be helpful in judging the sustainability and desirability of the evolution of a limited set of key economic variables.

Financing in Support of Growth-oriented Adjustment

The second principal function of the Fund is to provide financing in support of the balance of payments adjustment programmes of member countries. As of August 1989, the Fund had 49 arrangements of this nature with 46 countries, which was up from 46 in 40 countries a year earlier. There were undrawn commitments of SDR 10,232 mn, compared with SDR 3,533 mn a year earlier. Because countries undertaking such programmes often also request rescheduling of their external debt within roughly similar time periods, it is important to identify the terms and conditions of Fund lending, and the linkages which are often established between debt rescheduling and a country's relationship with the Fund.

Fund resources are made available to a member in balance of payments difficulty, but the amounts are: 1) limited in proportion to the member's quota in the Fund; 2) made available for short- to medium-term periods, usually three to five years, but as much as ten years under certain facilities; and 3) subject to conditions designed to assure attainment of viability in the member's balance of payments position over an appropriate period. A viable payments position has meant — especially for developing countries — a current account deficit that can be financed by capital inflow in terms that can be serviced through the growth of the economy, and without resort to additional restrictions on trade and payments (which would add to, rather than correct, existing distortions).

Policies carried out in the context of a Fund supported programme are essentially designed to restore domestic and external balance in the economy, thus setting the right conditions for sustainable growth over the medium term. Balanced economic policies include market-related levels for strategic prices, such as interest and exchange rates, which are fundamental 'supply-side' policies because they are crucial to the mobilisation and efficient allocation of savings. Fund-

* Portions of this article have appeared in publications of the International Monetary Fund.

[1] Opening Address by the Managing Director of the International Monetary Fund at the Annual Meeting of the World Bank and International Monetary Fund, September 26, 1989, *IMF Survey*, vol 18, no 19, p.294.

supported programmes also emphasise measures directed explicitly at improving supply conditions and strengthening the productive base of the economy.

The extent and pace of overall adjustment is often dictated by external resource constraint. However, this does not imply that more financing and slower adjustment would be less costly. Members have a wide range of choice over specific adjustment measures; there is no single 'blueprint' which is applied by the Fund. Often, the 'seal of approval' given by the Fund to a member country plays the most important role in overall adjustments, since it can have a catalytic effect on other sources of finance.

The Fund provides direct financial support to members who are undergoing economic adjustment programmes in a variety of ways. The usual financing vehicles are the stand-by arrangements, and extended arrangements. For low income countries, there is additional assistance under the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF), both of which cover three year adjustment programmes. At the end of the 1989 financial year, there were a total of 14 stand-by arrangements, two extended arrangements, 23 SAFs and seven ESAFs in effect [IMF Annual Report, 1989].

Credit Tranches, Stand-by and Extended Arrangements

The credit tranche policy is the Fund's regular or basic lending policy. A member can make purchases in four credit tranches, each equivalent to 25 per cent of its quota. A first credit tranche is one that raises the Fund's holdings of the purchasing member's currency in the credit tranches to no more that 25 per cent of quota. A member may use the Fund's resources in the first credit tranche — which may be appropriate if the payments deficit is relatively small — if the member demonstrates that it is making reasonable efforts to overcome its difficulties.

Subsequent purchases are made in successive tranches, the upper credit tranches. These drawings are subject to conditionality. The purpose is to assist the country while assuring that fund resources are used in support of policies to restore sustainable payments with economic growth. Such use is almost always made under stand-by or extended arrangements. A stand-by or extended arrangement enables the member to make purchases from the Fund, up to a specified amount, during a given period without further review of its policies, as long as it has observed the performance criteria and other terms included in the arrangement.

The duration of a stand-by arrangement is usually 12 months but may extend to a maximum of three years, with repayment within a period of three and one-fourth to five years after purchase. Extended arrangements normally run for three years but may be lengthened to four years. The Fund's Extended Fund Facility (EFF) and the Fund's temporary policy on enlarged access allow members to borrow substantially higher percentages of quota than under the credit tranche policies. The repurchase of drawings under the EFF are made within four and one-half to ten years after each purchase. Repurchases under the enlarged access policy are made over a period of three and one-half to seven years.

Performance Criteria

Purchases of the amounts available under a stand-by or extended arrangement are available in instalments during the period of the arrangement. However, the member's right to draw is always subject to its observance of performance criteria, including possibly a further review of the situation described in the programme. The performance criteria typically cover credit policy, government or public sector borrowing requirements, and policy on trade and payments restrictions. They also frequently cover the contracting or net use of short-, medium-, and long-term foreign debt, and changes in external reserves. Performance criteria allow both the member and the Fund to assess the member's progress in carrying out policies during the stand-by or extended arrangement period. Failure to observe a performance criterion suspends purchases under the arrangement until the Fund and the member reach understandings, based on consultations and Executive Board action, for the resumption of purchases.

The Fund's Executive Board examines all requests for the use of the Fund's general resources (other than the reserve tranche purchases) to determine whether the proposed use will be consistent with the provisions of the Fund's Articles and policies.

The Structural Adjustment and the Enhanced Structural Adjustment Facility

The SAF was established in March 1986, in order to provide concessional financial assistance to low-income members who faced serious balance of payments difficulties and who need to undertake programmes of structural adjustment. Financing for the facility is being provided by the SDR 2.7 bn of Trust Fund reflows scheduled to become available during 1985-91. Loans carry an annual interest rate of 0.5 per cent, and repayments are made semi-annually between five and one-half and ten years after the disbursement.

The ESAF was established in December 1987 to provide additional finance to low income countries in balance of payments difficulties and undertaking structural adjustment programmes. It derives its finance mostly from loans and grants. The maturity of the loans, and the interest rate is the same as that under SAF, but access under the ESAF is considerably larger. Whilst eligible countries may currently obtain a maximum of 70 per cent of their quotas in three tranches from the SAF, under the ESAF, access is expected to average about 150 per cent of quota over three years, but may reach up to 350 per cent in exceptional circumstances. The amount borrowed under ESAF depends on the strength of the country's adjustment effort, and size of its 'balance of payments problem'.

An eligible member seeking SAF or ESAF funds develops, with the aid of the Fund and the World Bank, a medium term policy framework for a three year adjustment programme set out in a 'policy framework paper' (PFP). This describes the macro-economic and structural policy priorities and objectives, as well as the structural reform and economic policy measures for the three-year period. It also contains a more detailed description of the structural reforms and economic policies to be implemented in the first year. This is updated annually on a three year rolling basis. An additional role envisaged for the PFP is that it serves as a basis to attract financial support from other sources, such as bilateral donors, by providing a coherent macro-economic and structural framework for such support.

Performance during a programme year is monitored by means of benchmarks, some of which are quantified, that reflect the programme's key objectives, targets, and policy goals. Although disbursements are not directly related to the observance of benchmarks, financial benchmarks are usually specified on a quarterly basis, and if deviations occur, policy adjustments are introduced as necessary, under the subsequent annual programme.

Other Facilities

Compensatory and Contingency Financing Facility

The Fund also has a number of facilities designed to meet the special needs of member countries. The Compensatory Financing Facility, CFF, established in 1963, was the first special facility created by the Fund. Its purpose is to provide financial assistance to members — particularly primary commodity exporting countries — experiencing balance of payments deficits resulting from export shortfalls. Such shortfalls must be temporary and largely attributable to circumstances beyond the member's control.

Initially, the CFF covered only shortfalls in earnings from merchandise exports, but coverage has since been widened. In May 1981, coverage was extended to provide assistance to members whose balance of payments were adversely affected by sharp increases in the cost of cereal imports. Members may base their requests for use of the CFF on export shortfalls alone or on a combination of export shortfalls and excesses in the cost of cereal imports.

Purchases (loans) made under the CFF are additional to those that members may make under tranche policies. Repurchases (repayments) under the CFF are made in eight quarterly instalments, beginning three and a quarter years and ending five years after purchases.

In 1988, a further expansion of this facility was established, and it was renamed the compensatory and contingency financing facility (CCFF). This retains the essential features of the CFF, but adds a mechanism for contingency financing of member countries that have entered into adjustment programmes. The contingency mechanism partially protects programme countries from unanticipated disruptive movements in key account variables such as export earnings, import prices and interest rates.

The amounts of financing available to a member under the CCFF are up to 40 per cent of quota each on account of the export shortfall and the external contingency elements, and up to 17 per cent of quota for the excess cereal import cost. In addition, members may request to draw an optional tranche of up to 25 per cent of quota to supplement any one of these three elements. Where a member has a satisfactory balance of payments position — except for the effect of an export shortfall or an excess in cereal import costs — a limit of 83 per cent of quota applies for either of these elements. For countries in these circumstances, a combined limit of 105 per cent of quota on the use of the export shortfall and excess in cereal cost elements applies.

In addition to the cumulative limits on contingency financing of 40 per cent of quota (or 65 per cent of quota, including the optional tranche), such financing generally may not exceed 70 per cent of access under the associated arrangement. There is also a cumulative sublimit of 35 per cent of quota for contingency financing on account of deviations in international interest rates. Members are encouraged to obtain parallel financing from commercial banks and to use market mechanisms to reduce their exposure to interest rate risks.

Buffer Stock Financing Facility

The buffer stock financing facility was another facility designed to smooth out fluctuations in primary commodity prices, and thus variations in export earnings. It was established in 1969 to help finance members' contributions to approved international commodity buffer stock schemes. Drawings may be made for buffer stock financing up to the equivalent of 45 per cent of quota. As required for purchases under the CFF, the member is expected to cooperate with the Fund in an effort to solve its balance of payments difficulties. To date, the Fund has authorised the use of its resources in connection with tin, cocoa, rubber, and sugar buffer stocks, but drawings have been made with respect only to tin, rubber, and sugar. Repurchase provisions are the same as for credit tranche and compensatory financing purchases, except that repurchases must be made if buffer stock contributions are returned to members. No loans on this facility are now outstanding.

Besides these facilities, the Fund also provides emergency assistance to member countries to meet payments problems arising from sudden natural disasters. Thus in 1988/89, SDR 71.8 mn was drawn by Bangladesh to cope with flood damage, and SDR 36.4 mn by Jamaica to meet foreign exchange needs following hurricane damage in September 1988.

Strengthening of International Debt Strategy, and the Fund's Role from May 1989

In May 1989, the Executive Board of the Fund approved new guidelines for the Fund's involvement in helping those developing countries who are members in facing serious debt problems. The guidelines provide for Fund support for commercial bank debt and debt service reduction by member countries.

All members are eligible for financial support of debt and debt-service reduction schemes, under the new guidelines issued by the Fund, provided that certain conditions are met. The Fund must be satisfied that:

1) the member is pursuing an economic adjustment programme with strong elements of structural reform, in the context of a stand-by or extended arrangement

2) voluntary, market-based, debt and debt-service reduction will help the country regain access to credit markets and achieve external payments viability with economic growth

3) financial support for debt and debt-service reduction represent an efficient use of scarce resources.

In reaching a judgement on each of these points in a particular case, the Executive Board will be guided by a number of considerations. These include whether the member is pursuing policies designed to improve the climate for saving and investment, help reverse capital flight, and attract private capital inflows and direct investment.

The guidelines provide that the proportion of Fund resources committed under an extended or stand-by arrangement that could be set aside to reduce the stock of debt would normally be about 25 per cent, although the exact proportion would be determined on a case-by-case basis (for example, it is 30 per cent in the Mexican case), drawings on set aside amounts would normally be phased, in line with the member's performance under the adjustment programme. However, some front-loading or phasing in accordance with specific financing needs of the member's debt reduction plan may be permitted.

In certain cases, the Fund would consider additional access to its resources, provided that such support would be decisive in promoting further cost-effective debt and debt-service reduction, and in catalysing other financial resources. Such additional access, of up to 40 per cent of the member's quota, can be used for interest support in connection with debt and debt-service reduction. Actual access will be determined case-by-case, in the light of the magnitude of the member's balance of payments problems, the strength of its adjustment programme, and its efforts to contribute its own resources to support debt and debt-service reduction.

The Fund will periodically review the progress of individual operations to ensure that a substantial reduction in debt or debt-service reduction obligations is occurring, consistent with movement towards a sustainable balance of payments position for the debtor. The Fund will not, however, be directly involved in the negotiations between members and their bank creditors. The Executive Board has stressed the importance of close collaboration between the Fund and the World Bank in supporting effective debt reduction operations by member countries.

Fund practices with respect to assurances on bank financing have varied, depending on a variety of considerations. The objectives of the policy on financing assurances are to ensure that: adjustment programmes are adequately financed: that financing helps return the country to a viable balance of payments position, enabling it to repay the Fund; the burden of financing is shared equitably; and orderly relations between the member country and its creditors are maintained or re-established.

The new guidelines modify the policy on financing assurances, in the light of the changes in the financial environment, and the possibility that debtors may need time to agree on financing packages with their creditors. These guidelines have a provision for the Fund to approve an arrangement before the conclusion of a financing package between the member and its commercial bank creditors. Approval may be given where prompt fund support is essential for programme implementation, where negotiations with banks have begun, and where an appropriate financing package is expected to be concluded within a reasonable period of time. When circumstances warrant, the practice of seeking a 'critical mass', and the possibility of approving an arrangement in principle, will continue to be followed. In such situations, a critical mass of bank commitments is obtained prior to approval of a stand-by or extended arrangement by the Executive Board, or the arrangement is approved in principle, but does not come into effect until a critical mass has been secured by the banks.

In promoting orderly financial relations, every effort will be made to avoid arrears, which could not be condoned or anticipated by the Fund in the design of programmes. Nevertheless, an accumulation of arrears to banks may have to be tolerated where negotiations continue and the country's financing situation does not allow them to be avoided. The Fund's policy of non-toleration of arrears to official creditors remains unchanged.

Following the adoption of the operational guidelines for its support of debt and debt-service reduction in May 1989, the Fund approved arrangements involving such support for four countries — Costa Rica (on May 23), the Philippines (on May 24), Mexico (on May 26), and Venezuela (on June 23).

For the Philippines and Venezuela, the Board approved extended arrangements, and set aside 25 per cent of resources approved under the arrangements for debt reduction. A stand-by arrangement was approved for Costa Rica, with 25 per cent set aside for debt reduction. All four arrangements also provide for the possibility of additional resources of up to 40 per cent of the member's quotas for debt-service reduction.

Conclusion

Thus one should stress that the way forward does not lie in unilateral approaches, whether one is a creditor or a debtor. Rather, all actors in the situation, both debtor and creditor countries, commercial banks and the international institutions themselves, must recognise their common interest in reaching a realistic understanding of the situation. From this, one can move towards a situation where an end to the process of debt workout is in sight, and in which the possible solutions can be freely negotiated and market based.

IMF Facilities: Amounts Committed and Terms of Credit, April 30, 1989

Credit Facility	*SDR million amount committed but undrawn as of April 30*	*No. of arrangements in effect*	*Available to:*	*Interest rate*	*Duration of arrangement*	*Repayment period*	*Conditionality*
Stand-by	3054	14	All members	Variable[2]	1-3 years	3½-5 years[3]	Yes
EFF	1032	2	All members	Variable[2]	3-4 years	4½-10 years[3]	Yes
CCFF	NA[1]	5	All members	Variable[2]	1 year	3-5 years	Depends upon BoP
BSFF	NA[1]	None	All members	Variable[2]	1 year	3-5 years	Depends upon BoP
SAF	1566	23	Low income undertaking adjustment	0.5%	3 years	5½-10 years	Yes
ESAF	955	7	Low income undertaking adjustment	0.5%	3 years	5½-10 years	Yes

Source: IMF Annual Report, 1989: Table 11.2, p.60, 11.3, p.61, and information provided by the author.

[1] CCFF and BSFF resources are normally drawn in full by members as soon as the Fund approves access; thus, undrawn balances seldom exist. Five countries drew SDR 238 mn under the CCFF during the Fund's financial year ending April 30, 1989; there were no BSFF drawings.

[2] The Fund charges interest based on the cost of its funds plus a margin for operating expenses and additions to reserves. The charges vary from period to period. For example, the basic rate of charge applied to the use of the Fund's ordinary (quota) resources was 5.50 per cent in the first half of the Fund's 1988/89 financial year, but increased to 7.38 per cent in the second half of the year.

[3] Resources provided under the enlarged access policy to augment drawings under standby and EFF arrangements are repaid over a period of three and one-half years to seven years after they are purchased. The Fund borrows these resources at market-related rates, and drawings under the enlarged access policy carry an interest charge reflecting the Fund's cost of borrowing plus a small margin. The average rate of charge in FY 1988/89 was 7.62 per cent.

The New Roles and Facilities of the World Bank

Anthony Toft

Introduction

This contribution aims to illustrate the World Bank's involvement and role in the changing debt workout process. In order to understand the WB perspective, it is necessary to go back to March 1989, and look at the position of the highly indebted countries before the Brady Plan. It is appropriate to be focussing in particular on the commercial banking situation, before looking in further detail at the WB's support of the position that debt and debt service reduction must be an essential component of any viable solution to the problem of Third World debt.

HICs and Their External Debt after Seven Years

During the 1980s, the HICs suffered from overall economic deterioration, which consequently affected their commitment to debt repayment and servicing. For most indebted countries, growth rates have been negative or declining for much of the 1980s. For the so-called Baker 17 (WB's HICs), the real GDP growth rate was negative from 1982 to mid-1983, rose slightly during the following two years, but has since been declining. Per capita consumption too has not been encouraging; for HICs as a group, consumption was lower in 1988 than in 1982. This decline has also been a feature of the relatively 'good performers', such as Chile and Mexico.

Other economic indicators emphasise this pattern of declining economic growth rates. Gross domestic investment, for example, has shown a sharply negative trend since 1982. Again, for merchandise imports, rates were negative during the early 1980s, and then showed, on average, a zero growth rate between 1985 and 1987.

In the face of these discouraging trends, the debt burdens of the HICs remained ominously high. Debt service ratios have been consistently higher for the HICs than for LDCs as a whole, but whilst there has been a sustained decline in ratios for the latter since 1986, there has been no similar pattern for the HICs. Similarly with debt-export ratios, which reached a peak in HICs of 310 per cent in 1987. Overall debt owed to commercial banks by the HICs increased significantly during this period of 1982-87. For example, Chile's debt to commercial banks in 1982 was US$ 3.7 bn; by 1987 it had risen to US$ 11.3 bn. In Venezuela, the commercial debt rose from US$ 11.8 bn to US$ 23.6 bn. Yet, while the commercial debt situation has been worsening, net flows from private sources have also been dramatically decreasing. Thus the net transfer position of the HICs has been deteriorating sharply since 1982.

As a result of the combination of the deteriorating economic situation and the considerable debt burden, there has been a discernible strain on the commitment, and even ability, of many governments to establish more open economies, with increased mobility of resources and trade. Furthermore, governments have increasingly found themselves in a position of having to resort to arrears to help fill financing gaps.

The Commercial Banks and the HICs

The Brady initiative is essentially concerned with the contribution made to the debt crisis by the international commercial banking community. This is understandable, given the fact that not only are some two thirds of the external claims on the heavily indebted countries held commercially, but that the trends concerning the banks' position *vis-a-vis* the debt crisis threaten a major shift to public sector financing in the future.

However, the present external debt burden of these countries is NOT exclusively a commercial one. While it is entirely appropriate that attention be focused on the problems posed by the new realities of what could be described as the commercial banking 'market place', similar attention will need to be given in the not-too-distant future to the burdens posed by the claims of the official sector, as represented by the Paris Club.

A fundamental shift in commercial bank attitudes towards the debt strategy in recent years can be traced back to several underlying factors. Firstly, most commercial banks no longer viewed the debt problems of the HICs as being of the most pressing concern to them. This was for a number of reasons. Previously, banks had expended considerable efforts to strengthen balance sheets, but often at real cost to asset base, shareholder equity and even staff size. This is reflected in the fact that for virtually all banks, LDC exposure has been declining markedly as a factor on their balance sheets. The amount owed by HICs, for example, as a percentage of total capital of US banks, has declined from 132 per cent in December 1982, to only 46.6 per cent in June 1989. The decline has been even more pronounced for non-US banks. In addition, for many non-US banks, the decline of the dollar has helped reduce the relative importance of HIC assets *vis-a-vis* other assets. Major reserve increases in respect of LDC holding have also taken place, and profits from other banking activities have gone up.

Secondly most banks are more concerned about profiting from new competitive challenges than they are about the debt crisis. As a generalisation, in Europe, the focus in March 1989 was on the 1992 economic integration within the EC. In the US, opportunities offered by the opening up of interstate banking, the possibility of engaging in the securities business and leveraged buyout action were prime focuses of attention. US banks were also interested in exploiting the 1992 opportunities in Europe. In Japan, deregulation of the financial sector and the opportunities for expansion into the US and European markets through acquisitions loomed large. Indeed, at the risk of oversimplification, it is probably true to say that today, the debt crisis is no longer viewed by the banks as a threat to the financial system, but rather as a potentially potent force in a competitive war. Depending on the particular bank in question, this force is either a weapon which can be used to 'beat up' competitors, or a weak link in one's defensive armoury.

Thirdly, and probably most importantly, it is doubtful whether any bank believed these countries were suffering from a temporary bout of illiquidity. For the most part, they probably saw the problem as one of creditworthiness — they believed that full recovery of existing claims was at best a long way off, with progress being uneven and subject to numerous policy failures. This had ramifications for the new money process. If you are convinced as a banker or a shareholder, whether rightly or wrongly, that a borrower may not ultimately be capable of making good in full on its debt obligations, is there not a point at which it ceases to make sense to increase one's exposure in order to keep those assets current, even at the risk of protracted arrears resulting in a number of cases?

Fourthly, the new money process has been made less attractive for banks by the fact that they have been forced into a partial recognition of losses on their LDC assets. In the last two years, as we have seen, whether as a result of regulatory pressure or inducement or because of appropriate banking prudence, provisioning against HIC assets has increased very significantly. For the US banks, provisioning does not translate into a write-down of regulatory capital. But with the new Bank c International Settlements capital adequacy rules du to come into effect at the end of 1990, US banks ar likely to consider further increases in provision (which is probably implicit in providing new mone these days) as akin to a capital loss, because thes provisions will no longer be counted as capital.

If one adds to these factors the fact that banks saw ver low margins on their lending to debtor countries, an the increased emphasis on profitability and capit adequacy standards, one can see that by early 198 'new money' had become an increasingly unattractiv proposition. The relative contribution of new mone to debt relief declined from 1983 on, so that by 198 only a very small proportion of total debt relief cam through 'new money'.

This is not to say that the World Bank believes th 'new money' process dead. New money does enabl banks to keep existing assets current, which mig otherwise have had to be treated as non-performin and written down. In general, the concerted lendin process worked to maintain pressure on all countri to pay the maximum possible amount of debt servic despite the fact that this process may have bee generating inadequate relief for many HICs. Howeve generally speaking, where the losses that one implicitl risks incurring by not providing new money a 'manageable' for a bank, the predisposition will be t accept such losses, and to try to benefit from th compensating competitive advantage it may gain ov banks who cannot extricate themselves, or for who the impact of losses is more severe. Obviously ho 'manageable' losses are depends on the lendin arrangement, but in the case of lending to the small HICs, the losses are manageable for most banks. Suc predisposition towards protective behaviour is greatl strengthened when prospects for a general resolutio to a country's debt problems appear to be very dim.

The consequences of this trend have been mo dramatic. Whereas in 1982 the commercial ban disbursements to HICs exceeded debt servicing flow back to the banks, by the end of 1986, the situation w reversed. By 1987, for every one dollar disbursements by the banks, they were getting $4 i return through debt servicing. Put another way, i 1986 there was a net transfer of finance from the HIC to the commercial banks of almost $20 bn.

The 'menu' approach to debt rescheduling is in essenc a reflection of this tendency amongst banks to engag in self-protective behaviour. Those banks for whic the new money process continued to be desirable, c even indispensable at times, favoured the men approach in order to make the overall process mo attractive to as many banks as possible.

However, the benefits of the menu varied from on economy to another. The depth of economic activit and the state of some economies do not always len themselves well to some menu items, such as relending, or else do not allow significant relief to be obtained from such items. As a result, larger more complex economies were most likely to benefit from the menu approach. Other factors also limited the adoption of this approach — the time and effort required to design such packages was often daunting. Banks too often wanted to limit the scope of some menu items.

However, the biggest limitation to the menu lay in its most vaunted asset: its market driven nature. The market, as represented by the banks, can be said to have decided that self-preservation was the safest course of action in a competitive world. More importantly, concerted action was not seen as a viable route to self-preservation. The exhortations to banks by creditor governments to fend for themselves, and the regulators' drive to re-instill traditional prudential practices by the banks, was taken as a signal that an independent course of action was ultimately the safest one.

In summary, in March 1989 the World Bank predicted that, in the absence of any major new initiative in the debt strategy, the number of banks participating in the new money package would be likely to narrow further, as would the number of countries benefiting from such financings. It was thought that there would be further efforts to broaden the so-called 'menu' of options. This would be aimed at encouraging continued participation by distinguishing new claims from old, and at extracting some financial relief from those banks unwilling to participate in new lending. Yet, at the same time it was realised that concerted new lending for the HIC's would only be obtained with great difficulty, if at all. In March 1988, a WB Board paper stated that:

'Despite the fact that banks continue to hold about two-thirds of total medium and long-term claims on the heavily indebted countries . . . pressures not to lend will grow, forcing selectivity and strong reluctance to accept exposure increases that in other circumstances might look quite reasonable. All countries are thus likely to experience delays in assembling new money packages, constant downward pressure on the amounts to be obtained and continuation of the short-term approach that has characterised the concerted lending process since the beginning. Some countries, particularly smaller ones, may be faced with a choice between either reduced growth or further recourse to arrears to commercial banks . . .'

World Bank Support of Debt and Debt Service Reduction

It is from the trends and factors outlined above that the World Bank drew the inescapable conclusion that debt and debt service reduction must be an essential component of any viable solution to the problem of Third World debt. The facilities established by the World Bank to support this solution, were adopted in May 1989, and essentially parallel those of the IMF.

There are a number of pre-conditions for a country to obtain World Bank support for a debt and debt service reduction scheme. It must have a large debt burden, and be pursuing a medium-term structural adjustment programme which is acceptable to the World Bank. The need for debt reduction in order to achieve medium-term growth and adjustment objectives must be clearly demonstrated. Finally, the country in question must show significant benefits resulting from the intended financing relief operation in terms of improved growth and investment prospects.

If these conditions can be met, the World Bank is prepared to allocate up to 25 per cent of the World Bank's planned adjustment lending programme to a country over a three year period, to support operations involving significant principal reduction. As an alternative, the World Bank will allocate up to 10 per cent of its overall lending three year programme, in those cases where the World Bank's lending programmes are concentrated on investment lending. In addition to this, there will be incremental resources available of an additional 15 per cent of the overall three year lending programme.

While these resources are intended to be made available over a three year period, the need for significant front-loading is of course recognised by World Bank management. In the case of the Mexico package, this translates into a management proposal to provide some $1.9 bn of debt and debt service reduction support by January, 1990.

Whilst the World Bank has been fully prepared to endorse Secretary Brady's initiative and make available resources in support of this new phase of the debt workout process, the World Bank envisualises its role in the post-Brady speech world as something more specific. There is a consensus within the World Bank that its primary contribution to the debt workout process should continue to be what it has been for several years now: tackling those institutional and policy flaws in the HICs which contributed so significantly to the accumulation of huge debt burdens in the first place. The World Bank must continue to build up assistance to the investment process in these countries, without which growth will certainly be elusive. In recent years, the proportion of World Bank commitments to adjustment lending has grown steadily, especially in HICs, where adjustment lending actually exceeded project lending in the 1989 financial year, to total a little over $4.5 bn. What this means in practical terms is illustrated with reference to the World Bank's proposed policy-based work programme for Mexico and the Philippines in the coming five years.

World Bank Operations in Mexico and the Philippines

The World Bank has now become Mexico's largest single source of new money. In the past year, three major adjustment programme operations have been entered into, including a Financial Sector Adjustment Loan, a Public Enterprise Reform Loan and Industrial Sector Policy Adjustment Loan. The policy dialogue with Mexico will include:

a) a review of the current regulatory and financial framework in industry and agriculture

b) a study of tax reform options

c) an intensive analysis of urban air pollution in collaboration with the World Health Organisation

d) an assessment of infrastructure and energy sector issues

e) the development of strategies for integrated health and nutrition initiatives

f) the assessment of improved programmes to ameliorate rural poverty; and

g) an analysis of environmental issues to come up with a set of recommendations.

Over the medium-term, the World Bank plans to maintain a lending programme for Mexico averaging over $2 bn a year.

A commensurate effort is planned for the Philippines, with an overall lending programme running at an average of $700 mn a year for the next few years. Of this, 75 per cent will be for investment purposes. The Philippines programme started in early 1989, and involves:

a) continuing the process of trade liberalisation

b) improving tax collection and overall revenue efforts

c) continuing the process of privatising public corporations and government owned banks

d) reforming regulations governing the financial sector

e) restructuring and expanding the public investment programme

f) supporting the social sector and poverty alleviation programmes

g) pursuing a major agrarian reform

h) monitoring monetary and fiscal performance to assist in meeting targets designed to limit inflation.

Whilst the approach taken by Mexico was one of comprehensive debt reduction, the Philippine proposals place emphasis on some new money, but in combination with debt buybacks. Thus the World Bank will continue its emphasis on adjustment lending, but tie this in to support for the debt and debt service reduction process.

Conclusion

Whether the process set in motion by Secretary Brady will mark the final stage in the debt workout process remains to be seen. In my view, we are probably somewhere between the end of the beginning, and the beginning of the end, in terms of achieving a viable solution. For most of the HICs, it is probably fair to say that it is a matter of years before the time arrives when they can feel, with any measure of confidence, that their debt problems have been overcome. It is also clear that we have a great deal of innovation ahead of us. Neither the Mexican nor the Philippine proposals will necessarily be appropriate precedents for other countries. Clearly, there are other countries for which the Philippine emphasis on new money plus debt buybacks will be appropriate. There may be other countries where the comprehensive debt reduction approach taken by the Mexicans will prove feasible. But, for a significant number of countries, new money prospects are very dim and the necessary adjustment programmes conducive to Mexican-type arrangements are nowhere as advanced as they are in Mexico. In these countries, ways will need to be found to provide short-term cash flow relief other than through conventional rescheduling and new money, while the adjustment effort is being intensified as a precondition for permanent debt or debt service reduction.

The fact is that dealing with adjustment and investment issues are the World Bank's *raison d'être*. It is our special responsibility to work for and support reform and adjustments designed to address those institutional and policy flaws which contribute significantly to the accumulation of debt burdens. However, the responsibility for supporting adjustments designed to address the *consequences* of such debt burdens lies with the overall creditor community. The World Bank is a part of that community, and we intend to play, and indeed believe that we *are* playing, a responsible role in addressing these consequences.

The Paris Club and African Debt*

Peter Mountfield

Origins and Evolution

It will be helpful to start with an institutional account of the Paris Club, because there is relatively little written about it, and much misunderstanding. In origin, the so-called Club goes back 34 years, to the Argentine debt settlement of 1956. Indeed, the Club celebrated its 30th Anniversary in 1986 with a splendid dinner at the Banque de France. But the 1956 negotiations were very different from the present system. The background was, of course, non-convertibility. And the Argentine negotiations concerned the speed with which blocked accounts would be freed up. Thus the problem was essentially the same: a lack of hard currency resources to meet existing obligations. But the financial framework was completely different. Some of the intellectual approach, and indeed the language of the present-day Paris Club agreements reflects these early origins. Above all, it was a multilateral solution to the problem. One of the contemporary documents on Treasury files puts it very clearly:

> It would be surprising if the Argentines abandon their preference for bilateral discussions. Our proposals for a roundtable conference clearly alarmed them. They prefer to negotiate bilaterally in the belief that the lessons learned in one encounter may be applied to good effect in the next. The prospect of sitting down with representatives of high technical competence from several countries together is not calculated to attract them in their present situation. They are afraid of being manoeuvred into uncomfortable positions and of being faced with unpalatable decisions. This is, I think, the chief reason why they counter our proposals with plausible arguments that the disparate nature of their debts and the dissimilar preoccupations of their creditors make a joint examination of this problem impracticable.

The pattern which was established for Argentina in 1956 has served the financial community well ever since, and I think the debtors now accept that.

During the 1970s, the pattern of multilateral government debt negotiations became relatively standardised. But there was a significant shift over time. In 1972 and 1974, there were two major debt reorganisations involving Ghana and Indonesia (the latter the result of the plan formulated by Hermann Abs). These agreements were on a very long timescale — 30 years I believe — and at concessional interest rates. It is interesting that the lenders (primarily but not exclusively aid agencies rather than export credit agencies) apparently absorbed the implicit costs of concessional interest rates without a murmur. Later in the 1970s as a number of African countries, 10 years or so after independence, began to run into payment problems — many of them the result of early economic mismanagement as much as malign external conditions — the practice grew up of the major creditors meeting together regularly but informally. Nearly all of them were members of OECD and the meetings were almost always under French chairmanship. There were one or two exceptions: for example, Britain chaired one of the later Ghana debt conferences, and the negotiations with Turkey, itself an OECD member, took place there rather than in the strictly Paris Club format. Many of these negotiations still centred on old aid loans, although the UNCTAD resolution 165 of 1979 recommended the progressive conversion of such loans into grant — the process known as RTA. Partly as a result of that, and partly as a result of the changing pattern of indebtedness, the focus has shifted from the early 80s onwards towards export credit debt — that is, loans made directly, by bodies like US Exim, or guaranteed by bodies like ECGD. Nearly all such lending was on commercial terms (though much of it was at slightly concessional rates, as defined by the OECD consensus). From 1982 onwards, the major debtors moved centre-stage, but the path had been laid down for them by Poland, which went to a Paris Club procedure (diplomatically given a different name) in 1981.

Since then, the sausage machine has become highly automated, and negotiation follows a fairly standard pattern with surprising speed. The Secretariat recently produced some startling figures to demonstrate the scale of these operations. In 1987 alone, the total volume of payments rescheduled amounted to $26 bn. Even if you subtract Poland and Yugoslavia, we rescheduled $18 bn of debt of 15 developing countries. That is $2 bn more than the total gross disbursements of the World Bank (including IDA) and of the IMF. It represents an enormous contribution to easing the immediate cashflow problems of the debtors. And it only involved 17 meetings, each one or two days long, plus a few informal technical meetings among the creditors. Contrast this with the weeks spent by the banks on each case.

*The views expressed in this article are the author's own and not necessarily those of his department or government.

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Main Features of a Paris Club Agreement

How does the Paris Club operate? Perhaps the easiest way to understand it, and the rationale behind it, is to analyse the main features of an Agreed Minute — the formal process-verbale which records the decisions of a meeting. In form, this is simply a recommendation to creditor governments by their representatives meeting in Paris informally under French chairmanship. To give legal force to these recommendations, they have to be translated into a series of binding bilateral agreements. Those signed by the UK, though not all the others, actually take the form of international treaties registered at the United Nations. Many others are simply an 'exchange of letters'.

The Agreed Minute begins with a recital of the countries and international organisations attending the meeting, and of the fact that they listened to a presentation by the debtor of his serious financial position. The formal and slightly stilted language conceals an important truth: that the creditors meet with the debtor under the shadow of a threat of imminent default, in order to provide a tidy and mutually-acceptable solution rather than an untidy and acrimonious default. This criterion of 'imminent default' goes right back to the Argentine agreement (and indeed, probably to pre-war days). The same paragraph solemnly takes note of the determined efforts being made by the debtor to put his house in order. This too has long-standing historical antecedents. But its purpose, these days, is to provide a peg on which to hang a reference to an IMF-approved adjustment programme.

The Agreed Minute then proceeds to define the debt covered by the agreement. In practice this is very important. First of all, it almost invariably excludes short-term debt. This means that export credit agencies can go on providing short-term cover, secure in the knowledge that this at least will be serviced and turned over freely. The debtor country is able to go on financing part of his imports, including vital food and spare parts, on ordinary commercial credit terms without having to put up immediate front-end cash. The major exception to this rule was Nigeria, who built up enormous short-term arrears in 1983 which subsequently had to be rescheduled — in effect, capitalised and spread over the medium-term. It is a precedent we are very anxious to avoid repeating. So the debts which are covered by the agreement are medium and long-term, a mixture of some old aid loans (if not covered by RTA already) and a lot of export credit. Inter-governmental loans other than aid are very rarely included, though I can think of a few cases. Very often, these debts are sub-divided into arrears built up on recent maturities; new maturities; and arrears or new maturities of previously rescheduled debt (known in the trade as PRD). All those are defined in relation to contracts entered into not later than a certain date, known as the 'cut-off' date. This too has an important strategic significance, much insisted on by the IMF. The theory is that if a debtor country is forced to reschedule a second or third time, the cut-off date will not be moved — i.e. credit agencies can go on lending to the debtor even after rescheduling, once again secure in the knowledge that such new loans will be exempted from further rescheduling. In fact, ECGD introduced a new facility in 1985, the so-called DX facility, specifically to cover such cases, and the Chancellor made rather a virtue of it at the Interim Committee meeting of October 1985.

Having defined the debt to be covered, the minute goes on to set out the proportion to be rescheduled — ideally, about 85 per cent of principal and no interest, but often, in practice for the poorest countries, 100 per cent of both. (I should note at this point that while the banks do not reschedule interest, the Paris Club does. Such rescheduling is sometimes the financial equivalent of the 'new money' increasingly rarely being provided by the banks. More usually the banks continue to receive their interest, while the government creditors reschedule part or all of theirs, thus increasing their exposure both absolutely and relative to the banks.)

Then the minute goes on to set out the terms of such rescheduling — the grace period, the new repayment schedule, and the timetable for meeting the down payments if any (i.e. the 15 per cent or so which is not to be rescheduled, but which is often spread out over 12 or 18 months). Then the minute specifies that such rescheduled loans shall carry interest at 'the appropriate market rate', to be determined bilaterally. After that, it requires the debtor to seek comparable terms from other creditor governments, and from other institutions (mainly banks, but sometimes also commercial creditors; this was particularly important in the case of Nigeria).

The minute does not specifically say that debt due to the international institutions will be excluded, but there is a tacit understanding that this is so. I imagine the reasons for this exclusion are well understood: it is essentially because the IMF was seen as a revolving fund, whose resources must be preserved and if necessary refinanced from other sources. The IBRD sees it as in the interests of its borrowers that it should continue to obtain the finest possible terms for its own market borrowing, which in turn means that it must be exempted from rescheduling.

The next section of the Agreed Minute deals with conditionality, in a rather back-handed way. It provides that the agreement continues to have force, so long as the debtor country has an arrangement with the IMF 'in the upper credit tranches' — i.e. a standby agreement. The wording has now been modified to cover SAF and ESAF agreements as well. This clause contains a bit of a nuclear deterrent in as much as, if an IMF agreement lapses we cannot actually afford to invoke the clause, because that would be to push the debtor country back into technical default. It is the whole object of the Paris Club procedure to avoid that. I return to this point in a moment. Then there are some technical provisions to ensure that the different creditor governments are all treated on an equal footing, and that the referee — in this case, the Secretariat — can see fair play; and often there is a goodwill clause committing the creditors to consider in principle a renewal of the agreement if the debt problems continue. The whole thing is set out in rather stilted language, in two versions, English and French. Both are equally unreliable. It is then signed, with a great flourish, by the Finance Minister of the debtor country, and by all the countries round the table.

Proceedings of the Club

So much for the format of the agreement. What actually happens? First of all, there is a good deal of pre-cooking. We do not actually proceed to a negotiation until an IMF programme has been approved (though sometimes pressure of time means that we have to rely on a telegram from Washington to tell us that this has happened). In practice, when the IMF staff endorses an adjustment programme, they have to make assumptions about the amount of debt relief which the different groups of creditors will be prepared to offer. This is a slightly chicken and egg situation, but we get round it by having a monthly round up in the Paris Club of all the debtor countries known to be in the pipeline. By the time we get to a formal negotiation, the IMF have a pretty good idea of how far the creditors are prepared to go. In practice, as I shall demonstrate, the variables in the equation are rather limited. On top of that, there is preparatory negotiation, very informal, between the chair and Secretariat on the one side, and the debtor government on the other, to make sure that everybody understands the figures and the procedure. Failure to do this has on occasion led to an almost complete breakdown of negotiations, with some pretty hair-raising late night cliff-hangers.

The formal part of the proceeding begins with a presentation by the Finance Minister of his country's problems and of its adjustment programme. Some of these presentations are awfully tedious. All the creditors present should have had the details long ago, in the form of the IMF Staff papers presented to the Board, and the better-organised debtors circulate prepared statements a few days before the meeting, often prepared by their private bank advisers. But there is no equivalent procedure to 'reading it into the record' in Congress, and we have to sit through the whole recital. This is followed by short, usually repetitive, statements by the various international institutions. These are often in inverse ratio to their importance. What everyone listens for, of course, is the IMF representative. Again, these statements could and should be provided in written form, but we have to sit through them. This process takes up much of the first morning, after which we move into a creditor caucus. The IMF observer usually sits with us for this stage.

The Secretariat prepare a 'payment capacity' table to support this part of the discussion. Usually, this only looks one or two years ahead; the period covered by the consolidation. They also prepare a Tableau Magique, with each of the main parameters of the agreement along one axis, and the names of the creditor countries along the other. Filling this in automatically indicates the lowest common denominator of agreement, and since the Club always proceeds by consensus, one can see at a glance what the opening offer is likely to be. The chair tries to formulate this fairly, perhaps involving some bargaining if one or more creditors holds out from the consensus. Then this is put to the debtor country — often over the lunch break on the first day. Then follows a period of shuttle diplomacy, more or less protracted according to the difficulty of the operation. The chairman moves from the debtors' room at the back of the building to the main conference room where the creditors remain assembled. If the proceedings are more than usually protracted, the chairman sometimes allows time off for dinner. Sometimes the procedure is drawn out over more than one day, in order to give the debtor government time to consult its authorities at home. Usually, the creditors have plenipotentiary powers already. Finally, settlement is reached, and the formal documents are signed. A polite speech is made on both sides, and appropriately these pay tribute to the creditors' generosity. There is then a bland press statement, which contains none of the serious material of the negotiation. After that, the process becomes one of bilateral negotiations, sometimes spread out over the next six months. Notably this process puts a considerable strain on the organising ability of an underdeveloped African country.

Finally, it is worth noting one difference between our procedures and those of the banks. The Paris Club does not negotiate new-money packages (though when it reschedules interest it does provide equivalent relief). We try to avoid being drawn into multilateral pledging sessions, leaving that to be organised in the donor groups convened by the World Bank.

There are a number of points worth bringing out about this procedure. One is the key role played by the chair and the Secretariat — full-time officials of the Direction du Tresor, part of the Ministry of Finance roughly equivalent to the home and overseas finance sides of the British Treasury. The chairman of the Paris Club is the Directeur du Tresor himself, Jean Claude Trichet. His immediate deputy, the Chef de Service Internationale (in British terms a Deputy Secretary) also spends a great deal of time and effort on this work, as does his immediate subordinate, the Sous-Directeur responsible for bilateral affairs and African countries. The more important national delegations are also headed at senior level: the Americans, by a Deputy Assistant Secretary from the State Department; the Canadians, by my opposite number in the Finance Ministry there; the Germans, at the same level from the Economics Ministry, and so on. Note that some governments are represented by the Foreign Ministries, others by Finance or Economics Ministries. But they all have plenipotentiary powers from their governments. The Export Credit Agencies (in most countries public corporations rather than a government department as in England) are represented by observers. So are some central banks. The individual creditors meet informally from time to time, and keep in touch between meetings by telephone and telex. The name Paris Club is not entirely a joke. The 17 or 18 heads of delegations all know each other pretty well by now, and are on first name terms. We dine together for a working session once a month. The informal contacts at and between meetings play an important part in the way the operation works. Most importantly, in my view, is the fact that the whole operation is run by a single national administration, and a highly professional one. There are none of the problems one has with an autonomous international Secretariat trying to carve out a role for itself. Nor, to be fair, do the French abuse their position in favour of francophone African client states. They exercise a genuinely neutral role, and do it with enormous professional skill.

Some Current Issues

Let us move from this formal account to some of the issues raised by the Paris Club's present modus operandi. The first and most important point, and certainly the most controversial, is conditionality. These days it is a golden rule of the Paris Club that we will not consider rescheduling without an IMF programme in place. There is a limited category of countries, not currently IMF members, or newly admitted, for which different procedures have been evolved. I think I helped to evolve them, in the leading case of Poland a few years ago. We were anxious to ensure conditionality, and to make certain that creditors were not wasting their money when they agreed to reschedule on generous terms. But there was no IMF to appraise the Polish economy for us, or to suggest terms. We tried to do it for ourselves. We set up a small task force, of the four or five major creditors, and paid a number of visits to Warsaw for direct contact with the different Ministries there, in an attempt to work out a pattern. To be frank, it did not work well. We had neither the skills, nor the supporting staff, of a typical IMF mission. We did not know how to translate IMF conditionality, with which we were reasonably familiar, into the terms of a centrally-planned economy as Poland then was. Nor could we grapple with the very idiosyncratic Polish official statistics. With a sigh of relief, we handed the job over to the IMF when Poland rejoined. We used slightly similar tactics for Mozambique before that country joined the IMF. The results have not been very satisfactory. Normally, we have insisted upon a standby agreement, though in three recent cases we have started with an SAF. Increasingly, I think, we shall see longer-term agreements, under the SAF and now the ESAF, forming the basis of Paris Club operations, possibly for coterminous lengthened consolidation periods. We have considered, but not so far accepted, the idea of agreements based solely on IBRD lending, in the form of an SAL. Perhaps that reflects the feeling of many creditors that IBRD conditionality is not yet as tight as that of the Fund, and there is a tendency in the Club to look at the Fund as its main supporter.

The next point concerns our estimate of the payment capacity of a debtor, and thus the terms of our rescheduling. I noted that the Secretariat produced payment capacity figures for the period covered by the rescheduling — that is, the maturities falling due in the first year or 18 months. They seldom attempt a longer horizon. We all know how difficult it is to draw up projections of payment capacity, based as they are on forecasts of export earnings which are particularly difficult for monocultures like many African countries, and which involve making assumptions about the openness of OECD markets for their exports. It is also extremely difficult to judge the tolerance of the local population to continued austerity, and their willingness to do without imports for all but essential purposes in order to release resources for debt service. So long-term projections are difficult to come by, and not always worth the paper they are not yet written on. However, I think we should look more carefully at long-term debt maturity profiles to avoid the very awkward bunching which we have sometimes imposed on the debtor country. It is going to be very important to look at the combined impact of repayments due to the banks, to the IFIs and to the Paris Club creditors.

Another set of problems concerns the simplification of our procedures. Look at Zaire, which has rescheduled nine times in the last 12 years. Each consolidation was done on slightly different terms, and several of the greements have been re-rescheduled two or three mes. The result is a multiplicity of separate categories f debt, often involving comparatively small per- ꞔntages of percentages of percentages. There is a case ɔr rolling all the existing stock of debt together in one all, and reconsolidating the lot over a longer mescale, to achieve a more realistic repayment :hedule. We have done something like this, xperimentally and particularly for one country — oland — and I hope we shall be able to do more. The roblem is to do so in ways which preserve parity of ·eatment between different groups of creditors.

.nother thing we ought to do is to simplify and speed p the process of signing bilateral agreements, which an be terribly time consuming for the debtor overnments concerned. Maybe a standardised greement form would help, but different national :gal systems and different institutional arrangements mong the creditor countries make that hard to chieve. There are in fact only two main points left pen for bilateral agreement — the actual list of debts ɔncerned, and the 'appropriate market interest rate' ɔ be charged. The first has obviously to be handled ilaterally. The second means finding a rate which voids a continuing loss to the Export Credit Agency ɔncerned — i.e. it has to cover its own cost of ınding. So far we have not found an internationally- greed formula to define this multilaterally in dvance. The result is to leave room for much time- ɔnsuming bilateral negotiation afterwards, with very nall savings to the debtor at stake. Another ossibility is to revive the idea of multi-year ꞔscheduling agreements. (I think it was I who coined ıe acronym MYRA for these, in the context of an arly Yugoslav agreement.) The early experiments ·ere not very successful. We were probably too recise in trying to set down conditions in advance. Ve are now looking again at procedural changes ·hich will allow us to give the debtor country some ssurance of continuity, while reserving the levers of ɔnditionality in the hands of the creditors.

:onclusions

'o sum up: the international debt problem, looked at ·om the viewpoint of the creditors, is primarily a ıatter for the banks, and only secondarily for the overnment creditors. The government creditors are roportionately more important in Africa than in atin America and elsewhere. Some mechanism is ssential to ensure the orderly restructuring of ıtergovernmental debt. By a series of historical ccidents, the Paris Club has evolved into that ıechanism. It is in fact an extremely efficient ıstrument for the purpose, processing very large olumes of debt with remarkable speed and lack of ·iction. It can do so because it relies upon the IMF to enforce appropriate conditionality, to protect the creditors' long-term interests. Its procedures may look a bit odd, but each element has its historical and current rationale. Some further improvements are no doubt possible, and we are looking at them. The Club regard themselves as a pretty hard nosed group of debt-collectors. But they also recognise that their operations serve an essential developmental role, by removing one of the inhibitions to future development. Increasingly they see their operations in that context, and have evolved their procedures to fit.

Postscript

Since this paper was prepared, in May 1988, there have been several new developments. The most important was the decision of the Toronto Summit of the seven major industrialised countries, in June that year, to soften the terms of rescheduling applied to the very poorest and most heavily-indebted countries. This decision followed an initiative launched by Nigel Lawson, when Chancellor, in April 1987. Creditors choose from a menu of options, including cancellation of one-third of the debt (as proposed originally by President Mitterrand), reducing interest charges so as to bring down the net present value by about one-third, or rescheduling over much longer periods. So far 13 countries, mainly in Africa, have benefited from the new 'Toronto Terms', one of them for two years running. Two others have been given extended repayment periods. In another development, the Club agreed to base rescheduling in appropriate cases on a 'Fund-monitored programme' rather than on a conventional Stand By. (These programmes are being developed for countries which are seeking to escape from the Catch-22 of large arrears to the IMF which make it impossible for the Fund to grant a normal Stand By immediately; such countries desperately need debt rescheduling as a precondition of recovery yet would not qualify for it if the Club continued to insist on a Stand By.) Finally, the Club is now paying very close attention to 'comparability of treatment' between government and banking creditors. As explained, the practice of the Club in rescheduling interest has led in many cases to a big increase in its exposure relative to that of the banks. And at the same time the International Financial Institutions have tended to increase theirs. This progressive transfer of risk from the private to the public sector has gone too far (as the Interim Committee of the IMF noted at its April 1989 meeting). So the Club is no longer prepared to be treated as 'financier of last resort', it increasingly limits its own debt relief packages to what it considers to be its own fair share of the total burden carried by all creditors, thus putting the responsibility upon the banks to make their own contribution or risk facing a default.

BANKERS' VIEWPOINTS

A. The Debt Problem at the Crossroads

William Rhodes

The strategy that had been followed since August 1982, when the debt crisis began, focused on new money as the cornerstone of the financial packages that commercial banks assembled for various restructuring countries. The emphasis was on burden-sharing and cooperation among the various parties — creditor and debtor governments, the international financial institutions, and commercial banks.

The common goal was to provide the countries with both the time and resources — by postponing debt repayments and encouraging new money — while they made necessary economic reforms. These reforms, in time, would allow the countries to return to the voluntary capital markets, where they could again raise the incremental funds that they will need, as developing countries, for their future growth.

New-money exercises, which encouraged large numbers of creditor banks to continue lending to the countries, clearly were consistent with that goal.

Voluntary debt-reduction programmes were introduced in 1984 and they grew in importance. In 1988, for the first time since the debt crisis began, the countries of Latin America, as a group, managed to reduce their external debt.

An indebted country gains from debt reduction to the extent that it reduces its total debt at a discount to face value. However, the country takes the longer-term risk of limiting its future financing. Banks that have taken losses on loans to a borrower are less likely to lend again to the same borrower.

Progress was made under this new-money-oriented strategy with support from commercial banks and other creditors, many of the restructuring countries started reforming, privatising and opening their economies. Chile, Uruguay, Mexico and the Philippines, all of which have returned to growth, are cases where the right economic policies are working. As an example, during the second half of the 1980s, growth averaged 6.6 per cent a year in Chile and 4.9 per cent in Colombia, while in Mexico it has now reached 3 per cent. There have also been a few, though small, voluntary market transactions, by Chile, Mexico, Uruguay and Venezuela.

Some of the countries, however, have so far failed to make meaningful economic reforms, and progress overall has been slower than many of us had hoped. Last March, US Treasury Secretary Nicholas Brady proposed that voluntary debt reduction by the commercial banks replace new money as the centrepiece of a changed strategy. He also made the point, largely overlooked since, that some continuing flows of new money must remain an essential part of that strategy.

In response to the Brady proposals, the International Monetary Fund and the World Bank agreed to offer certain resources to back debt-reduction programmes for countries that have viable economic programmes. Commercial banks have negotiated preliminary agreements on three packages under the revised strategy — with Mexico, the Philippines and Costa Rica. Earlier this month, at the invitation of Mexico's president, Carlos Salinas de Gortari, creditor banks started signing the first of the three packages at a ceremony in Mexico City. Negotiations are underway with several other countries, the most prominent of which is Venezuela.

The Mexican package — the most complex and innovative ever assembled in the international markets — is the first during the debt crisis to emphasise voluntary debt reduction more than new money. Yet it combines the two in a way that, the government of Mexico believes, will allow the country to put the debt crisis behind it, create a base for investment and enter a period of sustained economic growth. Given continued progress with the government's economic-reform programme, I think Mexico can accomplish this. At a recent meeting in Mexico City, President Salinas reiterated his commitment to open the economy, privatise, deregulate and maintain order in public finances by reducing the deficit as a percentage of GDP.

The response from the international banking community has been unprecedented for any package of this magnitude. Virtually all of Mexico's approximately 460 creditor banks will have signed, by the time we close the books, and issue the debt-reduction bonds, toward the end of April, 1990. In fact there may be no free-riders.

The agreement covers all of Mexico's $48.5 bn in medium- and long-term debt to commercial banks. Banks representing 41 per cent of the debt chose to reduce principal, at a discount of 35 per cent; and 49 per cent chose to reduce debt service by limiting

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interest payments to a fixed 6¼ per cent; and the remainder, or 10 per cent, chose to lend new money. If the foreign offices of Mexican banks are included in the figures, new money is approximately 13 per cent of the total.

When we announced the agreement in principle last July, it was criticised for containing too little debt reduction, not enough discount and too much new money. However, the debt-reduction instruments account for about 90 per cent of the agreement, and debt-principal reduction is twice as much as initially forecast.

Even more important, the package is a demonstration of confidence in Mexico, and recognition of its historic economic reform programme, by its various creditors — governments, the multilateral organisations and commercial banks.

This demonstration of support should help the country further reduce the cost of servicing its very large internal debt and attract new investment from domestic and foreign sources. Since our negotiations began last spring, internal interest rates within Mexico have dropped, flight capital has been returning and there have been increased signs of new investment inflows. Economic growth reached three per cent in 1989, the highest since 1982, and Mexico's reserves have risen to more than $7.2 bn. It all comes down to regaining confidence.

I was first quoted in July 1989 saying that the Mexican agreement is no cookie-cutter. The package for Mexico is responsive to circumstances in Mexico, which differ from circumstances in other countries. For example, compared to the three basic options in the Mexican agreement, the Philippines agreement has just two options — a debt buy-back and new money — while the Costa Rican agreement has no new-money option. Some other countries may need only one debt-reduction choice. Some will need new money, others will not.

Given the different circumstances of each country, I expect that the case-by-case, or country-by-country approach, which has been followed since the crisis began, will continue.

As we look ahead, however, I have several major concerns over the changed strategy, all of them closely related.

One is the fact that the resources made available by the public sector to support debt reduction are proving insufficient to meet the expectations of various borrowing countries and, generally, to resolve the debt problem.

In this respect, it would be helpful if other surplus industrialised countries would follow the leadership of Japan and establish recycling programmes. Through the Paris Club, the industrialised countries could also help Latin America by lengthening restructurings and grace periods and lowering interest payments, much as the commercial banks have been doing.

In addition, government export-development agencies should restore their lines of credit more rapidly to countries making progress in economic reform.

I have several specific recommendations that I hope the interim committee will consider when it next meets to review the changed debt strategy:

First, the multilateral institutions could further help the restructuring countries by allowing them more flexibility with the resources that currently must be allocated specifically to each type of debt reduction, whether a cash buy-back or instruments to reduce debt principal or debt service. The fungibility, or as I refer to it, co-mingling of these resources would enable each country to use the funds to its maximum benefit, for the debt-reduction techniques most appropriate to its particular needs.

Second, Colombia should be a leading candidate to benefit from the World Bank's new Expanded Co-Financing Operation (ECO) for countries that have not restructured their debt. At the same time, the World Bank should consider extending that programme to countries that are successfully coming out of the restructuring process, have met their obligations and are following viable economic programmes. Chile, Mexico, Uruguay and the Philippines come to mind.

Third, one of the lessons we learned from the Mexican package is the importance of up-front enhancements. The international financial institutions could help the indebted countries speed their negotiations with commercial banks by being more flexible in up-fronting enhancements for debt reduction. A group of commercial banks recently completed a $1.2 bn bridging to the enhancements for Mexico only with great difficulty and after long negotiations.

Fourth, the World Bank could facilitate the countries' negotiations with their commercial banks by being more forthcoming in granting waivers to its negative-pledge clause. This would permit a greater variety of financing techniques specifically designed to the countries' needs.

Another concern is the overly-strong emphasis being placed, in practice, on voluntary debt reduction over continuing flows of new money. In the three packages negotiated under the changed strategy, all the public-sector enhancements are devoted to encouraging debt reduction; new money is underemphasised or ignored completely.

Many banks feel that this signal, and others that they have been receiving from some public officials, stress debt reduction only, not new money, and they are responding accordingly. Both Mexico and the Philippines needed incremental new money from commercial banks to help finance the debt-reduction options in their packages. Yet both countries have had difficulty raising new money. Other countries, including some less successful at economic reform, could face a similar problem in future negotiations.

Of more fundamental concern, many countries in Latin America will continue to need some new commercial-bank funding over the longer term, as they have in the past, to complement their own savings, foreign investment inflows and funds from official sources.

Yet debt-reduction programmes — particularly those involving debt-principal reduction — basically encourage banks to end their lending relationships with the participating countries. It is appropriate that some banks, consistent with their business strategies, choose to go this route. It is also appropriate that such banks do so through burden-sharing, by voluntarily taking losses through debt-reduction programmes. These programmes, unlike discounted sales to third parties in the secondary market, pass on the benefits of those losses to the countries themselves.

At the same time, there is a core group of international lenders, my own institution included, that have a commitment to the future of Latin America. These banks would be willing, under the right circumstances, to continue to support, with new money where needed, those countries that are making serious efforts to reform their economies.

Consequently, commercial-bank financing packages should be designed not only to provide exit instruments for banks wishing to leave, but also to encourage a core group of banks to continue lending to the developing world. If this does not happen, many developing countries will have to rely exclusively on their own internal savings and capital flows from official sources. Recent history suggests that this dependence could severely limit the growth of Latin America and the rest of the developing world.

Specifically, I support a more balanced financing approach for future commercial-bank packages — one that, in addition to voluntary debt reduction, recognises the importance of continuing new-money flows. New-money options that have proved successful in earlier packages include: trade-finance facilities, on-lending, project financings, new-money bonds, debt-equity conversions and co-financings with the World Bank, and perhaps, with regional development banks, such as the IDB.

With the exception of co-financings, all of these options are negotiated solely between the restructuring country and its creditor banks. Unlike enhancements for debt reduction, they do not involve any public funds.

I am further concerned over significant increases in arrearages in interest payments to commercial banks by a number of countries, since the adoption of the current strategy. In some cases, this development may reflect a perception by those countries that the current strategy condones their use of arrearages as a form of external financing. The international financial institutions, for example, in some cases have broken with previous policy and disbursed funds to countries that are in arrears to commercial-bank creditors. The international financial institutions are beginning to see, however, that arrearages to commercial banks can also stimulate arrearages to them.

The arrearage problem, if not addressed satisfactorily, will have important ramifications for both creditor banks and indebted countries. Last year many creditors increased their loan-loss reserves, significantly reducing earnings. Some of them cited mounting arrearages as a major reason.

Of the three countries that have negotiated debt-reduction agreements under the changed strategy, Mexico and the Philippines were fully current on interest, and Costa Rica, though in arrears, was making regular partial payments. The Costa Ricans agreed, as part of their commercial-bank package, to clear arrearages through a 20 per cent downpayment, a repayment schedule without grace period and a rolling three-year interest guarantee on past-due interest. This part of the agreement with Costa Rica demonstrates the importance that banks place on resolving pending interest-arrearage problems.

Continuing arrearages will make it increasingly difficult to complete future commercial-bank financing packages for the countries in question and therefore will retard their programmes of economic growth and reform.

The combination of voluntary debt reduction and some new money, where needed, is therefore the most promising way out of the debt crisis. This formula can be successful only if accompanied by demonstrated progress by the countries, in reforming and opening their economies and encouraging local savings and direct investment.

Given the problems and uncertainties that I have outlined, I believe that the current strategy has positioned the debt crisis at a turning point.

If not managed carefully, the strategy could undermine the progress to date, and leave future financing for much of Latin America entirely to governmental sources. If managed carefully, however, with a renewed emphasis on cooperation among all parties it could alleviate the situation and set the stage for the eventual return of some of the restructuring countries to the private capital markets.

B. How a Major Creditor Views the New Proposals

[olyon Larkman

ɿefore dealing with the Brady proposals specifically, ɜt me say that the commercial banks in addition to enerating ideas themselves have been, and remain, ɛceptive to new ideas on how the debt of rescheduling .DCs should be managed.

'hat is not to say that we will not appraise each idea in professionally critical fashion. Neither do we feel bliged to accept those ideas merely because we have o similarly structured alternative plan. When we first ıw Secretary Brady's ideas in print we felt that they ıould be given a fair consideration. They have ɛceived such consideration and, not to put too fine a oint upon it, have been found wanting.

he Problems with Brady

'e have five major points of issue with the Brady an:

The significance of the relief ultimately accorded to e LDCs and HIMCs needs to be questioned riously.

There is a high risk of sending the wrong signals to e borrowers — good and bad alike.

) It requires only one credit group, the commercial ınks, to take a hit.

) It is based upon a major misconception regarding e banks' role as providers of medium and long term ıance for LDCs and HIMCs.

It seriously understates the degree of public sector ɜponsibility by largely ignoring the part played by vernment policies in exacerbating the debt crisis.

fore dealing with each point separately, I would ıke the 'umbrella' point that all these factors coming ɜether as they do under Brady produces a most satisfactory result, in that it raises expectations in btor countries to unrealistic levels that will be ficult to meet. Furthermore, it threatens to divert ention away from what we consider to be the most portant ingredient of the process and that is the orm efforts and structural adjustment in the lebted countries themselves.

'take each point in turn:

Significance of Relief

ere must be considerable doubt whether indebted ıntries' expectations in terms of the quantum of relief they will receive by way of the Brady proposals can in fact be fulfilled. My economist colleagues have undertaken a study which shows that for the four major Latin American debtors, Argentina, Brazil, Mexico and Venezuela, savings in cash flow terms over the period 1990-92 are likely to total some US$12 bn or just over 17 per cent. For the purpose of their studies, relief was front loaded but the final picture could emerge somewhat worse, as no account was taken of any increase in interest payments to the World Bank or IMF on the funds used in debt or debt service reduction schemes.

This leads to the somewhat anachronistic feature of the Brady plan, new money is to be coupled with debt relief. It makes no commercial sense for a banker to incur losses through debt and debt service reduction on the one hand and provide new money (which may feed through with further buy back schemes, bearing in mind the fungibility of money) on the other.

It is at this point that we should also explode the myth of returning flight capital. Although claims have been made that flight capital is returning to Mexico, I do not know how this is being measured as its departure in the first place can at best only be 'guesstimated'. Flight capital only returns once a track record of stable economic management has been established. Frankly this will take years.

ii) The 'Wrong Signals' Risk

There is a significant risk that countries benefiting from debt and debt service reduction may interpret this as the first step along a road leading to a more generalised form of debt forgiveness. (Banks are into debt for equity, debt for goods but most emphatically *not* debt forgiveness).

There is a risk also in respect of those countries that have fulfilled their payment obligations, often at considerable cost. Where is the incentive for them, the virtuous, to continue making such payments? This is coupled with a matching risk that banks, as a result of their debt and debt service reduction experiences, will be less inclined to support even those LDCs whose loans are still performing, thus precipitating further rescheduling requests.

iii) One Creditor Group Participation

It is apparently only the commercial banks who are to be considered as contributors by way of debt and debt service reduction. There is a general assumption that all official sector exposure is maintained at its full face value. But, apart from the question of public sector responsibility, the issue of debt relief is too large for it to be borne solely by one creditor group. The multilaterals and governments have preached continuously over a number of years to the commercial banks about burden sharing. They too should be prepared to practice what they preach.

iv) The Misconception of Banks' Roles in Financing LDCs

The official sector has failed to recognise that the withdrawal of the banks from this type of financing, far from being an aberration, is a return to the traditional style of relationship between countries and the commercial banking community. This is one based primarily on the financing of trade.

The explosive growth in medium term bank exposures to LDCs resulted from two oil price shocks. The official sector was more than happy to stand by and watch the banks recycle oil surpluses. Economist colleagues tell me that from 1966-69, on average, bank lending accounted for 13 per cent of the major Latin American borrowers' debt. This expanded to 44 per cent in the 1974-77 period and leapt further to 55.6 per cent in 1978-81, just prior to the crisis breaking. It peaked at just over 63 per cent in 1984 after we put in all that new money, a fact often conveniently overlooked in the US Treasury, and since then it has fallen below 60 per cent. In my view, this figure will continue to fall as banks restrict themselves to financing short term trade and limit medium term exposure to projects likely to generate hard currency to meet servicing costs and ultimate repayment.

v) Public Sector Responsibility

The economic environment facing the LDCs was not of the commercial banks' making. The greatest influence arose from policy decisions made primarily within the OECD. Creditor country governments actively encouraged the recycling by commercial banks of petro dollar surpluses, not once but twice.

Floating rate debt, sustainable in the 1970s, became increasingly expensive for the LDC borrowers in the 1980s. The rise in interest rates was part of a policy framework in industrial countries, the US in particular, designed to combat the inflationary impact of the second oil price shock primarily through a tightening in monetary policies. It is arguable that the increase in interest rates went well beyond levels we could reasonably have anticipated when the funds were originally lent. Indeed, the high real rates have not proved a temporary phenomenon and, whilst precise linkages may be difficult to prove, I believe that strong connections exist between the high interest rates and dollar volatility of recent years and structural imbalances in the OECD, most notably the twin US deficits.

Leading on from there, surging nominal and real interest rates in the early 1980s were major contributing factors to the downturn in OECD economic activity. One estimate calculates the impact on non-oil LDCs of global recession and higher interest rates in 1981-82 as exceeding $140 bn.

Recession fuelled the fires of protectionism, and there is no doubt that its growth in industrial countries has made it even more difficult for LDCs to achieve the level of export growth needed to meet the debt service bill. Protectionist pressures have not abated and according to estimates made by the World Bank, such pressures will have cost LDCs at least $60 bn in 1989, almost ⅔rds of their projected interest bill of $100 bn.

In the face of such evidence, it is hard to see how the commercial banks can accept the burden alone and a positive outcome still be anticipated.

Where Next?

The limited ability and willingness of the commercial banks to extend new finance to the LDCs should be quite clear by now. We do not question the desirability of foreign policy goals such as the spreading and strengthening of democracy, but it must be accepted that banks are commercial institutions and our operations must reflect our primary obligations to depositors and shareholders. Writing off debt concurrently with lending new money makes no commercial sense whatever.

Accepting that the banks will return to their more traditional roles of trade and project financing, this leaves the long term financing gap to be filled. The return to private direct investment offers, in my view, the greatest potential for channelling resources to the LDCs. These flows however, will only arise once the adjustment process is well bedded in and consistent economic performance established. In the meantime, the official sector will have to assume the burden if only for the reason that the twin problems of debt and development are too important to be left entirely to bilateral negotiations between commercial bank creditors and debtor countries.

C. The Time is Ripe*

Alfred Herrhausen

Efforts are no longer centred on rescheduling and fresh money actions, but on debt reduction and debt service reduction, i.e. debt relief. This takes account of the changed perception of the problem's structure and of the fact that a solvency crisis cannot be overcome by making the insolvency criteria, i.e. the debt burdens, even heavier. This insight represents a hope-inspiring breakthrough towards a new type of solution after a ong period in which, for quite understandable easons, it was taboo even to think of debt relief as a possible strategy.

But the question arises as to whether a strategy which s more likely to produce a solution can now be leveloped and realised on this new basis. The risk that his will again not succeed, despite the more realistic onceptual approach, is obvious.

'he banks are now called upon to embrace the basic bjectives of the Brady initiative and proceed with ieir implementation. For this to happen, however, enerally valid positions will have to be formulated 'hich allow scope for tailored refinements in specific ises and concrete measures within a broader range of ptions. Quick and resolute action is imperative.

/hat is to be done? One can hardly ignore the weakest nk in the chain because that would mean waiving the dispensable solidarity of creditors.

ut one may ask whether these links do have to ibsist. The answer to this is: no. Two of them are, as it ere, 'amenable' to reshaping, i.e. surmountable to a :gree conducive to solving the problem. These two e the connected scenarios of the creditor banks and eir governments and supervisory authorities. The fferences within these scenarios can be eliminated by cisions on the part of those involved; they can be velled'. The result of this would be that all links in e chain on the creditor side would become equally 'ong in terms of the described criteria, and a ›mmon denominator' would be possible, which, in ms of quality and quantity, would be adequate to : debt problem and thus this time — at least on the le of the lenders — bring a solution within reach.

is common denominator should be structurally complicated and take effect quickly. It should be expressed in a general offer from the creditor banks, supported, i.e. made possible, by 'their' governments and supervisory authorities and be available to all debtors who 'qualify' for it.

Which debtor countries 'qualify' in this sense would have to be decided by the Bretton Woods institutions, i.e. World Bank and International Monetary Fund. They would have to examine very closely what economic policy means the debtor governments intend to use to solve their economic and political problems, i.e. overcome their insolvency crisis, and thus practise effectively and on a lasting basis the 'self-help' that is to be shored up by the help of the creditors. *Conditionality would remain indispensable as the basis for any accommodation by lenders; its fulfilment would be the decisive contribution to solving the debt problem!* Conditions would have to be defined on a case-by-case basis, and their implementation, as agreed, monitored by the Fund and the World Bank.

So there are two things that debtors must do: develop and put forward an adequate economic programme and implement it with resolve. This complex cannot be dismantled. It can only be surmounted through the application of efficient economic policy measures; it must be 'worked off' — using the resources released as a result of the bank creditors' offer.

What form could such an offer take? It should consist of three parts and focus on the three criteria which characterise any debt:

a) amount

b) interest rate

c) maturity

It should also envisage a series of phases, i.e. be given a sequential structure, in order to allow adequate monitoring.

The negotiation basis could be as follows:

1. During a five-year period, the interest rate on original indebtedness will be reduced in stages to e.g. 70 per cent, 60 per cent, 50 per cent of its present level (with the exception of specified obligations, such as short-term trade financings). During these five years, the creditor banks — where they have not already done so — will create tax-deductible provisions in respect of their capital claims in the amount of up to 50 per cent. Provisions already created by some banks in excess of this rate will, of course, remain unaffected by this.

2. After five years, interest rates will be restored to the then prevailing market level in order to bring the debtors back into the normal international interest rate context. At this juncture, capital claims representing original indebtedness will — always assuming that conditionality has been complied with — be reduced, either immediately or in stages, to e.g. 70 per cent, 60 per cent, 50 per cent, as relief and with recourse to the provisions which have meanwhile been accumulated.

3. The maturity of loans outstanding at the start of such a scheme will be fixed generally at 25 or 30 years, with a grace period of five to seven years.

Creditor banks which feel that they are currently unable to participate in such an offer will basically have the option of contributing by means of new money. Apart from recycling interest payments, such banks will also enjoy a variety of other options.

In addition, agreements with debtors should include the following features:

— An option to issue convertible bonds in currencies other than the US Dollar.

— Betterment clauses which would take effect in the event of a particularly favourable development in a debtor country's external economy (due to factors like the price of oil or the level of interest rates).

— 'Claw-back' clauses which would take effect in the event of non-compliance with conditionality.

The material effects of debt relief of between 10 per cent and 50 per cent for 15 highly indebted countries show that the arrangement I have described would put the countries concerned in a position to switch a considerable volume of resources so far earmarked for debt service purposes to areas which would help put their domestic economies back on a healthy footing. It has been pointed out repeatedly in the debt debate that the borrowing countries need money for their ongoing development. It would be more correct to say: they need resources. Because what they do not need under any circumstances is new debt; the simple reference to the need for money fails to make this critical distinction. The changed allocation of resources, made possible by this offer from the creditors, could be of great assistance: the biggest debtors' 'savings' may be larger in the first five-year period than the fresh money injections they have so far requested. They will obtain net resources for therapies that will support economic recovery. Here, the debtor countries have the special responsibility to correct the distortions which have arisen in production and debt as a result of excessive weight given to their public sectors. Debt/equity swaps, privatisations and further measures to strengthen the private sector should therefore remain important elements of the still valid menu approach.

The international creditor banks' offer, the basic structure of which is outlined above, presupposes, if it is to materialise, that the responsible state authorities make it possible. By means of appropriate fiscal and accounting legislation, they must harmonise the starting situations of the banks involved with respect to the debt problem. This means in concrete terms: firstly — the provisioning required under the offer described must be tax-deductible, i.e. eligible for deduction from taxable income. Secondly — these provisions must be accorded the status of a provision *sui generis* in that capital resources remain unimpaired in the year they are utilised.

Over and above that, a further arrangement could be examined: such generous 'help towards self-help' by the creditor banks raises questions in two directions — forwards (into the future) and backwards (into the past). As far as the future development is concerned, it probably has to be assumed that any further capital requirements on the part of debtor countries can no longer be met in the foreseeable future, with assumption of the full credit risk, by the banks which now participate in the debt relief scheme. Here, the Bretton Woods institutions and/or the governments of the industrialised nations would have to provide the funds required. At best, the banks would sustain their engagement in short-term trade financing, project finance and co-financing.

As far as the past is concerned, the banks face the question as to the value at which they should report in their balance sheets claims remaining after possibly granting partial debt relief. In principle, of course, their value depends on the creditworthiness of the debtors. But as this creditworthiness does not exist at the present time and the actual purpose of the approach described is to initiate its restoration, there will still be a risk for some time, a risk which the banks should take account of at their own discretion by creating provisions. Appropriate guarantee commitments from creditor governments (credit enhancement) could cover this risk for as long and insofar as the creditworthiness of the debtors has not been restored.

One can therefore establish that:

1. A debt service and repayment relief offer would be in keeping with the insolvency character of the debt crisis.

2. Such a general offer on the part of the creditor banks would put their involvement on an equal footing.

3. A *conditio sine qua non* would be the creation of appropriate tax and regulatory regimes by the governments and supervisory authorities responsible for the creditor banks. This would then harmonise banks' starting positions.

4. The Bretton Woods institutions and/or the governments of the industrialised nations would have

'his section has been extracted from the Deutsche Bank nslation of an article 'The Time is Ripe — Debt Crisis at Crossroads' which was originally published in German in ındelsblatt' No. 124, June 30, 1989.

to meet any further capital requirements on the part of debtor countries (with exceptions such as short-term trade financing), as long as market forces, including autonomous movements of private capital belonging to the countries themselves, do not begin to work.

5. The residual claims of the banks could be secured by credit enhancement.

Assuming this overall scenario, the future problem structure of the international debt crisis will be concentrated on the following criteria:

The 'help towards self-help' from the banks involved would take effect in the form of interest rate reduction immediately after the World Bank and the Fund confirm qualification. With regard to the relief on principal foreseen for later on, the banks will have enough time to take the necessary balance sheet measures.

There still remains the debtor's duty to qualify, i.e. precisely those problems which form the actual core of the crisis are still there. In the discussions which will have to take place between Fund and World Bank on the one side and borrowers on the other, the subject of negotiation will no longer be debt, but economics, i.e. the only field that can eventually give us a once-and-for-all solution to the debt crisis: the right economic policy strategies! They cannot be superseded, but only supported — here and there perhaps made possible in the first place — by 'accommodative action' on the part of the banks. But if such policies are not successfully established and implemented, there will be no solution! This fact places a heavy burden of responsibility on the negotiating partners involved. At the World Bank and the Fund, this will lead to what is virtually a standing international economic conference, the results of which will decide the fates of entire countries.

The creditor governments, for their part, should clearly recognise the geopolitical relevance of the new phase of the debt crisis and accept it by assuming an obligation of their own. The distribution of roles, to be understood in appropriate dimensions, between banks and governments transcends 'burden-sharing' — i.e. support of the Bretton Woods institutions, adjustments in the banks' legal/tax environment, generous reschedulings by the Paris Club and a flexible policy on the part of national export credit insurers — and must have qualitative and political substance. In view of the urgency of finding an effective solution this time, reproaches such as 'bailing out the banks' are inappropriate. They are incorrect anyway. If it is argued that by participating in the losses incurred by the banks, the state is thereby putting some of the burden of these losses on society as a whole, then one should be fair and admit that society as a whole also continually benefits from banks' profits, because the state is always, unavoidably and rightly so, one of the main recipients of a portion of these profits through income taxes. It is the typical characteristic of a balanced taxation system that good and bad are shared: profits and losses. The socialisation of negative company results corresponds to the socialisation of positive results.

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D. Joint Memorandum to the Treasury and Civil Service Committee*

Sir Kit McMahon and Sir Jeremy Morse

(A) What is Your View of the Brady Plan for Mexico?

Perception of Brady Initiative

In the aftermath of the launch of Secretary Brady's Initiative, the process of debt rescheduling has been destabilised and debt service disruption increased. Ultimately the success of the debt strategy will hinge on the ability of debtor nations to implement economic programmes which reaccess — on a total voluntary basis — international capital markets. Against this objective the ambitions of the Brady Initiative look vulnerable. In particular the Initiative has:

Heavily underplayed the need of developing countries for new lending, not only to fill financing 'gaps' but also to achieve growth and thereby attract investment. The unwillingness of banks to provide new lending reflects a radical change in attitude and calls into question the future source of funds to meet the needs of the developing nations;

Raised expectations of both performing and non-performing debtors for debt forgiveness to an unobtainable level but has failed to provide resources on a matching scale;

Placed excessive emphasis on promoting debt forgiveness which is not an end in itself and will not, in isolation, restore sustained growth and ensure access to capital markets;

Provided the wrong incentive to countries, encouraging delinquency in debt servicing and forestalling economic adjustment plans in the expectation of winning debt reduction. The better managed countries are disadvantaged;

Created a view within the banking community that debt reduction or debt service reduction aimed at bank lending in isolation is not an equitable sharing of the burden;

Broken the earlier link between IMF finance and the maintenance of interest payments to banks (the Fund will now advance credit to a country even if it is in arrears to its bankers).

Mexico Financing Package 1989-92

In the period which has elapsed since the launch of the Brady Initiative on March 10, 1989, the creditor community has focused on Mexico as a test case.

The resulting financing package agreed between Mexico and the Advisory Committee representing commercial banks has been resisted by the wider banking community to the extent that commitments to provide a balanced response to the country's invitation have been found lacking. The dearth of new lending from the banking community reflects two major flaws in the Brady Initiative.

These are:

— the unwillingness of commercial banks to provide new lending:

The success of a Brady-inspired package rests on an appropriate measure of debt reduction and debt service reduction, accompanying a supply of new lending. Any proposal to prioritise the dual aspects of debt reduction will result in an unbalanced menu of options and the incompatibility of new lending and debt forgiveness.

Excessive emphasis on debt reduction will mean that many banks which pursue that route will consider themselves to have exited from a country and will not expect to be called upon for additional financing of any kind in the future. Lenders may seek to withdraw any remaining voluntary trade and interbank lines.

— the scale of debt reduction:

The response to the Mexican package is estimated, at best, to save the country less than $1 bn in external interest payments each year. This is equivalent to around 10 per cent of Mexico's total interest payments to external creditors and cannot, in isolation, be expected to have a major impact on growth prospects.

The projected saving on external debt service equates to about 5 per cent of domestic interest payments and, therefore, will only have a marginal impact on the country's ability to meet domestic obligations.

Though the Mexico proposal is the largest of its kind so far attempted, the scale of achievement is insufficient to have a material impact on the country's economic prospects. As a result the Brady Initiative barely scratches the surface of the Debt Crisis.

* This section has been extracted from a slightly longer joint memorandum submitted to this House of Commons Committee, dated 17th January, 1990.

IDS Bulletin, 1990, vol 21 no 2, Institute of Development Studies, Sussex

Contribution of Creditor Community

Once the problems confronting a country have been diagnosed then a solution should be tailored to meet the specific situation. New lending or short-term debt service reduction would be appropriate to cover a liquidity shortfall whilst debt reduction is needed when the country's solvency is at stake.

On the occasions that it is considered necessary to provide a wide ranging menu of options then voluntary debt reduction and debt service reduction, debt buy backs, new lending by banks and measures to attract private capital must be promoted as an integral package. Focus on any one component to the exclusion of the others will undermine the whole effort.

In this regard it was encouraging to hear Mr. Brady, in his speech to the IMF in September 1989, state:

> Several countries . . . are already working toward new financing packages consistent with the strengthened strategy. As they discuss their needs and options with the international financial institutions and banks, their varied interests have become increasingly clear. While reducing debt burden has been the emphasis of many, new financing is still important for many countries. Although the elements and the mix will vary from case to case, it is important that there be a proper balance between new money, debt and debt service reduction.

Therefore, new lending must be attracted through a more flexible stance in the provision of enhancements. Resources allocated by international financial institutions should be totally fungible and used in whichever way ensures maximum benefit to a country. To ensure that the impact of an agreed financing programme is at a level which strengthens a country's economic prospects the Brady Initiative should extend beyond bank borrowing and capture the debt owed to the official sector. Rescheduling or restructuring this exposure through the Paris Club is no longer sufficient.

The longstanding debt crisis can only be resolved through cooperative effort and an equitable sharing of the burden. The political will of industrialised countries to participate in the solution — through the commitment of a meaningful amount of resources — appears to be lacking.

(B) What Role should Government and the Bank of England respectively play in relation to Debts to Commercial Banks owed by Other Countries?

(i) Government

HM Government has adopted a low profile in the debt crisis and appeared slow to react when the Brady Initiative was launched. Chancellor Lawson emphasised his opposition to any solution which transferred the problem from the private to the public sector and initially resisted the use of IMF/IBRD funds to support interest reduction programmes.

Eventually the Government relented but, along with certain other G7 countries, insisted on a strict set of guidelines governing the use of resources devoted towards enhancements. The guidelines are seen by many banks to be unhelpful to the smooth implementation of debt relief programmes.

Any suggestion that under the Brady Initiative the official sector is taking over the burden from the commercial banks must be dispelled.

Indirectly and through the multilateral institutions, the Government should ensure the continuation of adequate economic programmes in debtor countries and adequate conditionality between such programmes and financing packages.

Another major role played by the Government is through the Paris Club. In this area the Government has made it clear that requests for rescheduling of principal and/or interest from Third World countries will result in exclusion of that country from additional financing. In an environment in which the commercial banks are actively involved in rescheduling and are now being confronted with involuntary debt reduction it would be helpful to have a more relaxed attitude on the part of Paris Club members towards maintaining rescheduled countries on cover.

An equitable sharing of the burden would demand that Paris Club lenders afford debt relief alongside commercial banks.

It is recognised that on occasions a third-party can usefully mediate between debtor and creditor, but it is regrettable that the political interference of the US authorities in the negotiations between the Bank Advisory Committee and Mexico reached unacceptable levels.

(ii) Bank of England

The central role of the Bank has predictably been one of prudential regulation. The principal feature of regulation is the Matrix which is accepted by many as logical and one of the more rational approaches to the problem.

Rather like most systems of country risk assessment used by banks, the Matrix suffers to a certain extent from being backward looking. It implicitly assumes that past behaviour is a guide to future behaviour. In an environment where debtor nation attitudes towards rescheduling and interest moratoria are influenced by official interventions such as the Brady Initiative previous patterns can be misleading.

A critical role for the Bank is to ensure that UK banks are not disadvantaged in relation to international competition through the provisioning guidelines set — the 'level playing field' concept. Under the Mexico proposals the Bank of England policy is heavily weighted towards debt reduction, whilst in certain other countries debt reduction and debt service reduction are treated in a similar manner with collateralised par and discount bonds deemed to constitute non-Mexican risk.

(C) What is your View of the Bank of England Matrix for provisioning against Third World Debt and whether the Inland Revenue should allow against Tax, Provisions for Such Debts in Excess of the Requirements of the Matrix?

(i) The Matrix

The Bank of England matrix has been very useful in providing an objective method of determining the relative riskiness of different countries through the 15 factor scoring system, though the Revenue and the banks have sometimes reached different scores.

Meetings between the British Bankers' Association and the Revenue on the tax deductibility of provisions against Third World debt have brought the Revenue from a position where they wanted a discount on the percentage provisions indicated by the Matrix to one where (with one exception) they broadly accept the results of the Matrix.

The exception is Brazil, where the 1988 rescheduling caused the Matrix to indicate an improvement, though the banks (and the Bank of England) believe it is an apparent rather than real improvement.

The difference of opinion over Brazil in 1988 is the only major obstacle to agreement with the Revenue of the main Country Risk Provisions for 1987 and 1988. That said, some banks contend that provisions charged in the accounts in excess of the Matrix should be allowed for tax purposes, based on the considered opinion of the bank as to the likely amount of irrecoverable debt.

(ii) The Tax Legislation

The Taxes Act 1988 states on the tax deductibility of debts:

> . . . no sum shall be deducted in respect of:
>
> (i) any debts, except bad debts proved to be such, and doubtful debts to the extent that they are respectively estimated to be bad, and in the case of the bankruptcy or insolvency of a debtor the amount which may reasonably be expected to be received on any such debt shall be deemed to be the value thereof.

The above section frequently poses problems when negotiating normal commercial bad debt provisions with the Revenue, almost always with the meaning of 'doubtful debts to the extent that they are respectively estimated to be bad', even where company accounts and other financial data are available. Differences of opinion arise as to the extent of the likely loss, often on the realisable values of the assets in the event of a liquidation.

If these questions pose difficulties in normal commercial situations the difficulties of estimating losses is greatly magnified when considering sovereign risks where governments, government agencies and the availability of foreign exchange for private sector debtors to discharge their obligations are factors to be taken into account. After all, it was said at one time that countries do not go bankrupt, but events over recent years might suggest otherwise.

The challenge, then, is to determine — with or without a Matrix — the extent to which Third World debts are bad. Whilst the Matrix can assist in setting a floor on the provisioning level, it could also impose a ceiling when dealing with the Revenue; because if they recognised the Matrix they would not reckon to allow relief on provisions in excess. On the other hand, if the directors of a bank have, after due consideration, estimated the extent of the irrecoverability of their Third World debt and provided for the shortfall, this can be argued to satisfy the requirements of the tax legislation, and even if the resultant provisions exceed the Matrix levels the relief should be given. The Revenue, though, have the right to question the basis on which the estimate of loss has been made.

(iii) A Revised Matrix

The most subjective feature of the existing Matrix is the alignment of the percentage provision bands against bands of scores. The present alignment was considered appropriate in 1987 and (presumably) in 1988, but with the increased perception of risk in 1989, many banks have moved provisioning percentages above the old readacross levels in their half yearly results, and in some cases to even higher levels since then.

The Bank of England is expected to issue a revised Matrix in the near future. It is expected that it will broadly support levels of provisions averaging around 50 per cent, i.e. the levels reached in the UK banks' 1989 half year results. Provisions above the 50 per cent level will be unlikely to be tax deductible unless the Revenue, of their own volition or under political pressure, accept the argument put forward by several of the major international banks, that their loans to Third World countries will not be recovered to any material extent. The loss may result from debt forgiveness, debt service reduction, sale of the debt, swapping for other debt or equity, or simply never being repaid.

In all these circumstances, a case could be made that losses should be allowed for tax purposes and that the relief should be given at the time that the lending bank records the estimated amount of the loss in its accounts.

BANK REGULATORS' VIEWPOINTS

A. Supervisory Attitudes in the USA*

E. Gerald Corrigan

I would like to make a few remarks about my current thinking concerning supervisory issues related to bank exposure to LDCs, including supervisory attitudes toward new instruments such as those which will be part of the Mexican financing package. Before turning to those supervisory issues, allow me to make several more general observations on the LDC debt situation. As a matter of perspective, several points are worth stressing even if in summary fashion. They are:

First, despite all the problems, the frustrations and the setbacks, I believe that more progress has been and is being made than is often recognised. Certainly, when we look at individual countries — a process which has always been at the heart of the case-by-case philosophy — there are a number of instances in which progress has been dramatic.

Second, now as in the past and in the future, sound macro and structural economic policies in the debtor :ountries are the necessary pre-conditions for lasting success. But, as in many things, necessary conditions are not always sufficient. To bridge the gap between :he necessary and the sufficient, we must keep firmly in mind that cooperative efforts between the debtor :ountries, the commercial banks, the IFIs and the :reditor countries remain essential. It is still a package deal such that if any of these groups fails to fulfill its responsibilities, all will suffer including the one that by its short-sightedness triggered the unravelling in the first instance.

Third, obviously debt reduction and debt service reduction have an important and necessary role to play in the process. However, debt reduction or debt service reduction, no matter how well conceived and executed, are not a *full* substitute for the extensions of fresh credits to the debtor countries by *both* official institutions and commercial banks. This is the very essence of the approach laid out by Secretary Brady in his speech in March of this year.

Stated differently, absent access to private sources of finance over time, the longer run capacity of the debtor countries to finance growth and development would be in further jeopardy, especially since it seems some self evident that governments in the industrial world are not willing or able to take on that task in isolation. Thus, what we need is a balanced approach to financing in which fresh credits, public and private — operating in tandem with elements of debt and debt service reduction — remain an important part of the process.

In this regard, I would note that the proposed Mexican and Philippine financing packages both contain options providing for fresh credits. In each case modest amounts of new money from the international commercial banking community will be vitally important to the ultimate success of these financing packages.

Fourth, having emphasised the importance of fresh credits, let me also stress the very considerable benefits of debt or debt service reduction. In the case of Mexico, for example, the permanent cash flow benefits growing out of the contemplated debt and debt service reduction transactions are truly significant. But, as important as the cash flow gains may be, there are other important benefits to Mexico. For example, the principal amount of a very sizable fraction of Mexico's external debt will be fully secured at maturity and it is likely that tens of billions of dollars of such debt will have an interest rate of 6.25 per cent locked in for 30 years — not an inconsequential element of protection against the vagaries of the interest rate cycle over time. Needless to say, to the extent Mexico benefits from these arrangements, it follows that creditors, both current and prospective, should also benefit. That, too, is the essence of the Brady initiative.

Let me now turn to my current thinking about supervisory attitudes toward LDC debt in general and to the specific supervisory treatment in the US of Mexican-type transactions and instruments. Let me stress that these views are a reflection of my own thinking, but they are not necessarily the last words on this subject. My comments fall into four major points:

First, the overall thrust of policy with respect to reserves against country exposures is unchanged. Banking organisations are expected to have adequate capital reserves to cover the risks associated with all forms of lending, including country exposures. In exercising this responsibility to assess the adequacy of an organisation's reserves, account will be taken of a bank's overall financial condition, focusing particularly on its asset quality, capital, and management, against the background of current and prospective financial and economic conditions. These assessments of reserve adequacy will continue to be made on a case-by-case basis.

We want very much to emphasise this case-by-case philosophy in a manner that avoids the perception that there is a single reserve or provision ratio that is 'right' for all institutions at all times.

Second, sovereign risk related provisions or reserves can be viewed in the following framework:

The measure of exposure will be the amount of credit outstanding to all countries that are 'criticised' or 'classified' by the Federal bank supervisory agencies in accordance with the appropriate provisions of US law and regulation. However, when measuring overall commercial bank exposure to such countries, it would not be unreasonable to deduct the amount of performing trade credits outstanding to all such countries. In other words, performing trade credits can be viewed as outside the framework of any special reserving or provisioning requirements. It should be noted also that there are a few countries that, by virtue of their economic and financial performance, have been upgraded from the list of criticised or classified. As such, existing and new credits to such countries can be seen as outside the need for any special requirements so long as their improved status is maintained.

The measure of reserves or provisions against exposure will include the amount of funds taken out of current earnings or charged against retained earnings for this purpose. In addition, the assessment of reserve adequacy can, within acceptable bounds, take account of prospective tax benefits available to individual banks as a result of loan loss provisions taken against such exposures.

For US banks, taxes paid are generally not reduced when provisions or reserves are *established.* However, as actual charge-offs occur, taxes may be reduced, providing the opportunity to replenish the reserve without additional charges against net income. Thus, the after-tax level of reserves can be significantly greater than the stated level of reserves. The purpose of the tax adjustment to the reserve coverage ratio is to take account of this consideration and in the process make reserve ratios for US banks more comparable with international practices. For example, based on developments prior to the current quarter, this tax adjustment factor raises the average effective reserve coverage ratio of US money centre banks by almost 5 percentage points.

The measure of reserve coverage may also take account of the *present value* of any collateral or interest guarantees growing out of Mexican-type swaps of loans for new debt instruments carrying such collateral or guarantees. For reserve adequacy purposes, it is quite reasonable to treat this amount as an addition to reserve coverage so long as the new bonds are being serviced in an orderly fashion and the guarantees are intact. This too will have the effect of raising effective reserve coverage beyond that suggested by a simple ratio of exposure to reserves.

Third, taking account of these definitions and concepts, and in circumstances in which reserves for individual banks are judged to be at acceptable levels, additional reserves need not be automatically established in connection with fresh credits extended to the debtor countries in connection with internationally supported financing programmes. Any such judgement will, of course, be subject to continuing review, a process which will become all the more straightforward in a setting in which economic policy and performance in the debtor countries is strengthened.

Finally, with regard to debt or debt service reduction transactions such as will be part of the Mexican financing package, the following additional comments will apply.

When a bank participates in debt reduction transactions, a lower level of reserves can be quite acceptable so long as the new debt instrument is booked at par and appropriately enhanced (collateralised at maturity with interest support) and is being serviced in a timely manner. In particular, where such transactions are essentially an exit instrument and reserves are otherwise at acceptable levels, the present value of the collateral and interest guarantees may suffice as adequate reserve coverage depending on the overall circumstances unique to individual banks.

In instances involving debt service reduction transactions, the new bonds may, for supervisory purposes, be booked in the investment account at par so long as the *sum* of reserves (as defined above and taking account of the present value of collateral and interest guarantees) and the 'fair value' of such bonds equals or exceeds their par value. In the alternative, banks may follow the guidance recently provided by the Securities and Exchange Commission regarding the accounting treatment of such instruments.

While other treatment of these transactions may be appropriate, banks should consult with the appropriate Federal bank supervisor regarding the supervisory and prudential merits of any alternate approach in advance of utilising such approaches.

This approach is intended to balance a number of considerations in a context of providing the maximum degree of flexibility to individual banking institutions. It starts with the premise that prudential standards must be just that — prudent. However, it also recognises that reserves or provisions are not charge-offs or write-downs. Indeed, what we are all striving for is a result in which the great bulk of these reserves will not be needed and as conditions improve banks

*An edited version of remarks by E. Gerald Corrigan before Group of Thirty, Washington DC, September 25, 1989.

will be able to recoup elements of such reserves into future income or devote them to other prudential purposes. Aside from these prudential considerations, the approach is designed to (1) recognise countries whose performance has resulted in their 'promotion' out of the classified or criticised categories; (2) recognise the special nature of trade credits; (3) provide very flexible treatment for debt or debt service reduction transactions of the Mexican type; and (4) provide the necessary flexibility within which banks can, consistent with their own business and credit judgements, choose new money options without having to provide further reserves so long as their overall reserve position is adequate.

There is one final point to be emphasised in regard to reserving or provisioning practices. Namely that reserves or provisions provide an important cushion against possible losses in the principal amount of bank exposure to debtors. They are, in other words, a cushion in balance sheet terms. However, reserves (or for that matter write-downs) do not reduce the bank's claim against the debtor. For this reason and others, debtors should not conclude that the mere existence of such reserves constitutes a license to ignore their fundamental obligations to their creditors. By the same token, major creditors should remain mindful that even a generous level of reserve coverage does not mean that they can walk away from the process. Neither the balance sheet nor the income statement — to say nothing of the risks to the well-being of the global economy including its implications for both the balance sheet and the income statement — would be well served by such neglect.

The months immediately ahead will not be easy. There are 10 or more developing countries in some stage of discussion, negotiation or syndication of new financing packages with official and private creditors. However difficult it may be, it should be very clear that now is not the time to cut and run. With flexibility, with commitment, and with a renewed sense of that commonality of purpose of which I spoke earlier, I believe we can and must see it through.

5TH DUDLEY SEERS MEMORIAL LECTURE

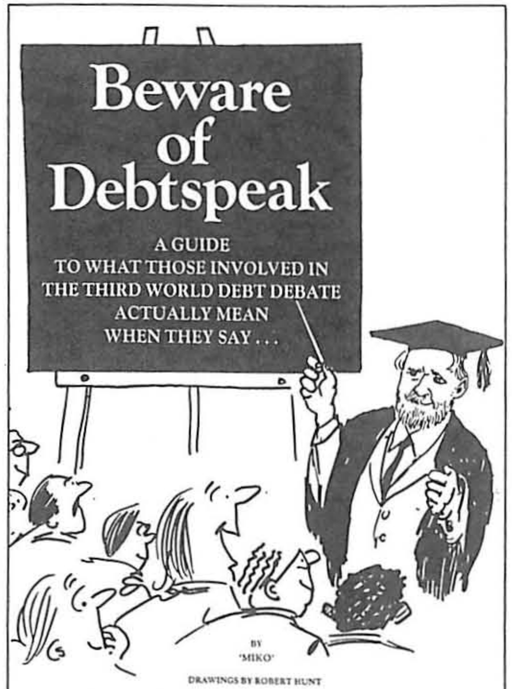
CONCILIATORY DEBT REDUCTION

WHY IT MUST COME & HOW IT COULD COME

BY MIKE FABER

DELIVERED ON 25 SEPTEMBER 1988 AT THE FREE UNIVERSITY OF BERLIN

The Institute of Development Studies at The University of Sussex



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B. The New Bank of England Rules for Provisioning

Stephany Griffith-Jones

I Introduction

In August 1987 the Bank wrote to all UK incorporated institutions authorised under the Banking Act which had exposures to countries experiencing debt repayment and servicing difficulties to encourage them to reconsider the adequacy of their provisions against exposures to such countries. The Bank of England developed a framework for objective analysis for measuring the extent of the difficulties of each country (known as the matrix). During the last two years this framework has been used as a basis for discussions between the Bank and each institution so that an appropriate level of country debt provisions for supervisory purposes can be determined.

In January 1990 the Bank of England reviewed the structure of the matrix and the factors contributing to the assessment of repayment difficulties. The Bank has also looked again at the level of provisions indicated by the matrix, bearing in mind the widespread market perception that the situation among debtor countries has on balance deteriorated. The result of this review is reflected in a number of technical changes in the matrix and *in a significant increase in the average level of provisions produced by its application.*

Besides the increase in the average level of provisioning, there are two significant changes. The first concerns the source of the minimum score of 10 from category A and B factors. Previously, evidence of *actual* default was required before the question of provisioning arose; provisioning could not be triggered by category C (economic) factors alone. The Bank now believes it right that indicators which provide evidence about the *likelihood* of debt repayment difficulties in the future, even without actual default, should be capable of triggering provisioning; therefore, while the minimum score of 10 remains, it now applies regardless of the source.

Secondly, in order to avoid sudden changes in future provisioning requirements the Bank believes that a smoothing technique should be introduced based on a moving average.

II The New Bank of England Matrix

There are three stages in the process of deciding an appropriate level of provision:

(i) to identify countries with current or potential repayment difficulties;

(ii) to identify the nature of those difficulties and the extent of the country's problem; and

(iii) to determine, at this point, what proportion of exposures to that country is unlikely to be repaid in full.

A number of factors or criteria can be identified to help make this decision. These factors can be incorporated in a matrix and weighted to reflect their relative significance for determining the appropriate level of provision in respect of an exposure.

The Bank of England groups them into three categories, namely:

A Factors which evidence a borrower's inability or unwillingness to meet its obligations, whether at the due date or thereafter;

B Factors which show a borrower's current difficulties in meeting its obligations; and

C Factors which provide evidence of the likelihood of repayment difficulties either persisting or arising in the future.

The matrix includes a total of 16 factors under these three categories. They can be applied to any country and to any type of exposure taken either in aggregate or by type of exposure. The Bank of England's aim has been to identify a range of observable factors which point to the likelihood of a partial or total failure to repay. For this reason differing levels of maximum score are attributed to the different factors, reflecting their perceived relative weight in the aggregate assessment of repayment difficulties.

The factors and the weights attaching to them are set out in the matrix attached. Only one factor (16) is to be weighted within a range according to individual judgement.

It is suggested that a minimum score of 10 is required before the appropriateness of provisioning needs to be considered.

Methods of Scoring

The total score for a country is the sum of the individual scores for each factor. Changes in the circumstances of individual countries should be taken account of by updating country scores whenever rovisioning levels are redetermined.

n order to avoid excessive volatility in the scores, the Bank considers it appropriate to take a moving average over 15 months, starting from the date of this aper, as the basis for determining the level of rovisions.

etting the Level of Provisions

nce the moving average has been determined, the Bank of England instructs that levels of provision hould be established within broad bands, shown elow:

Score	*Provision* Jan 1990
10-24	5-13%
25-39	14-23%
40-54	24-37%
55-69	38-58%
70-84	59-75%
85-99	76-89%
100-119	90-96%
120-145	97-100%

If one compares the January 1990 matrix (Table 1) with the one issued by the Bank of England in August

ble 1

January 1990 Matrix

ctors [Columns 1-3] — 'B' Factors [Columns 4-7]

mn	(1)	(2)	(3)	(4)	(5)	(6)	(7)
ition	Moratorium in effect	Rescheduled at any time in the last 5 yrs or in the process of rescheduling, or has significant transfer problems and/or a limit on debt scheduling without agreement from creditors	Second or more rescheduling during the last 5 years of principal amounts rescheduled since Jan 1983, or transfer problems recorded in Column 2	Significant arrears of interest or principal to IFI's	Arrears of principal on original or rescheduled loans from other external creditors: excluding agreed arrears	Arrears of interest on original or rescheduled loans from other external creditors: excluding agreed arrears	New money following re-scheduling to clear arrears, or capitalized interest arrears, or Paris Club rescheduling of arrears
:	0-3 mths - 2 4-12 mths - 4 12-36 mths - 8 >36 mths - 12	(12 for latter) 3-5 yrs - 6 2-3 yrs - 8 <2 yrs ago - 12	(12 for latter) 2-5 yrs - 6 1-2 yrs - 8 <12 mths - 12	<2yrs - 10 >12 mths - 15	0-3 mths - 4 >3 mths - 8 >12 mths - 10	0-3 mths - 4 >3 mths - 8 >12 mths - 10	3-5 yrs - 4 2-3 yrs - 8 <2 yrs - 10
ry	2, 4, 8 or 12	6, 8 or 12	6, 8 or 12	10 or 15	4, 8 or 10	4, 8 or 10	4, 8 or 10

ctors [Column 8-16]

	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	TOTALS	
tion	Interest service ratio	Viable import cover	Debt/ GDP ratio	Debt/ exports goods and services ratio	Not meeting IMF targets/ unwilling to go to IMF	Unfilled financing gap over next 12 months excluding agreed arrears during restructur-ing negotiations	Market price	Highly dependent on a single source of income: commodity export, single commodity based export, service earning	Other factors	TOTAL SCORE (Max 145)	PROVIS-IONING RANGE
	>15% - 3 >25% - 5 >35% - 7 >45% - 10	<4 mths - 3 <2 mths - 5 <1 mth - 7 >0.5m - 10	>50% - 3 >75% - 5 <100% - 7 >150% - 10	>200% - 3 >300% - 5 >400% - 7 >600% - 10	3	2	<70 - 2 <50 - 4 <30 - 8 <10 - 12	2			
	3 - 10	3 - 10	3 - 10	3 - 10	3	2	2-12	2	0 to 5	TOTAL	

1987, the main difference is that the scores set up in the later matrix tend to be significantly higher, particularly for countries which are very 'uncreditworthy'. For example, factor 14 (accounting for the secondary market price) now ranges from 2-12 points; in the August 1987 matrix the range was from 2-4. As a result, it becomes easier for countries to get higher scores, and thus for higher provisioning to be required against their debts.

Scope of Application

There are two alternatives:

(i) to apply the factors and resulting provisioning percentage against all claims on a country;

(ii) to apply the factors and resulting provision percentage separately to different classes of asset.

The Bank's view is that, for supervisory purposes, the percentage provision should be applied to a bank's total exposure to, including risk transfers to and excluding risk transfers from, a particular country, unless it can be satisfied that a particular claim or class of claims will be repaid in full.

This latter decision is somewhat controversial, as it would have seemed preferable to separate trade credit (so essential to sustain trade flows) and *only* to require provisioning *if* it was not being serviced regularly.

The matrix itself is attached reflecting the new scores. It has been reported that the new matrix will imply Bank of England support for levels of provisioning averaging around 50 per cent, as compared to the levels of 30 to 35 per cent provisioning set in the earlier 1987 matrix. It has also been reported that the British Inland Revenue (the UK tax authority) will accept the Bank of England's new guidelines as *one* of the factors, when calculating allowances against tax.

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Some Accounting and Tax Aspects of LDC Debt Provisioning[1]

Mitchell Hogg

Accounting Treatment

A number of accounting issues arise concerning the Mexico proposals in relation to the bonds that will be ssued to give effect to the Brady Plan.

Balance Sheet Presentation of Bonds

Although the bonds, if purchased in the secondary market, could well be classified as 'investments', I would favour maintaining them as 'advances'.

On a substance over form approach it is a rescheduled oan.

However, if it is now intended to sell the bonds or otherwise deal in them, then they should be treated as dealing investments'.

The fact that the bonds have a market price (in Luxembourg) does not necessarily mean there is a iquid market. Even if they are readily saleable, this loes not prevent them being recorded as 'advances' provided there is an intention to hold to maturity. After all, these days 'loans' can be sold.

Recorded Value of the Discount Bond

The discount bond will mature at only 65 per cent of original value, therefore the bond should not be ecorded at a value above this.

t should be recorded at the 65 per cent of original alue, less any further provision needed to reflect redit risk over the remaining life. The credit risk may e considered to be negligible as the bonds are backed y US Treasury Bonds.

ince the 35 per cent discount has been waived a loss as been 'realised' (i.e. the full 100 per cent will never ow be recovered) so this amount should be written ff against the provision leaving gross cost at 65 per ent, less further provisions as deemed necessary.

gain, an intention to deal or trade the bonds would iggest using a mark to market approach.

ecorded Value of the Par Bond

n the case of the par bond it could be argued that no djustments are needed and that the bonds continue to e shown at gross cost less provisions for credit risk. owever, I believe a yield adjustment is also needed. Due to the rescheduling arrangements the bonds must inherently have reduced value (reflecting the reduced interest rate). This amount can be isolated by comparing past and present yields. If this is regarded as a 'realised' loss then, as above, this could be reflected by writing off an appropriate amount of bond, but I do not believe this presentation is mandatory (i.e. the value reduction could be held as a provision).

However, regardless of the presentation, the write-off reflecting reduced interest income should not be taken out of the provision for credit risk (i.e. the components of the provision must be separately identified) although credit risk can be assessed on the net value after the write off for reduced yield.

Again, a trading intention would mean the bonds are marked to market.

If the bond is to be held to redemption then, assuming a write down is recognised to reflect the reduced yield of the par bond, it is reasonable to recover that discount on a yield to redemption (actuarial) basis.

However, the provision for credit risk must also be reassessed and adjusted as necessary. If the yield reduction was held by way of provision (as opposed to actual write off) it may result in adjustments within the provision, but no net effect overall.

Bonds held for trading would continue to be marked to market without regard to yield implications.

Future Provisions

Future provisions against capital and uncollected recorded income will be needed in the usual manner but, as indicated above, this is likely to be negligible for the capital element and would also reflect any guarantees of the interest element.

Technically the discount should be amortised even if the market value of the bond is below cost where the bond is to be held to maturity. However, if this is indicative of problems with recoverability then it may involve an equal increase in a provision for credit risk (as discussed above). In practical terms, therefore, the amortisation may not be recognised.

New Money

Any bank making new loans would have to make extra provisions. At a minimum, these extra provisions would have to accord with the Bank of England matrix.

Policy Statement

Ideally the policy adopted should be fully disclosed, i.e.:

- whether bonds are disclosed net or gross;
- whether immediate write off is made;
- whether discount (on par bonds) is being amortised;
- that further provisions are made where necessary.

International Provisioning

As shown in Table 1, the secondary market values of most of the main LDC debt has continued to fall.

In response to this fall, the four major clearers in the UK have made additional provisions against LDC debt over the past year as follows:

	Dec 1988 %	*June 1989* %	*Dec 1990* %
Barclays	38	48	70
Lloyds	34	47	72
Midland	33	50	50
Nat West	35	48	75

Table 1 **Secondary Market Prices for Selected LDC Sovereign Debt, 1988-1990**

	Mar 1988	*Sept 1988*	*Mar 1989*	*Sept 1989*	*Mar 1990*
Argentina	28	22	17	17	11
Brazil	47	47	34	30	26
Chile	57	60	59	64	65
Mexico	49	48	40	43	40
Philippines	51	52	41	49	49
Venezuela	53	49	34	41	39
Average for these six countries, weighted by end 1987 external debt	46	45	35	36	33

These provisions are much higher than can be justified under the new Bank of England matrix (published January 1990). For example, using the matrix, provisions against the major LDC borrowers at 31 December 1989 should be approximately 50 per cent.

Different levels of provisions are applied internationally.

For example, in Canada a matrix system sets mandatory reserves at 40 to 45 per cent. In Switzerland and Germany there are no formal rules but most major banks have provided over 50 per cent. In Japan the Ministry of Finance 'guidance' stipulates an average maximum of 15 per cent against exposure to 39 problem countries. This is to be raised to 25 per cent by 31 March 1990.

In the USA provisioning policy is very mixed, more often than not relating to the strength of the individual bank's balance sheet. Some banks have sold out of LDC debt (First Interstate, Wells Fargo and Security Pacific). Many sound regional banks have provisions in excess of 50 per cent.

J. P. Morgan recently added $2 bn to its reserves for credit losses for LDC debt, increasing provisions from some 40 per cent to 100 per cent. Only trade related short-term lending, which accounts for about 30 per cent of J. P. Morgan's portfolio to LDCs, would not be covered by the reserves.

Manufacturers Hanover Trust, Chase Manhattan and Chemical Bank have raised their provisions against LDC debt to some 36 per cent, 46 per cent and 65 per cent respectively. Citicorp is now the only US money centre bank which maintains its provisions below 30 per cent of its long-term exposure to developing countries.

Tax Treatment in the UK

Introduction

The legislation relating to how LDC provisions are to be treated for tax purposes is contained in Section 74(j) of the Taxes Act 1988:

'No sum shall be deducted in respect of any debts, except bad debts proved to be such, and *doubtful debts to the extent that they are respectively estimated to be*

[1] The information and figures in this article should be regarded as accurate as of 31 January 1990, except in respect of the figures contained in Table 1 and the comments about the Finance Bill 1990 which follow.

The Finance Bill 1990 lays down clearer guidelines concerning tax relief for LDC debt provisions. These proposals allow banks to claim tax relief on provisions up to values which approximate to the current Bank of England matrix levels. Future increases in allowable provisions will be restricted to 5 per cent of the principal sum per year from March 1991 onwards — i.e. the limit for December 1990 financial statements will be the same as December 1989. The same principle will apply to losses which are crystallised by selling debt, unless it is sold back to the debtor country when full relief for any loss will be given immediately.

Although the proposals are not necessarily as generous as banks might have wished, they nevertheless do set down some firm guidelines and also ensure that the banks will get full tax relief even if it does take a few years.

bad, and in the case of the bankruptcy or insolvency of a debtor the amount which may reasonably be expected to be received on any such debt shall be deemed to be the value thereof.'

The relevant test for LDC risk debt is in italics.

There is limited decided case law.

In Absalom v Talbot 26 TC 166,

> Lord Atkin defined 'respectively estimated' as requiring each debt to be separately valued.

In Anderton & Halstead Ltd v Birrell 16 TC 200,

> Rowlatt J. decided 'What the statute requires . . . is an estimate to what extent a debt is bad . . . Such an estimate is not a prophecy to be judged as to its truth by after events but a valuation of an asset upon an uncertain future to be judged as to its soundness as an estimate upon the then facts and probabilities'.

In Dinshaw v Bombay Commissioner of Income Tax 13 ATC 284, it was stated that,

> Continued trading by a debtor does not of itself prohibit bad debt relief.

Development of the Revenue Position

The Revenue starts from the position that:

a) sovereign risk debt cannot be bad (i.e. countries do not go 'bust');
b) secondary market prices are irrelevant in determining provision levels.

The Revenue's Statement of Practice ('SOP') dated 25 January 1983 admits bad debts relief in principle. However, it does not preclude the Revenue from going back to their starting position.

Prior to the introduction of the Bank of England ('the Bank') matrix agreements for bad debt provisions were often based on generally accepted percentages.

In 1987 the Revenue indicated that the introduction of the Bank's matrix would be helpful in agreeing allowable provisions. However, the matrix was regarded by the Revenue as having a prudential element which would give rise to the disallowance of part of any provision. In subsequent discussions during 1988 it became clear that the Revenue were looking for a close correlation between the read across and allowable provisions.

By the beginning of 1989 the Revenue had made an offer which had to be accepted by the seven leading UK banks but which could be extended to other banks. There were three options, all of which involved an agreement of matrix scores to give an agreed read across:

(a) 1987 provisions would be agreed at the lower of the direct read across or the provisions made. A similar basis would be used for 1988 and subsequently; or

(b) Discussions on 1987 allowable provisions would be deferred pending discussions on 1988. This might involve some smoothing between the two years; or

(c) 1987 and 1988 would be agreed on the basis of the 1987 read across or the actual provisions if lower.

In the event provisions for Brazil caused a problem with banks because the matrix produced a lower score in 1988 than 1987. However, under pressure from auditors and the Bank of England, banks maintained provisions for Brazil at the 1987 levels. This apparently led to the Revenue offering a refinement of the direct read across basis. The treatment of Brazil would depend on the 1989 matrix score. If the 1989 score exceeds that of 1988 both 1988 and 1989 will be based on the 1989 score or the actual provision if lower. If the 1989 score is equal or less than the 1988 score then the allowable provision for each period would reflect the score for the period or the actual provision if lower.

Further developments are awaited in the light of the provisioning policy for 1989.

The Role of Export Credit Insurance

Gerald Breach

The Job of the Export Credit Insurer

In selling overseas, an exporter will require his buyer to pay for the goods or services supplied either when the order is placed or at some date or dates thereafter. The longer the exporter extends such (export) credit, the greater the risk he runs that his buyer will not be able to pay when the due dates arrive. Exports of raw materials, consumer goods, spare parts, small items of equipment, etc. would normally be paid for on delivery or not later than 180 days from delivery. Exports of machinery and equipment and larger items would normally require the exporter to extend credit over a period of years from delivery probably ranging from two years to five years depending upon the value of the order concerned. Under such arrangements the buyer would be expected to pay a percentage with order, a percentage on delivery with the balance (usually 85 per cent) spread over the agreed credit period with payments being made at six-monthly intervals. For major exports of capital goods and for projects, even longer credit terms would be required often extending up to 10 years or more from date of delivery or date of completion of the project. Most exporters would not regard themselves as being in the business of financing the credit advanced to their buyers and would therefore look to their banks to fund the credit period either by making advances to the exporter against the security of the amounts receivable from the buyer (Supplier Credit) or by the bank themselves advancing sums directly to the buyer in order that the latter might pay off the credit as goods are delivered with the banks then being repaid their financing loan over the contractually agreed period (Buyer Credit).

In extending credit in this way both the exporter and the bank are exposed to the risk that when the time comes to effect payment, the buyer himself may be either unable to pay because of lack of funds (Buyer Default) or the buyer's country may have insufficient foreign exchange at its disposal to enable it to remit to the exporter's country the sterling or whatever equivalent of the local currency that the buyer wishes to transfer over (Transfer Delays). Other events outside the control of the exporter or his buyer, etc. import restrictions, war, etc. may also intervene to frustrate payment or contract performance. Most exporting countries now possess organisations such as the ECGD (Export Credits Guarantee Department) in the UK whose function is to insure the exporter and his bank against these non-payment risks. In most countries there is a mix of private sector and Government sector organisations fulfilling this function, with the private market concentrating its activities at the short term end of the business (i.e. up to 180 days) and the Government sector concerning itself with the medium and long term credits where the horizons of risk would normally prove unacceptable to the private sector.

In the UK, these functions are carried out mainly through the Government sector by ECGD (a separate Government Department responsible to the Secretary of State for Trade and Industry) both for short term and medium/long term credits, although the private sector does provide a measure of support mainly for short term business. The way in which official export credit support is organised can however vary from country to country. For example Eximbank in the USA is an organ of Government but acts both as an insurance operation and as a lending operation. Hermes in Germany is a private sector company but operates on behalf of the German Government in this area. EID/MITI in Japan is a Government operation coming within the Ministry of International Trade and Industry. What they all have in common, however, is that either as Government or on behalf of Government they provide insurance and financial support for their national export programmes. Not only do they come in at the beginning of the particular export transaction in this way, but also when things go wrong and transfer delays occur because of foreign exchange difficulties faced by particular debtor countries, they will then come together in concert with the Government of the debtor country to arrive at a programme for the rescheduling of their officially-supported debts. The forum for this coming together is the Paris Club.

Within the United Kingdom, ECGD operates both in the short term credit area (the Cardiff-based Insurance Services) and in the medium/long term project area handling exports of capital goods for projects (the London-based Project Group). It is the Government's intention that from April 1 1991 these two different types of business will be run as separate organisations,

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with Insurance Services being converted into a company that will progressively be privatised. This is expected to help customers operate in the expanding and increasingly competitive European market that will exist after 1992. The facilities of the Project Group will remain within Government, a decision which recognises that such business often involves very large contract values, has repayment terms spread over a very long horizon and will normally be seen as being particularly exposed to the transfer risk. For example, much of the ECGD's current unrecovered claims are the result of the foreign exchange shortages being experienced by many developing countries around the world. As at March 1989, some £4.4 bn of unrecovered claims were recorded of which some £3.8 bn were the subject of Paris Club rescheduling agreements. Normally the title to such debts will remain with the exporter but he will give authority to the ECGD to act for him in recovering that debt through the Paris Club arrangements. In the meantime the exporter will have had his claim paid by the ECGD provided it is covered under the terms of his insurance policy.

The sums involved can be huge. Over the two years ending March 31 1989 the ECGD insured £28 bn of UK export business and paid out more than £1.5 bn in claims arising from political events which in the Department's language are defined to include currency transfer delays as well as such events as war, etc. Altogether the amount at risk which ECGD carries is in excess of £21 bn and claims paid out in recent years have averaged over £800 mn per year. This much exceeds the ECGD's income from premiums of around £180 mn per year and even when recoveries of earlier claims and interest on Paris Club rescheduled debt are taken into account at around 325 mn is a vivid illustration of the serious problems which the international debt crisis continues to pose for all export credit agencies. Experience suggests that a major part of gross unrecovered claims will eventually be recovered under the Paris Club arrangements but only after a considerable delay. When the total of unrecovered claims is in excess of 4 bn, as it is for ECGD, the accumulated borrowing by the Department from the Consolidated Fund to finance the negative cash flow until recoveries are received (£1.6 bn at March 31 1989) is a substantial figure. One way of looking at that figure, which some people favour, is to say that it represents an ex post facto and unintended subsidy to the exporters of capital equipment to projects in countries which subsequently ran into grave balance of payments problems. However, this ignores the fact that ECGD continues to pay interest on its borrowings at a commercial rate and that most of the debt is the subject of inter-governmental Paris Club agreements and is thus sovereign debt, the greater part of which will eventually be recovered.

When transfer delays prevent exporters being paid in foreign currency for their goods on the project side, a country may be placed 'off cover' for certain types of business. In this context it is important for us to distinguish between 'non-performing' risks which arise when the buyer is in default and transfer delays which are the result of the balance of payments problems and policies of the country itself. We also need to distinguish between cover for medium term business and cover for short term business. By turnover some 80 per cent of exports insured by ECGD are short term, i.e. sold on credit terms of up to 180 days, but the preponderant part of the risk is from the medium and long term business. It is often the case that short term debt is serviced according to contract while medium and long term debt is not. In such circumstances a country may be 'off cover' for medium and long term finance thus making it difficult for British exporters to participate in new projects in that country while at the same time remaining on cover for short term credit. Therefore at any one time the countries hit by debt problems may be off cover. It is, however, seen as an important part of ECGD's role to continually monitor such situations and to seek to restore medium term cover as steps are taken by the host government to resolve its economic problems. It is here that the role of the Paris Club assumes a particular significance.

The Role of the Paris Club

A significant part of the LDC debt problem can be seen as a mutual problem shared between the debtor countries on the one hand and the export credit agencies as creditors on the other. In this approach, the exposure of Export Credit Agencies (ECAs) in the LDC countries, a large part of which can be described as debt in the sense that maturity dates have come and gone with no payment being made, can be regarded as an investment of mutual benefit to both parties and the question arises as how best to protect and optimise their investment by encouraging economic growth in the debtor country.

The approach taken, a mix of debt rescheduling and a controlled flow of new credits, seeks to preserve ECA interests in a way that continues to benefit both parties. The main thrust of the argument therefore is the function of the Paris Club on the rescheduling front and on the reopening of officially-supported credit to rescheduling countries.

As explained, ECAs will normally continue to provide support for the classes of debt not taken into debt rescheduling. If, as is usually the case, short term debt is excluded from any rescheduling, agencies are likely to go on providing cover for such credits reasonably secure in the knowledge that this class of business at least will be serviced and turned over freely. The same considerations would apply if, for example, public sector debts only were rescheduled leaving private sector debts to be serviced on due date.

More often than not the agreement will relate to all classes of medium term credits which will be further broken down into arrears on recent maturities, new maturities over an agreed forward period and, all too sadly these days, arrears on previously rescheduled debt.

The communique following the Toronto Summit meeting represented something of a breakthrough. First it recognised that Paris Club creditors had already introduced a policy of extended grace and repayment periods for the poorest debtor countries. The key development was the willingness to offer a menu of concessional rescheduling interest rates, longer repayment periods at commercial interest rates, partial write-off of debt servicing obligations during the consolidation period or a combination of these options. The intention is to allow official creditors to choose options consistent with their legal or budgetary constraints.

The menu approach heralded a departure from the normal Paris Club requirement for rescheduling terms designed to ensure equal burden sharing. However it was still intended that the range of options should be available within a framework of comparability or equal effort.

After the Toronto Summit attention switched to the Paris Club which represents a somewhat greater number of creditor countries. There was sensitivity that the smaller countries not represented at Toronto would not wish to be told what to do by the major creditors. In fact most of the smaller creditors adopted a positive attitude and ironically some of the difficulties which emerged when trying to work out the technical details came from some of the larger.

Creditors will indicate which particular option they will apply as part of the multilaterally Agreed Minute which records the outcome of individual negotiations. They will be able to choose different options on a case by case basis and they can provide a combination of measures, perhaps differentiating between different types of debt.

There has been some discussion of the precise eligibility criteria to be used to determine which countries should benefit. However, the Paris Club, whilst laying down guidelines such as:

i) high debt service compared with export income;

ii) sufficiently poor to qualify for IDA credits;

iii) adequate efforts being made to service debts;

iv) adherence to an IMF adjustment programme;

will not provide special terms automatically to any debtor. The countries of sub-Saharan Africa are prime candidates for consideration but the decision will continue to be taken in the Paris Club on a case by case basis.

The Resumption of Cover

Turning to the question of new ECA credit flows in respect of LDC countries which have had recourse to debt rescheduling: the effect of rescheduling on the agencies is normally to bring about a suspension of further cover for the country in question at least so far as the class of debts being rescheduled is concerned. By definition such cover would probably already have been reduced to a minimum if not withdrawn altogether as the economic situation in the country in question was seen to be deteriorating and moving towards the need for a rescheduling of ECAs' existing exposure.

Most ECAs, however they may be structured, follow a fairly common pattern of country risk assessment and controls which are a mixture of premium rates, ceilings on exposure, restrictions on the type of business or size of contracts that will be covered and ultimately the phasing out of cover altogether. By the time of an approach to the Paris Club, therefore, an ECA would already have run down its ability to accept new exposure to a minimal level.

The rescheduling arrangements associated with the putting into place by the debtor country of an economic recovery programme on the back of an IMF Standby Agreement or similar arrangement, the parallel commercial bank debt relief arrangements and the possible World Bank lending programme, will then create an environment which will lead the ECA to address the question of a resumption of cover for the country in question.

This compares with the previous approach whereby resumption of cover would be considered only after the debtor's creditworthiness had been re-established and a good debt repayment record built up which could often mean a gap of several years before cover could be restored. This policy came under scrutiny in 1984 due to the scale and severity of the debt crisis and the need to offer debtors an incentive to enter into policy adjustment programmes in concert with the IMF etc.

In the case of ECGB, this meant that towards the end of 1984 a decision was taken to allow cover to be resumed much earlier than before for selected countries which had rescheduled their officially guaranteed debt and who were adopting vigorous adjustment policies in conjunction with an IMF programme. The approach was intended both to help UK exporters maintain a stake in overseas markets which were in the process of recovering from debt service difficulties and to assist such countries' recovery efforts by providing export credit support for essential imports.

The criteria normally employed by ECGB when considering a rescheduling country as a candidate for this resumption of cover are that the debtor country must be committed to a readjustment programme supported by the IMF, that the Paris Club rescheduling negotiations must have been completed and a bilateral agreement signed with the UK and that the recovery programme embarked upon provides a reasonable prospect of current payments and debt servicing commitments being honoured given the relief afforded through the Paris Club and other associated rescheduling agreements. In applying the cover it would be expected that the credit support be related to exports of UK goods and services showing an early contribution to the foreign exchange earning capacity of the debtor country and its economic rehabilitation.

Large capital goods projects requiring lengthy lead times and pay back periods so far as the foreign exchange earning benefits were concerned would be the subject of one off consideration and we would expect such projects to be endorsed and preferably supported financially by the World Bank as relevant to the recovery programme.

This combination of Paris Club relief, on more favourable terms than in the past for the poorest debtors, and support for new flows of growth related credits against the criteria outlined will constitute the main plank of agencies such as ECGD in their contribution towards the management of the LDC debt problem.

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Japan's Attitude Towards External Debts of Developing Countries

Masahiko Agata

Introduction

Japan, having grown to be a major figure in the world economic scene and having persistent current account surpluses, and now determined to realign its economy toward one in better international harmony and to assume a relevant role in the multilateral efforts to re-establish the world's stability and growth, takes the contemporary debt issue as an important area where it should address its care and resources most positively, not for the benefit of only a few (nationality-, industry-, and entity-wise) but in the broadest possible global context. This paper intends mainly to discuss how its official efforts are being done and how an agency which plays a major part in such efforts acts. It does not represent the official view either of the Export-Import Bank or of the Government of Japan but purely that of the author, where opinions are offered.

The Contemporary Debt Issue

Is It Just a Question of How the Existing Debts be Dealt With?

In retrospect, the debt problem of developing countries had the most crucial stage in the 1970s — more specifically after the 1973 'oil crisis'. The abrupt increase in oil prices brought to the non-oil producing developing countries a drastic increase of their current account deficits, and the developed countries, also plunging into adverse balance of payments, were able to allow only a reduced flow of their official funds, more of which would otherwise have gone to compensate for the developing countries' widened deficits. The 'oil money' deposited with private money centre banks enabled a dramatic increase of commercial loans, notably syndicated loans on a floating interest rate basis to occur, and that in turn enabled the developing countries' undwindling appetite for investment to be met. The amount of private source funds borrowed by developing countries shot up from US$ 3.0 bn a year (average) during 1971-73 to US$ 13.8 bn a year during 1974-76. The subsequent rise in dollar interest rates, together with the shift of major commercial lenders' attitude toward more conservative balance sheets, pushed the developing country debtors toward the shorter-term finance that was available or to negotiated reschedulings with their creditors. Once news of a country's rescheduling became known, investors in that country were swift to precipitate in the flight of their own capital too.

This sequence prompted the realisation that developed nations need to maintain uninterrupted flow of financing toward the developing countries. In the autumn of 1985 the then US Secretary of the Treasury announced the so-called 'Baker Initiative' in which he stressed the importance for debtor countries to be seriously engaged in their economic restructuring measures while he called for creditors to be flexible in providing *new money* to an extent that would permit debtors to sustain growth. The Japanese government accepted the initiative positively as one that addressed the issue rightly; i.e. making a *dynamic approach* placing an emphasis on enabling the debtors' economies to be active and helping them return to the reproductive spiral. To date, this *dynamic approach* has not changed as the mainstay in Japan's debt strategy, in the belief that developing economies have a fair chance to attain a path of self-sustaining growth if they follow the lessons particularly of the Newly Industrialising Economies (NIEs) which proved their potentials by achieving and maintaining healthy and, indeed, remarkable growth through raising export-oriented industries.

If there was a weakness in Mr. Baker's concept, it was perhaps in the degree of expectation and the selection of method for the commercial banks' tolerance in providing new money while putting up bad-debts provisions for the same debtors. The 'New Baker Initiative' of late 1987 encouraged the use of new techniques; e.g. debt-equity swap and debt-debt conversion, etc. It was an attempt to broaden the choice of applicable means and to tap resources in addition to the conventional form of new money. The proposal made in 1988 by Mr. K. Miyazawa, then Minister of Finance of Japan, was based on a similar approach. He drew up a three-point plan calling for (1) agreement between the indebted country and the IMF on a medium-term structural adjustment programme, for which an Expanded Financing Facility (of the IMF) would be made available providing the base for two accompanying actions; i.e.

(2) increased financial flows from both multilateral- and bilateral-institutions, and

(3) splitting the existing obligations to private creditors into two; one being converted into bonds and the other rescheduled, both supported by the IMF-controlled special reserve account set up by the debtor as collateral (or 'credit enhancement'). The 'Brady Initiative', announced in March 1989, turned out to have much in common with this Miyazawa Proposal.

In parallel to such evolution, there were on-going efforts by the government of Japan to accelerate the increase of its Official Development Assistance — a medium-term plan to increase it to an equivalent of 1 per cent of GNP, or to US$50 bn, within a five year-period, shortened from the original seven years, and in May 1987 there came 'Emergency Measures', an announcement comprising principally the 6,000 bn yen-worth of measures to stimulate domestic demand on the one hand and a programme to have US$20 bn[1] of the accumulated current account surpluses rechannelled (recycled) to the developing areas in the world on the other. The latter, named the 'Recycling Programme', has become one major and yet unique source of *new money* in the context of international efforts to tackle the world debt problem.

Japan's Fund Recycling Programme

The First Round

As already said, the programme had a size of US$30 bn to be implemented from the three years ending with Japanese fiscal year 1989. It was decided that: (a) the recycled money should take the form of loans, except for the part made by way of the government's direct contribution to the multilateral development banks (MDBs), (b) the entire funds provided should be fully untied — their uses not tied to purchases of goods and services from Japan, (c) in providing public funds under this programme, private funds should be encouraged to come with them so that the whole recycling effect could be enhanced, and (d) its implementation be aimed at giving its effect as pin-pointedly and as soon as possible.

The $30 bn is classified into the following four basic categories by mode of implementation (Reclassified by the author. Each allocated amount shown is a minimum target).

Category-A $8 bn: direct support to MDBs, e.g. capital contributions and subscriptions to the IBRD, ADB and IADB, supplemental assistance ensuring MDBs' smooth issuance of bonds in the Tokyo capital market, etc.

Category-B $9 bn: loans made by way of co-financing with MDBs. This is further split into two; i.e.
- B1: $6 bn handled by the Export-Import Bank of Japan, and
- B-2: $3 bn handled by the Overseas Economic Cooperation Fund (Japan's aid-loan window).

Category-C $3 bn: loans provided by the Export-Import Bank of Japan, not in co-financing with the MDBs. It includes also the bank's partial purchase of bonds issued by foreign public entities.

Category-D (Non-Classified)
$10 bn: establishing 'Japan Special Fund' with the World Bank (approx. $20 bn), subscriptions to MDBs' capital replenishment (IADB, Asian Development Fund; approx. $3.9 bn), loan to the IMF (approx. $3.6 bn), etc.

As seen above, except for the part handled directly by the government itself, the programme's implementation has been commissioned to two governmental institutions, the Export-Import Bank of Japan (JEXIM) and the Overseas Economic Cooperation Fund (OECF). While the OECF's responsibility is easily identifiable as Category B-2 (more than $3 bn), the JEXIM was originally designated to handle a minimum aggregate of $9 bn (Categories B-1 and C) and later took charge of providing a SDR 2.2 bn loan (US$3.0 bn-equivalent) to the IMF for its Enhanced Structural Adjustment Facility (ESAF), which falls under Category D.

Where, then, are these funds actually to be applied? A part of the programme, Categories A and D, goes to the MDBs for their repletion of operational resources, be it to their ordinary capital resources or certain funds set aside for special operations. Categories B and C are applied to the selected priority projects and/or the most imminent structural adjustment policy packages of developing countries and areas. In the programme's operation, particularly in the latter (the so-called policy based lending = PBL), it is recognised that the application of funds to the most objectively needed areas often requires special efforts to do it correctly, for example inducing recipients to choose a difficult and occasionally unpopular project/policy option, ensuring the consistent and exact execution of the agreed project/policy, and, by no means less importantly, ensuring the use of funds to be in a truly *untied* manner.[2] For these reasons and because Japan's bilateral agencies wish to avoid any appearance of domestic intervention, co-financing and co-working with MDBs is found to be realistic and, indeed, considerably helpful.

Sometimes questions are raised regarding the use of the JEXIM as a major player in implementing the programme. Many such questions are based on an understandable yet incorrect comprehension of the character of the bank; i.e. it would be reasonable to expect JEXIM to be similar to the many export import banks in the world which are preoccupied with the task of promoting the respective nation's exports. If this view were correct, there would be no conceivable reason for the JEXIM to be involved in this Recycling Programme other than the concealed expectation that the programme would be effectively helpful to Japan's further exports. However, JEXIM is substantially different from many similarly named institutions in other countries for it has long been operating not only export credit but also other actual functions; i.e. import credit (traditionally financing natural resource development overseas and, lately, offering a promotional facility for manufactured imports: use of credit therefore is not linked to Japanese goods and services), overseas investment credit (financing Japanese direct investment overseas, particularly toward developing countries; untied to Japanese exports) and it has indeed a legal provision[3] under which it has been making loans to overseas borrowers for their necessities to import supplies freely from anywhere in the world provided that such import were for specifically agreed projects — '*untied loans*'. The bank has thus been acting as a multi-function long-term lender, not only for the cause of Japanese export. It had a good reason therefore to be chosen to play the main role in the Recycling Programme, dealing with developing countries' development financing. At the same time, however, there are areas under the programme that the bank is not so familiar with; e.g. dealing with the lower-income developing countries (those often called the 'Pure IDA Countries') and, especially, the basic infrastructural projects in these countries; and therefore those countries and types of projects are set aside to be handled by the OECF.

The Extended Round

In July 1989, just prior to the 'Arch Summit' and when the Recycling Programme was more than 90 per cent accomplished in terms of concrete commitments with eight months left in the programme period, the Government of Japan announced the expansion of the ongoing programme and an extension of the period. The extended programme was given an aggregate of 'more than $65 bn' in size and a programme period of five years toward end-FY1991 (inclusive of the original $30 bn for the three years). The incremental $35 bn is classified into the following three categories (Category names correspond to those of the original Programme, and this classification was redone by the author for readers' ease).

Category A $14.5 bn (government)

Category B, C $16.0 bn (JEXIM/OECF loans)

Category D $4.5 bn: JEXIM's loans specially made in parallel to the medium-term facility of the IMF.

Notable in this new, stepped-up programme is its inclusion of a pledge of $4.5 bn 'parallel lending' to accompany the IMF's medium-term facility, which would be provided when a medium-term structural adjustment programme is agreed upon with the debtor as part of the 'Brady Initiative' (or the 'New Debt Strategy') announced just a few months before. Under the New Debt Strategy-based packages to help Mexico and the Philippines, the JEXIM has committed $1,000 mn- and $300 mn-equivalent respectively as loans in parallel with the IMF credits (the former, in addition to the JEXIM's $1.05 bn loan in co-financing with the World Bank). It should be remembered, however, that even in such New Debt Strategy operations the JEXIM's untied loans cannot be made as a resource with which the recipient can 'buy-back' or otherwise dispose of its existing debts but can be provided only to finance the debtor countries' ordinary imports (excluding arms and a few other specifically negative-listed items) in accordance with the bank's statutory restriction.

Conclusion — Still a Long Way to Go

Aside from the above outline of Japan's official initiative in injecting net additional financial resources, there is a positive recognition of the constructive role that foreign direct investment can play in the broad context of the debt strategy. It becomes more evident when we take this foreign direct investment into account that the success of these debt strategies relies upon how the debtor countries endeavour to create an environment of confidence which will be required to attract new loans and foreign investment. The debt reduction scheme, although it has finally been admitted into the latest debt strategy, is the last concession that commercial bankers can offer, and can give only a marginal solution to the whole magnitude of the debt problems of developing economies in the world. It is a persistent fear that such a concession might cause a moral hazard discouraging those countries which are seriously and therefore painfully struggling to restructure their economies. Should such countries as Indonesia, Turkey, Colombia, etc., among others, who are exerting all their powers to resist the external debt burden and to meet existing obligations, fail to keep doing so, it will mean not only that all past efforts concerning those countries will go down the drain but also that the international financing system will end up carrying more insolvent assets than it can bear. Thus, one should always remember the needs of these better performing countries, keeping financial flows going to them and providing them with as favourable an environment as

[1] It has later become known as $30 bn programme, counting-in also a $10 bn programme that had been effected immediately prior to the comprehensive 'Emergency Economic Measures'. This $30 bn roughly coincides with the size of the negative net flow of capital from developing countries to the developed in 1986.

[2] For this reason the JEXIM entered a cooperation agreement with Crown Agents of the UK in August 1989.

[3] Article 18-8 of the bank's statute.

possible — particularly in keeping the interest rates of key international currencies low.

As for the countries whose external debt problems have been revealed, both the debtor countries and their creditors should avoid taking a short-sighted view simply to evade present debt burdens. They need a longer perspective in order to build up a structure that will enable the economy to expand after the restrained, equilibrium-aimed measures. These can be coped with only by a *dynamic approach* by the creditors and with the presence of willing donors.

There has been and still will be the so-called '*Vicious Circle of Poverty*' in many developing economies; i.e. a low level of standard of living causing a low rate of domestic savings, then a low rate of domestic investment that allows only low productivity, thus bringing about yet lower living standards — a mechanism which obliges the economy to resort to external financing when an investment becomes necessary, and thus is likely to cause the external debt servicing burden to grow. Altogether, the new debt strategies have a long way to go, in pain and with patience for at least some of those involved, on case by case bases — a way which cannot and should not be avoided under present circumstances. Japan is determined to bear its share, and is calling for others to do so, while the JEXIM is meeting the challenge of dealing with a great number of requests from interested governments and institutions concerning its untied loans under the Recycling Programme. Such a volume of work occasionally requires even the bank to make organisational and institutional adjustments in addition to maintaining its inevitable closer vigilance as a bank over its own asset profile.

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The Changing Secondary Market

Gordon Wood

The Secondary Market for LDC debt does not operate in the same way as a stockmarket for a number of reasons. The most notable difference is the basically illiquid nature of the Secondary Market. Although the total amount of value impaired sovereign debt exceeds \$1000 bn, only a tiny fraction of this can be considered as tradeable at any time. The reason for this is simply that most banks cannot afford the losses which they would incur by selling for cash. A rough weighted average price for LDC debt would be about 30 per cent of face value; in order to sell without loss, a bank would require provisions of over 70 per cent, and very few have achieved this level. Those who have, tend to heave a sigh of relief and drop the paper into the bottom drawer; they are happy to collect the interest income, which naturally looks high in relation to assets on the books at perhaps one third of face value, or even less.

The second major difference from a stockmarket is the motivation of the buyers of the debt. Generally speaking, the debt is not purchased by people who expect the price to go up. There is an increasing element of speculative activity by brokers in the market but usually in small amounts on a short term basis, because taking positions in a volatile, illiquid market is highly dangerous. There are two basic types of buyers: firstly, investors, either local or foreign, who require the paper for conversion into local currency to make investments or cancel indebtedness; and, secondly, banks which are conducting swap transactions — obviously having sold something they (or an intermediary) have to buy something to complete the swap.

The above characteristics must be borne in mind when considering whether, and to what extent, various factors will affect the market. One perhaps surprising feature is that economic or political events in LDCs, positive or negative, have much less impact on the market, at least in the short run, than might be imagined. This observation may be explained as follows: potential sellers of debt are constrained not by optimism about the prospects of repayment, but by their inability to absorb losses; potential buyers tend to be looking for cheap investment opportunities. For example, over the past year Yugoslavia's domestic economic condition has deteriorated, with inflation rising to over 1000 per cent; however, the price of the debt has risen from 42 to 56 over this period because of the existence of a debt conversion programme. Similarly the price of Chilean debt has been more closely linked to the existence of, and changes to, the country's debt-equity programme than to the economic fundamentals.

The market *is* affected, negatively, by actions which may impose pain on lenders. For example, a suspension of interest payments lasting for more than a few weeks obliges the banks to admit that these loans are value impaired. The cost of funding non-performing assets, coupled with pressure from regulators, may induce banks to sell for cash or swap into relatively more attractive countries. A demand for new money will have a similar effect.

Certainly the market has been affected by increasing levels of provisions made by lenders. Provisions enhance the ability of banks to take losses. Unfortunately, the market tends to anticipate such action and prices promptly fall to below the latest average provisioning levels.

At the risk of some over-simplification, the dynamics of the secondary market may be said to represent a balance between: 1) the supply of debt available from banks willing and/or able to take the losses and 2) the demand arising from official or informal debt conversion programmes. Given the enormous potential supply, it is not surprising that prices have tended to fall. It should be noted that the existence of a debt-equity programme in for example Chile does much more than create demand for Chilean debt. Intermediaries will naturally try to fulfil orders for debt by buying for cash but if willing sellers are not available at acceptable prices (which will be the case more often than not) they will try to induce banks to swap out of Chile into, perhaps, Mexico in return for a fee. The intermediary will then have to buy Mexican debt, creating demand for the latter. The market may be perceived as a bath-tap with the tap on and the plug out; cash sellers pour various types of debt into the pool where it is swapped and swirled about, eventually to flow out and be cancelled by debt conversions.

The Effect of Debt Reduction Plans on the Market

Until very recently debt relief would have had a

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disastrous effect on the world's financial system, wiping out the net worth of many large banks. Even now it will prove distinctly uncomfortable for banks with inadequate provisions, such as those in Japan and Italy. Elsewhere, there is a growing acknowledgement of the judgement of the market, i.e. that these loans are worth much less than their face value. There is no reason to suppose that such debt relief in itself will have basic direct effects on the way the market operates. It will simply introduce a new reason for indulging in swap transactions.

It is noticeable that despite the fanfare surrounding the Mexican agreement, Mexico's debt has fallen from 44 to 36 over the past few months (admittedly a period of falling prices in general). The fundamental point about debt forgiveness is that it forces lenders to take losses. Banks unable to do so have to swap out of countries such as Mexico and into others deemed less likely to follow suit.

Only 100 per cent debt forgiveness would have (obviously) a major impact on the market and that is not on the table except for a few African countries which can never hope to service their debts and which were never actively traded in the first place. However, the Mexican Plan and its possible successors are expected to have *indirect* effects on the secondary market, and these are discussed below.

Possible Futures for the Market

The first possibility which we may call the wishful thinking scenario from the creditors' point of view is that, one after another, countries will enter into rescheduling agreements with their creditors perhaps with an element of debt reduction; pursue the economic policies required to service their debts and pay them off over, perhaps, 20 years. If creditors were to believe that this was likely, sales at a discount would diminish sharply, investors looking for yield would bid prices up to par and the market would disappear. As I earn my living as a trader of the debt you will not be surprised to hear that in my opinion this scenario is the least likely of all. However, I can advance solid reasons for this opinion. The domestic sacrifices required over many years are in most cases simply too great for governments to demand and expect to maintain political stability. How many regimes could impose the internal discipline which enabled Romania to repay its debt?

You may say that under this scenario debtor countries would once again be perceived as creditworthy and could raise voluntary new money to service existing debts. However, most banks now acknowledge that they allowed cross-border lending to expand beyond prudence. They will take much convincing to re-start lending to countries which have caused problems in the recent past. Romania is now effectively debt-free, but despite its exemplary treatment of its creditors, that country would not find it easy to raise new money. In addition, if the secondary market price of a country's debt is 35, why pay it back at 100 (or at 65 after an agreed debt reduction programme such as Mexico's)? If the will exists to make at least some effort to repay the debt, countries will prefer to buy back their debt in the secondary market either: a) by encouraging foreign investment and the return of flight capital by allowing debt-equity conversion schemes or b) by direct buy-backs either openly, like Bolivia, or surreptitiously. Some take the view that debt buy-backs at a discount are somehow immoral; they should note that the Bank of England is openly repurchasing the British National Debt at secondary market prices.

Another scenario which puts me out of a job even more rapidly is repudiation. If this happens, the debt obviously becomes worthless. Even in this case, where there is an effective, as opposed to formal, repudiation, the debt continues to trade in the 'twilight zone' below 10 per cent of face value. Examples would be Peru, North Korea and Nicaragua. However, the consequences of repudiation are severe: all access to credit is cut off, trade stagnates, and the country's reputation takes years to recover. How much easier to agree a deal with creditors whereby they disburse new money to service the interest on existing debt, and agree to reschedule the principal.

Until recently, the only 'middle way' was the 'Perpetual Rescheduling' scenario. This involved at its simplest sufficient economic adjustment to generate a trade surplus, and a rescheduling of principal every couple of years, probably with an element of new money. This process ensured a flow of business for the secondary market as banks would sell for cash or swap out of countries to avoid calls for new money or another tiresome round of reschedulings. This process seems unlikely to continue. As banks increase their provisions they become progressively less willing to disburse new money; they have sufficient provisions to absorb losses if they have to, and are naturally reluctant to disburse new money which is then subject to an immediate write-down.

The current trend towards economic reform in return for partial debt forgiveness seems likely to prolong the life of the secondary market and to affect it in various ways. Firstly most of these new packages will include, at the insistance of the banks, debt-equity conversion options. These create demand for debt and generate fee income for creditors and intermediaries. They help to sustain activity in the market. Secondly, we may expect to see a proliferation of debt instruments. The Mexican Plan, for example, will, if successful, generate two new types of bond and a new money loan. This growth in the menu of options, should enable intermediaries to design swap packages more closely matching the requirements of their customers. The process will be aided by the improved 'tradeability' of the assets. In the early days of the market it was common to encounter Loan Agreements with vague, restrictive, or even completely absent provisions for the assignment of participations. Lenders viewed sovereign borrowers as clients, and often felt that to trade loans would damage relationships.

In practice, the borrowers do *not* care and lenders these days place little or no value on relationships which have proved to be so expensive. Consequently most new restructuring agreements require no more than a transfer certificate to be sent, after the event, to the agent and/or the borrower. Bonds require even less documentation. This trend will enable the market to process transactions more rapidly and efficiently.

Until recently LDC debt was very obviously being traded in a severe bear market. At current price levels, however, adventurous investors are beginning to think that the yield on certain countries' obligations compensates for the risk. For example an interest yield of over 25 per cent on Mexico may be attractive; even after the new plan is in place, an investor who has purchased the debt for 35 and then opted for the principal discount bonds is still gaining an interest yield of close to 20 per cent. As a rough rule of thumb, most LDCs could service half their existing debt without difficulty. Consequently an investor purchasing performing LDC loans for well under half price is not likely to show serious losses. Not a play for widows and orphans, but we may expect high yield investors to play an increasing, if still small role in the market.

Despite my opening remarks concerning the ability of banks to take losses, this is also changing as banks increase their provisions. Recently several banks have taken the view that having made large provisions and written down the debt to secondary market levels, they should turn a problem into an opportunity by trading the debt to generate fees. We may expect this process to continue, and this must inevitably increase competition in the market. Life will certainly become more difficult for market players lacking either a portfolio from which to operate or an established niche in the business.

In conclusion, the market seems likely to display the features of a mature market: many players, a wide range of assets, and intensifying competition.

As a final note on the debt crisis, it is worth pointing out to those hailing the Mexican Plan as a blueprint for solving the problem, that, even if they are right, the 'good news' is that the lenders' shareholders *may*, perhaps, be repaid one-half to two-thirds of the money lent, before allowing for inflation, and over a very long period of time. Hindsight may be a wonderful thing, but in this case the crisis could have been avoided by reference to previous experience.

Countries *do* go bust and have done so for centuries. The first known debt default is recorded in the Old Testament, when the Israelites were unable to pay the Phoenicians for work done on the Temple of Jerusalem. A later example is perhaps an even better parallel of recent events. At the end of the Middle Ages, the Bardi and Peruzzi were bankers in the world's financial capital, Florence. Fat with profits from loans to domestic industrialists and international traders they were looking for lucrative lending opportunities. They discovered a promising little under-developed country: it was politically stable, had a small population, and was the world's largest exporter of industrial raw materials. It was called England. The bankers lent very large sums to King Edward III, secured on exports of wool. Instead of using the money productively (from a banker's point of view!) he used it to pay for the pursuit of a war against France. Inflation soared as spending exceeded revenues, and Edward was forced to debase the currency. After Edward's victory at the Battle of Crecy, England prospered, but he defaulted on his debts. The Bardi and Peruzzi were ruined. Many similar examples could be cited and the moral is a simple one: sovereign lending has always been a licence to lose money.

Debt Relief for Child Development

ìtephany Griffith-Jones

JNICEF Debt Relief for Child Development

Γhe debt crisis and its management has had many ıegative effects on the heavily indebted developing :ountries. Clearly one of the most tragic effects are the ıuman ones. UNICEF, as well as other institutions uch as the World Bank, the IMF and the regional levelopment banks have documentated how vulnerable ;roups have in many cases borne a very large part of he burden of debt and recession in the 1980s.

n the case of Latin America and the Caribbean LAC), the region has become a net exporter of inancial resources with serious social consequences. \s a result of the large negative transfer of resources rom LAC, as well as of other factors, poverty ncreased in LAC between 1980 and 1985 from 35 per ent to 40 per cent of the population in relative terms .nd from 130 to 163 mn in absolute terms. The poverty vhich faces children and their families manifests itself n the form of high rates of infant and child mortality, nalnutrition, lack of basic services such as safe lrinking water and sanitation, low enrolment and ıigh drop-out rates in basic education, illiteracy, etc. \fter 40 years of steady progress in these areas in .AC, there has been a marked slowdown in recent 'ears. The heaviest burden of the economic crisis is herefore on children, the majority of whom are poor.

.n its 1989 **State of the World's Children Report**, JNICEF estimated that in 1988 alone at least half a nillion young children died in developing countries, particularly in Africa and Latin America), as a result ıf economic setbacks precipitated by the debt crisis. 'urthermore, the effects of the disinvestment in ıuman capital in the 1980s will extend to the next ;eneration, and its results will be reflected in stunted ıodies and the under-education of many adults of the ıext century.

'o help reverse the decline in living standards of 'ulnerable groups in heavily indebted developing ountries, UNICEF has launched an initiative, **Debt ₹elief for Child Development**, that would combine xternal debt reduction with assuring that the esources thus freed from debt service will be hannelled towards improving the health, nutrition .nd educational status of poor children and other 'ulnerable groups.

There is now wide acceptance of the need for debt reduction, at least in principle. The need for debt reduction was first raised by developing countries' governments, was later endorsed by the Japanese and French government, and now has practically unanimous support in the context of the Brady Plan. It is to be hoped that this new consensus for debt/debt service reduction will have favourable influence for **Debt Relief for Child Development**.

The structural stabilisation and adjustment policies adopted in many countries to face the darkening international environment have often resulted in the short run in a worsening of the situation of the poor and vulnerable groups as wages were frozen, food subsidies abolished, and social services benefiting the poor were drastically curtailed. Lately, the concept of 'adjustment with a human face' — first proposed by Richard Jolly at the 1985 SID World Conference in Rome — is being promoted in response to the worsening social and economic crisis. This type of adjustment calls for more expansionary macro-economic policies to secure an efficient use of scarce resources to meet the needs of vulnerable social groups: sectoral policies aimed at raising the productivity of small scale rural and urban producers; and monitoring of the human situation during the adjustment process. The Inter-American Development Bank and UNICEF initiative and other initiatives of Debt for Child Development described below will seek to promote such adjustment policies by supporting investment in human capital formation which is a *sine qua non* for longer-term socioeconomic development, as well as more democratic and stable political development, thus linking the use of these resources to debt reduction.

Different Formulations of Debt Relief for Child Development

The various formulations of **Debt Relief for Child Development** currently being pursued contain the following features:

a) commercial banks may 'swap' *de facto*, donate some of their debts owed by developing countries to UNICEF, and in doing so gain some tax relief (e.g. by deducting losses or by making a charitable donation). As part of this transaction UNICEF would arrange with the borrower Government to undertake child survival programmes using the proceeds which would be paid to UNICEF by the Government in local currency as a condition of the agreement between UNICEF, the bank and the Government.

b) Debts or just the debt service payments owed by developing countries to Governments or semi-public institutions may be paid in local currency which would be made available to fund UNICEF-assisted child survival and development activities in the borrower country in a programme jointly negotiated by the lender, borrower and UNICEF.

c) Donors may make some funds available to indebted countries to buyback their debt at a discount in the secondary market on condition that the borrower would then set aside some funds — a portion of the difference between the face value of the loan and its discounted value — for social development programmes to be implemented in cooperation with UNICEF.

Donations by banks of developing country debt to charities have received official support by authorities, such as the US Assistant to the Treasury, David Mulford and by the World Bank.

The UNICEF initiative of **Debt for Child Development** proposed that for countries where future prospects for the servicing of external debt are extremely bleak, private creditors consider donating part or all of their outstanding claims on those countries to UNICEF for utilisation in development programmes assisted and monitored by UNICEF. Such resources would be additional to resources already allocated by UNICEF, and would therefore represent a genuine contribution to improving the welfare of the poor (particularly children) and, by investing in human capital, to the country's long-term growth and credit worthiness.

The first country chosen by UNICEF for a debt development swap programme was Sudan, with the Sudanese government cooperating fully with UNICEF in the establishment of the programme. Other governments of debtor developing countries have also expressed interest in participating in such a scheme. UNICEF welcomes offers or suggestions about bankers willing to make debt donations for child development.

In December 1988, the Midland Group donated all its loan exposure to Sudan (amounting to US$ 800,000) for exclusive use by UNICEF in a health, water sanitation and reforestation programme now being implemented by UNICEF. The Sudanese government will redeem the debt in local currency, which will then be used solely for water sanitation, reforestation and health education programmes in the Kordofan region of Sudan, benefiting principally children and women.

The programme will benefit at least 5,000 villagers in 10 villages. It will provide them with clean water and sanitation, made possible by the building of handpumps; it will also improve the natural environment, as the additional water run-off will allow the planting of ten village seedling nurseries and ten village woodlots.

Midland Bank was the first bank to make a donation to the UNICEF scheme. It was also the first British or European bank to participate in a debt-for-development swap. Senior Midland officials have said that one of the main reasons why Midland was willing to make the donation was because the UNICEF scheme was related to such a specific well-designed and cost-effective project, which came with the clear support of the Sudanese government.

A few debt donations for charitable purposes have been made by US banks, following a 1987 Internal Revenue Service (IRS) ruling that allows donations of Third World debts and other obligations in exchange for tax breaks. For example, in February 1988 Fleet Norstar in Providence, Rhode Island, donated $250,000 in Costa Rican debt to a conservation effort in that country. In August 1988, American Express Bank donated $1 mn Nigerian obligations to the International Foundation for Education and Self-Help, which will use the funds as a part of a programme for nutrition, health and other social expenditure in Nigeria.

It seems likely that further debt donations to charities will be made, as these have important advantages not only for the debtor countries (and particularly the poorest sections of their populations) but also for the creditor banks. Amongst the main advantages for the banks are the following: firstly, the bank can *save* on costs, administrative expenses and, above all, on senior management time, relating to debt re-scheduling and processing of arrears linked to fairly small amounts of debt, whose repayment prospects are in any case very doubtful. This gain is particularly clear if *all* of a bank's exposure to a particular country is donated together. Secondly, the bank will benefit from a large amount of goodwill generated by such a donation. Indeed, the donations made so far have attracted a great deal of interest in the media. Thirdly, the bank's management will know that the debt donation will be used for purposes that benefit long-term development in the debtor economy. Last, but certainly not least, the bank may in most cases obtain important reductions in its tax obligations. We discuss these in some detail in the next section.

Tax Treatment of Debt Donations

In the case of British, American and Dutch banks we have verified that important tax advantages to debt donations can occur.

For example, a UK bank gives as a charitable onation a certain amount of debt to a charitable ıstitution, such as UNICEF, this would have tax dvantages for that bank; the magnitude of the tax dvantage basically depends on the level of rovisioning already made previously by the bank gainst that particular country's debt and the value of ıe debt accepted previously by the Inland Revenue as ıe appropriate one for tax purposes. As normally the ıtter is a lower amount, and as a donation implies that ıe Inland Revenue *will* accept the full loss, a donation ·ill imply a potential tax gain in the UK. (For alculations see Appendix 1).

ı the US case, similar principles apply for tax ·eatment of charitable donations of debt. The tax dvantage to the bank lies in the fact that the US ıternal Revenue Service will accept tax allowances ɔr the *total* of the debt donated, whereas if the same ebt was totally written off but not donated, the ıternal Revenue could and probably would question t least part of the write-off, as not being tax eductible.

urthermore, in the US, disclosure requirements (on etails of banks' financial results) are the most ‹tensive of the major creditor countries. This is one nportant reason why US banks are especially :luctant to accept losses, because they must report the etails of their performance so thoroughly and ·equently. In this context, a senior US private bank fficial pointed out that donation of debt that is nlikely to be serviced or paid, implies a clear ɪdvantage for the donating bank; the amount given ill be registered as a charitable donation taken from ·ter-tax profits, whereas a write-off of the debt would ɜ registered as a loss from pre-tax income. Though ıis distinction may seem somewhat formal, it is nportant to US banks and their shareholders, given ıe disclosure requirements and the emphasis on ıalysing short-term financial performance by the ıarkets.

ı the case of the continent of Europe, similar tax relief ·inciples seem to apply as in the United States and the nited Kingdom. For example, in the Netherlands, donation of debt would also be tax-deductible: the ınk would benefit if the debt had not already been ·tally written off. (The tax benefit may possibly be ɔmewhat smaller than for the US and the UK, as on ıe continent of Europe a higher percentage of ·ovisions against losses tend to be accepted by the tax ıthorities as tax-deductible).

o summarise, in the case of the three countries ‹amined — the United Kingdon, the United States ıd the Netherlands — tax advantages can be ɔtained from debt donations by banks to charities.

The IDB-UNICEF Human Capital Development Initiative

The Inter-American Development Bank (IDB) and the United Nations Children's Fund (UNICEF) are about to launch an initiative for human capital development in the 1990s. It is proposed that the initiative would be financed through a special Trust Fund called the 'Social Investment Trust Fund' which will be initially financed through contributions to IDB by interested donors. The IDB in turn would lend the funds to its member states in Latin America and the Caribbean (LAC) to finance the buy back of their external debt in the secondary market, thereby gaining the benefit of a considerable discount. As a condition of this borrowing, the LAC countries would agree to contribute an amount (a portion of the difference between the face value of the debt purchased and the new loan from IDB) in local currency to finance social development programmes, in their own countries. The new loan from the IDB Trust Fund would feature several concessionary terms including reduced interest rates and extended grace and amortisation periods. The programming of the social projects to be supported as part of the arrangement would be a joint exercise involving the borrower Government, IDB and UNICEF.

The details of the IDB-UNICEF initiative are being worked out. Furthermore donor government support is being negotiated. A helpful precedent is a trust fund that the IDB has recently established with support from the Government of Spain for a programme of economic, social and cultural progress in Latin America in commemoration of the quincentennial of Spain's links with the New World.

Considering the potential scope for social project financing and the needs associated with a multi-year set of projects identified by the IDB and UNICEF, an order of magnitude equivalent to US$500 mn in resources available to the Fund would be viewed as highly desirable.

IDB-UNICEF initiative hopes to transform the current crisis of investment in human capital into an opportunity for reviewing how to promote human development in the 1990s. In terms of human capital formation, investment in children must be given a high priority since they constitute an age group with very high rate of return in social investment. Accordingly, the present IDB-UNICEF initiative is conceived as an investment in the present generation of children so as to avoid the reproduction of poverty in the generations to come.

Social needs vary from country to country. Like in other areas of development, a *country focus* is irreplaceable and a continuous dialogue with the national authorities is the cornerstone for the planning of technical cooperation and financial assistance in the social areas. While leaving the selection of projects to country specific programming, the board priority areas for the IDB-UNICEF programme have been identified as follows:

a) basic health, including primary health care with particular emphasis on immunisation and control of transmissible diseases. Priority will be given to programmes well designed to reach timely targets in terms of the reduction of infant mortality, under-five mortality, maternal mortality and eradication of major diseases.

b) Nutrition programmes, especially those to eliminate severe child malnutrition and to reduce moderate malnutrition in the younger population, plus maternal malnutrition.

c) Basic education including virtual elimination of illiteracy, particularly among women, development of services for the young child including pre-school attention, universal primary education, training on life skills and civic values.

d) Universal access to environmental sanitation, particularly safe drinking water in urban slums and poor rural communities.

e) Social communication and mobilisation to help communities to organise and to train for the development of self-management capabilities to cope with their own problems.

f) Last but not least, cooperation to create and improve systems of social indicators required to target and monitor cost-effective social programmes, and to strengthen the administrative capacity of social sectors and local communities.

The initiative is timely in that it offers the possibility of mobilising *additional* resources for children, while making a positive, though modest, contribution to debt relief in a region where disinvestment in human capital formation threatens to perpetuate the cycle of poverty and deprivation.

Appendix 1.

Tax effects of a charitable debt donation by a British Bank

The effect is best explained by a hypothetical numerical example. Bank X has exposure in country A of £1 mn (face value), and has made a provision of 40 per cent against its exposure in Country A due to difficulties in getting the debt serviced and/or perceived risk that the principal may not be paid back.

The Inland Revenue however has only accepted (for tax purposes) provisioning of 15 per cent, as the Inland Revenue accepted the provision for risk of loss of principal but not for the future *reduced or delayed payment of interest*. In the initial situation, therefore, the bank's shareholders have accepted loan-loss provisioning of £400,000 while the Inland Revenue had for tax purposes only accepted £150,000.

Bank X decides to donate 10 per cent of its exposure in country A to UNICEF within the scheme of Debt for Child Development. The face value of the debt being donated is thus £100,000, and its balance sheet value is £60,000. The bank would thus incur an additional loss of £60,000.

Because the bank would *as a result of the transaction have no further right* to principal or interest, the Inland Revenue would *give relief for the whole face value to the extent this had not already been allowed*. The Inland Revenue had previously already accepted a loss of 15 per cent for Country A (equivalent to £15,000 given the amount to be donated). The arithmetic difference between the total loss (£100,000) and the previously accepted loss (£15,000), which would be equal to £85,000, could be set against profits in the rest of the bank's operations. Assuming that the bank is paying corporation tax at a rate of 35 per cent, and that it is overall registering a profit, the tax savings would be £29,750.

The NGO Attitude to Debt Reduction

'ohn Denham

'he last 12 months have seen significant developments 1 the co-ordination of activity on the debt crisis by :uropean non-government organisations (NGOs).

:uropean NGOs exist in many different forms. Many ive financial support to grass-roots projects in Third Vorld countries, using funds raised from the public nd through the aid administrations of their overnments. Most of these also carry out some 'ducational and lobbying work amongst their upporters and with their governments. Others oncentrate purely on educational, political lobbying nd solidarity work. The constituencies of the NGOs over a wide range of political viewpoints, and ifferent NGOs are associated with a range of eligious and secular groups.

:oncern about the debt crisis has risen steadily iroughout the 1980s, and has recently become articularly marked amongst the project funding gencies. Many have seen their grass-roots work verwhelmed by the negative impact of the debt and ie consequent adjustment policies. The need to espond to this experience has been reinforced by ressure from partner agencies in Third World ountries to campaign on the issue.

n recent years, there have been many campaigns in idividual countries, most of which have aimed to ersuade governments to extend relief on official debt o the poorest sub-Saharan African countries. Though ie results have been limited, it is generally accepted iat public pressure helped to create the political iitiatives which led to the Toronto agreement. Other ampaigns have concentrated on commercial debt and ie problems of middle-income debtor countries. A iird, and more specialised line of lobbying has been irected at adjustment policies and at the World Bank i particular.

'he coordination between national initiatives has, ntil recently, been limited. However, since March 989, a grouping of NGOs from 11 countries has been eveloping a common European debt campaign.

he initial focus of the campaign is to be the debt owed)' European banks and the need for a more oordinated (and sympathetic) response to the crisis om European governments and financial institutions.

he simple premise underlying the campaign is that ebt relief should be great enough to ensure each country has sufficient resources to allow sustainable economic recovery and development to take place. No figure on the level of debt reduction needed has been set, although the campaign refers to a variety of projections, including those from the World Bank, UNCTAD and WIDER that imply debt/debt service reduction of upwards of 40 per cent for major debtor countries.

In practice, many NGOs will be advocating at least 50 per cent debt/debt service reduction for the major debtors and the total cancellation of debts owed by the poorest countries.

In addition, the campaign will press for action on capital flight, including the identification of capital flight assets and will be arguing that certain loans — such as those tainted with fraud or corruption — should be regarded as illegitimate.

The campaign will be pursued in different ways in different countries but, at a European level, a 'twin-track' strategy will be pursued. All the major commercial banks will be approached directly and asked to respond to an appeal endorsed by over 50 NGOs. The appeal asks banks to accept the principle of the campaign and publicly support action on debt reduction, capital flight and illegitimate loans.

Though no major sudden change in banks' policies may be anticipated, the involvement of major and respected NGOs will add a significant new presure on the banks. This is particularly true in those countries where banks are subject to competition from other financial institutions offering personal banking services.

At the same time, Parliamentarians throughout Europe are being asked to support a joint letter addressed to Finance Ministers and the President of the European Community which urges more radical action on debt relief. This initiative stresses the need to go beyond the reliance on the voluntary participation of banks in any debt reduction strategy. It also stresses the current lack of European influence in the evolution of the debt strategy and the need to raise European concerns which are (or should be) different to those of the USA and Japan.

While the campaigning action around bank debt is now getting underway, initial plans are also being made for a parallel campaign aimed at increasing levels of official debt relief.

The campaign, while developed and run by NGOs, has been able to draw on the advice of several leading academics in Europe and a valuable partnership is developing through which the complex realities of the debt crisis can be translated into clear and simple messages for the public, media and politicians. The participating NGO also lay great stress on using the campaign to promote the views and experiences of their southern partners.

The campaign is currently serviced by a Dutch-based NGO, FONDAD[1] which stands for the Forum on Debt and Development a name which emphasises the strong conviction of participating NGOs that the failure to deal adequately with the debt problem puts in jeopardy the prospects of development for people in many Third World countries.

[1] FONDAD, Norrdeinde 107a, 2514 GE, The Hague, The Netherlands.

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