# WIDER

# STUDY GROUP SERIES
## No. 3

Debt Reduction

WORLD INSTITUTE FOR DEVELOPMENT ECONOMICS RESEARCH
OF THE UNITED NATIONS UNIVERSITY

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World Institute for Development Economics Research of the
United Nations University

# DEBT REDUCTION

Report of a Study Group of the World Institute for Development Economics Research (WIDER), on the Debt Problem of the Middle Income Developing Countries

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# DEBT REDUCTION

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## PREFACE

Following the initiative taken by US Treasury Secretary Nicholas Brady,[1] there is an urgent need for the international community to embark on the actual practicalities of debt reduction. The next steps to be taken are examined in the present report, which covers the objectives, resource requirements and techniques of debt reduction, participation by banking creditors, the link with policy reform, and means of stimulating new flows by alternative credit enhancement techniques.

This report carries forward the work begun in WIDER's first two Study Group reports, which focussed on the mobilization of Japan's current account surplus for world development.[2] The second of these reports argued for a significant measure of debt reduction in its recommendation of a debt reconstruction facility on which it would be open to Japan to take an initiative. The facility would pass on to debtor countries the discounts at which their debt was trading in the secondary markets in exchange for longer-term economic reform packages. The facility could be launched, in the first instance, as a Japanese Trust Fund which could have the option of raising resources for debt reduction purposes against the collateral of zero-coupon bonds issued by the Japanese government. In this sense, the proposal foreshadowed the collateralization technique later employed in the Mexican debt reconstruction towards the end of 1987.

Subsequently, this approach to debt reduction along with that of Mr. Jim Robinson, Chairman of American Express,[3] and other possible approaches, were discussed at a meeting of senior Third World debt negotiators organized by WIDER in April last year in Mexico, in collaboration with El Colegio de Mexico and WIDER Research Adviser Professor Jeffrey Sachs of Harvard University.[4] An important concern

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[1] Nicholas F. Brady, *Remarks presented to the Brookings Institution and The Bretton Woods Committee Conference on Third World Debt,* March 10 1989.

[2] WIDER Study Group Series No. 1, *The Potential of the Japanese Surplus for World Economic Development,* Helsinki 1986. WIDER Study Group Series No. 2, *Mobilizing International Surpluses for World Development: A WIDER Plan for a Japanese Initiative,* Helsinki 1987. Both groups comprised Saburo Okita, Chairman, Lal Jayawardena, and Arjun Sengupta.

[3] James D. Robinson III, *A Comprehensive Agenda for LDC Debt and World Trade Growth,* The AMEX Bank Review Special Papers, No.13, March 1988.

[4] This meeting took place in Oaxtepec, Morelos, Mexico on 21-22 April, 1988.

voiced at the meeting was that resources for debt reduction should be substantial enough to enable countries willing to undertake economic reform programmes to resume their economic growth. If this is to be accomplished, it follows that available resources should be concentrated on producing "success stories", which in turn could generate political support among creditors for mobilizing the additional resources required.

What was clearly needed was a practical approach to debt reduction anchored to the Bretton Woods institutions. In late 1988, I therefore invited Dr. Johannes Witteveen, former Managing Director of the International Monetary Fund, to chair a WIDER Study Group on the problem. The Group had before it a paper by Professor Sachs on the case for an international debt facility with a total capital adequate to buy back debt at its discounted value but involving quite modest amounts of paid-in capital.[5] This paper formed a valuable starting point for the work of the Study Group, which naturally received new impetus from Secretary Brady's proposals.

Lal Jayawardena
Director

*WIDER was established in 1984 and started work in Helsinki in the spring of 1985. The principal purpose of the Institute is to help identify and meet the need for policy-oriented socio-economic research on pressing global economic problems, particularly those impacting most directly on the developing countries. Its work is carried out by staff researchers and visiting scholars in Helsinki and through networks of collaborating institutions and scholars around the world.*

[5] Jeffrey D. Sachs, *New Approaches to the Latin American Debt Crisis*, September 1988. A paper prepared for the Harvard Symposium on New Approaches to the Latin American Debt Crisis, Institute of Politics, Kennedy School of Government, Harvard University.

## INTRODUCTION BY THE CHAIRMAN OF THE GROUP

In late 1988 I was asked by WIDER to chair a group of eminent representatives to draw up recommendations on the debt problems of middle income developing countries. While progress had been made since the start of the debt crisis in 1982 in resolving the problems from the creditor side, it had also, however, become increasingly apparent that progress was stalled with respect to the debtors due to their inability to shoulder the full burden of debt with growth. The debt service prospects of many highly indebted countries were not improving and the burden of indebtedness was acting as a disincentive for the policy changes required to restore their economies. I therefore envisaged that the major thrust of the Group's report would be to recommend that the emphasis of international efforts should shift towards encouraging debt reduction.

Thus, the recent initiative on debt of U.S. Treasury Secretary Nicholas F. Brady, represents a very welcome and important shift in debt strategy precisely because it emphasizes debt reduction. At the same time, since Secretary Brady was enunciating a change in general approach, many important aspects were rightly left open to be subsequently filled in through discussion and negotiation with other creditors, the debtors and the international institutions, in particular the World Bank and the International Monetary Fund.

The recent meetings of these different groups, and of the Interim Committee of the IMF in Washington, have gone a long way to clarify many of the important issues involved. Several of the elements of a debt reduction strategy, sketched only in general terms by Secretary Brady, have now become clearer. However, a consensus has not yet been reached on some important aspects. Moreover, as debtors and creditors start on the process of individual country by country negotiations, they require the support and encouragement of the international community.

The purpose of this report, therefore, is to encourage the process of putting the principles of debt reduction into practical operation so that the countries could resume normal growth as soon as possible and gradually overcome their serious economic and social problems. The six key issues on which an understanding is needed are as follows:-

i) the amount of debt reduction that should be aimed for and how debt reduction in the required volume can be funded and achieved in a timely manner;

ii) the techniques that should be employed, including the role of formal guarantees as compared with funded methods of debt reduction involved in buybacks and collateralization;

iii) how to achieve a maximum participation of banks in the debt reduction process so that relief is sufficient in volume and so that the costs of restoring creditworthiness are borne in large part by the private creditor banks as well as by the official sector;

iv) how to link debt reduction with the policy reforms needed in debtor countries and the respective roles of the World Bank and IMF;

v) how to achieve debt reduction in a manner that is compatible with a restoration of access of debtor countries to capital markets and to the eventual resumption of private flows on a voluntary basis.

vi) How to achieve debt reduction and a resumption of economic growth in debtor countries.

The report which follows contains analysis and recommendations on these inter-related points in the hope that it will provide a useful contribution to the deliberations on debt reduction now under way in the international community.

I am happy to be associated in the issuance of this report with the other members of the Study Group.

H. Johannes Witteveen

## EXECUTIVE SUMMARY

### 1. Amounts and Funding

For an effective debt reduction scheme, a debt reduction of at least $125 billion should be sought in the commercial debt outstanding of the highly indebted countries of about $370 billion.

This requires resources of about $50 billion. They must be provided quickly so that an immediate start can be made in debt reduction. This will require additional new funding sources as well as existing resources.

IMF Trust Fund arrangements offer the most flexible and quickest means for attracting additional resources for debt reduction and in particular for buybacks and collateralization.

Voluntary contributions to an IMF Trust Fund mechanism should be sought from countries in surplus such as Japan and Germany. Other countries may also wish to make loans or deposits with the Trust Fund or to make their markets available for borrowings connected with debt reduction schemes.

### 2. Techniques of Debt Reduction

The differences between debtor and creditor situations requires that a variety of techniques of debt reduction should be employed.

Resources which permit borrowers to enter into buybacks and collateralization have some advantage over schemes for debt reduction involving formal guarantees.

### 3. Participation

All banks must participate in the effort required. In order to reconcile the likely preferences of different banks for different debt relief options with the need to ensure a maximum participation of all banks, the concept of 'critical mass' remains relevant. It should be applied according to the principle of 'equivalent effort'.

### 4. The Link with Reform

The IMF should take the lead role in debt reduction so that debt reduction can be placed in the framework of a balance of payments adjustment plan which in turn will give further assurances to creditors as well as encourage a return of resident capital. An IMF quota increase is crucial. Additional resources through Trust Fund arrangements will provide the IMF with a means to offer new incentives to borrowers in their adjustment efforts.

Access to the IMF Trust Fund should not involve additional macroeconomic conditions for borrowers beyond those associated with regular tranche drawings and the financial terms should be commensurate with the needs of debt reduction.

The IMF must assist borrowers obtain a comprehensive relief package from all creditors and in particular, from commercial banks. Therefore, the IMF should link its own programme with the borrower, to the borrower's willingness to negotiate with the banking community on the basis of satisfactory debt reduction objectives. On the basis of these agreed objectives, the IMF should release its own resources in a manner to orchestrate a comprehensive settlement with creditors.

5. New flows

Because new flows on a voluntary basis are likely to be slow in forthcoming, (beyond those which are related to interest recycling) credit enhancement techniques, such as guarantees of multilateral and bilateral lenders, should be reserved to provide selective assistance to the process of stimulating an eventual return to markets. The World Bank has a potentially important role to play in this area. However, enhancement should not be provided simply for new banking flows that are for the purpose of interest recycling.

DEBT REDUCTION

REPORT

I. **<u>Amounts and Resources</u>**

a) <u>Amounts</u>

1.1 The recent acceptance by the international community of the desirability of debt reduction is an important and welcome change in strategy towards the problems of the highly indebted middle income countries.[6] At the same time, creditors are concerned about how the costs of debt reduction may build up; they are also concerned about the division of these costs between debtors and creditors and the division between private sector creditors and the public sector. Debtors on the other hand have an equal concern that debt reduction should be sufficient in volume. Looking beyond the narrow interests of creditors and debtors, debt reduction on a large scale is essential for the health of the world economy and for broad moral and political reasons.

1.2 There is no precise way of estimating how much relief is 'enough', but a bench mark figure, on an aggregated basis, involves a net reduction in commercial bank debt of around one third (about $125 billion). Depending on the level of interest rates, this would lead to a reduction in total interest payments of about 30-35% for the highly indebted countries and is equivalent to a reduction on the non guaranteed part of bank debt of about 50%.[7] A strategy providing for a debt reduction of $125 billion, supported by further policy reform efforts, is required to make a new start in the management of the debt problem. This would go far toward restoring countries' credit and enabling them to resume normal development.

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[6] The term debt reduction covers any technique that leads to a reduction in the present value of payments due to creditors.

[7] Total debt outstanding (end 1988) of the group of highly indebted countries (HICs) identified by the World Bank amounted to about $530 billion of which private debt was about $370 billion. Interest payments on this debt are running at about £33 billion a year of which about $23 billion a year is due to private creditors. Since about one third of commercial bank debt is guaranteed by the export credit agencies in creditor countries, the non guaranteed portion is $250 billion, so that a reduction of $125 billion would be equivalent to about one half of this non guaranteed debt. Net debt reduction of $125 billion would reduce debt outstanding as a percent of GNP to about 50% from close to 65% and interest payments to between 15-20% of exports compared to around 25% on average.

1.3 The judgement of how much relief would be needed has to be made on a country by country basis. For some countries a reduction in interest payments of one third may not be sufficient. The general criteria, however, seem clear. First, it should be sufficient to enable the country concerned to bring its stock of external liabilities down relative to its income and export capacity (a balance sheet test). Secondly, it should be sufficient to permit part of a country's future income growth to accrue to domestic residents and not just to foreign creditors (a cash flow test). Thirdly, it should be sufficient to permit trade lines and interbank lines to be maintained on a voluntary basis with a medium-term perspective of voluntary lending for other purposes (a restored creditworthiness test). In the absence of a country by country assessment of debt reduction needs and possibilities, the aggregate figures already referred to above give an approximate estimate of the total amounts that could be involved, if all highly indebted countries were to qualify for debt reduction schemes. At the same time it is the overall goal of restored creditworthiness that is important, rather than any target figure.

1.4 The resources needed for debt reduction of $125 billion in gross amounts would be about $40 billion if each one dollar of this commercial bank debt could be bought back at 30 cents per dollar of nominal value.[8] Secondary market prices are 'transaction specific' and therefore not a reliable guide to the price that might have to be paid. If the price were 50 cents for each dollar of nominal value, the resources needed would rise to over $60 billion. A figure of $50 billion has the merit of a good round number.[9] In so far as the $50 billion would be provided in the form of loans it would reduce the net amount of debt reduction achieved by the same amount. It therefore represents a less than optimum target amount. There is thus a case for concentrating limited resources on an initial group of countries presently capable of successfully implementing economic reform programmes on the premiss that early successes would generate political support in the creditor world for mobilizing additional resources beyond the initial $50 billion.

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[8] In February 1989, an average secondary market price for the debt of a group of 20 highly indebted countries, was about 33 cents on the dollar.

[9] Some proponents of guarantees suggest that debt reduction could be accomplished with less resources at less cost through use of guarantees. The issues surrounding the use of guarantees are outlined in Annex 1.

1.5 A critical assumption for the resources needed for debt reduction in the recent proposals of U.S. Treasury Secretary Brady, is that debt reduction would be 'voluntary' i.e. no bank would be forced to sell. It underlies the related point in the Brady proposals that normal sharing and negative pledge clauses in commercial bank documentation may have to be waived in some cases, where not already modified, in order to allow for different treatment between banks and for different debt reduction options to be employed. Nevertheless, a 'critical mass' of participating banks will be needed. This is discussed further in para. 3.1 below.

b) Sources of Funding

1.6 Because debt reduction involves banks in the recognition of loss, the private sector shares in the overall costs of debt relief. In fact, the shift towards debt reduction reflects, in part, the build up of bank capital and reserves which now enables the banking system to withstand losses. In looking beyond the losses incurred by the banking community itself, it is necessary to recognize at the outset that in one way or another a part of the cost of debt reduction will inevitably be carried by creditor country governments as tax revenues are reduced as commercial banks recognize their losses and reduce the book values of their outstanding claims. Creditor governments will also carry a risk of incurring costs as multilateral institutions make new loans available or provide funding or guarantees for debt reduction schemes and as official bilateral agencies, such as export credit agencies, make new lines of credit available or accept losses through participating in debt reduction under the aegis of the Paris Club. However, apart from tax losses and losses that may still have to be sustained through Paris Club arrangements, the other 'costs' will likely not impose a budgetary burden on creditor governments. Resources provided through multilateral or bilateral institutions will take the form of loans or contingent obligations and will present an actual cost to creditor governments only in the event that capital is required to be drawn to meet future claims.

1.7 One way in which governments could directly provide resources for debt reduction would be the establishing of a debt reduction facility funded in large part by direct government contributions. It can easily be demonstrated that a total capital requirement of $50 billion, (of which only a small amount, say 5%, would be paid in) if spread between many contributors and spread out over a payment period of say 5 years, would result in a small contribution for any individual contributor - even the largest. For example, if the largest subscriber were to contribute a 20% share, the annual budget outlay for the paid-in portion spread over 5 years would only amount to $100 million a year.

1.8 Apart from the fact that some creditor governments would have philosophical reservations about direct government funding of debt reduction in this way, a number of practical difficulties have to be recognized. First, there will be a considerable delay before any such scheme could enter into effect. Not only would a scheme have to be negotiated, but government appropriations would have to be sought (in 1990 fiscal year budgets) and effectiveness would probably depend on actual payments by major contributors because of the importance of banks within their purview. Not only will there be a lengthy delay, but in addition the international community envisages agreement on an increase in IMF quotas by the end of this year. This implies legislative action in 1990. It will be important to give IMF quota increases priority in legislative calendars. In general, therefore, the resources available for quick and timely debt reduction appear to be as follows:-

- the resources of debtor countries themselves, including those stemming from any return of flight capital;
- the existing resources of the World Bank and IMF;
- voluntary resources provided by creditor countries, including those available from 'off budget' sources such as export credit agencies.

1.9 To some creditor governments, the resources required of $50 billion for an effective debt reduction scheme would appear disturbingly high and suggest the need to scale down expectations for debt reduction.[10] However, the combination of funding sources indicated above would reduce the extent to which new funding will be needed. Moreover, if the funding from creditor governments is clearly linked to policy reform in the debtor countries, the resources of the debtor countries themselves would provide a large component. Nevertheless, it should be accepted that effective debt reduction will call for some additional new funding over and above the World Bank's general capital increase already approved, and the quota increase envisaged for the IMF. At the same time it should be remembered, as pointed out in para 1.6 above, that these additional resources will represent only contingent liabilities for creditors.

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[10] In fact, the resources required to achieve a net reduction in total debt of $125 billion would be larger. This is because while debt reduction is going ahead, there will be other actions taking place that add to the stock of debt - for example, new flows from official sources, interest recycling and interest capitalization as well as the loans for debt reduction itself. As discussed in paras. 4.7 and 4.8, the IMF will thus need to orchestrate a comprehensive settlement in the light of the debtor's total balance of payments and cash flow needs.

1.10 IMF Trust Fund arrangements would provide a way of furnishing the IMF with additional resources for debt reduction and could proceed ahead without waiting for the IMF quota increase to become effective. The way in which IMF Trust Fund resources could assist in the various techniques of debt reduction is described below.

## II. Techniques

2.1 A consensus on the precise techniques to be used in order to achieve debt reduction has not yet been achieved. The different avenues have different implications for creditors as well as debtors. Creditors are also sensitive to the extent to which some techniques involve an overt use of public sector resources. The main techniques are as follows:

a) Buybacks

2.2 Buybacks constitute the simplest form of debt reduction. The borrower repurchases a part of its external debt at a discount from a willing seller. The issue is where the borrowers' resources come from in order to finance the purchase. The Brady proposals envisage several channels. Private residents would provide purchasing funds if the country were pursuing stabilization policies that encouraged a reversal of flight capital. (However, flight capital will probably return (in part) only after stabilization policies take effect.) The proceeds of World Bank structural adjustment loans or IMF loans could be used directly to finance buybacks. Fund resources could also be used indirectly (i.e. the use of Fund resources would release or replenish a country's reserves which could then be used for buybacks.) Buybacks are not only the simplest form of debt reduction for the borrowers but their appeal to commercial bank creditors should not be underestimated. Impaired assets are removed and balance sheets cleaned up. There may be many banks that are now in a position to contemplate this step and would prefer a simple one-time solution.

2.3 An IMF Trust Fund established for debt reduction purposes would provide a mechanism for supplementing resources available under regular IMF facilities for buybacks. The resources of the Trust Fund could be made available alongside drawings under quota arrangements and could either be used directly by the borrower for buybacks or indirectly through the effect on the country's reserves. For the sake of appearances, there is much to be said for indirect support for a borrower's buybacks.

b) Collateralization

2.4 Under collateralization arrangements, an old debt is exchanged for a new debt which is for a reduced amount of principal or which carries a lower rate of interest. The principal and/or interest on the new debt (which could take the form either of a loan or a bond) is collateralized. The collateral can be provided in the form of deposits by the borrower or in the form of bonds (including zero coupons). It is the provision of this collateral which makes the reduced service on the new debt possible or the reduction in the principal. The appeal of collateralization is that it would focus on debt service reduction. Commercial banks may accept lower interest if that interest stream is secured and therefore low risk.[11]

2.5 There are three ingredients necessary for this kind of technique to be successful; first, the resources for the collateral have to be provided; secondly, the deposit arrangements must be secure (off-shore) and thirdly, negative pledge arrangements have to be taken into account. As far as the resources for the collateral are concerned the Brady initiative envisages again the use of World Bank or IMF resources for this purpose. Indirect funding would be involved because the borrower would receive a free foreign exchange boost to its reserves which would enable it to post collateral. As far as deposit arrangements are concerned, creditors need an arrangement outside the borrowing country and also immune from freezing (due to intergovernmental disputes) and from offset claims (by any bank that is a depository). The negative pledge clause is relevant because unless it is waived, creditors can claim that in the event of a future default, the collateral should form part of the country's overall resources available to meet all claims.

2.6 An IMF Trust Fund could again provide a borrower with supplementary resources from which it could provide collateral. Moreover, the Trust Fund could act as the deposit agency for collateral, since the use of an extra-territorial and neutral entity such as the IMF is clearly highly relevant to likely creditor concerns on this point. Under a variation of this approach, a third party (i.e. a country which is well disposed to the borrower but which cannot or does not wish to make resources directly available to the borrower) could deposit its resources into the Trust Fund on the understanding that they would provide the collateral for the borrower.

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[11] According to U.S. accounting principles the face value of outstanding loans might not need to be written down even if interest rates are renegotiated at below market levels.

c). Guarantees

2.7 Under guarantee arrangements, an old debt would be exchanged for a new debt which would be for a reduced amount of principal or would have a lower rate of interest by virtue of the interest or principal (or both) carrying a guarantee from the World Bank or IMF. There are a number of difficult issues involved in the application of guarantees which are indicated in Annex 1. If, however, guarantees were to find a place at some future point, an IMF Trust Fund would have no disadvantage compared with the World Bank as a source for funding formal guarantees. Since the Fund does not depend in the same way as the Bank on world capital markets, there might be an advantage in running any guarantee scheme from an IMF Trust Fund.

d) Debt Equity Conversion

2.8 The conversion of debt into equity has been the major vehicle for debt reduction so far. (Approximately $15 billion has been done.) The Brady initiative envisages that debtor countries should maintain 'viable' debt equity swap plans. It is generally agreed that such plans work if four conditions are met:

i) the domestic monetary impact can be afforded (otherwise the conversion of external liabilities into domestic can be inflationary and the effective interest cost can aggravate a government's total domestic debt burden);

ii) the official exchange rate is close to the free market rate (otherwise there is 'round tripping');

iii) the administrative procedures for conversion are simple and transparent (otherwise there is scope for corruption);

iv) a generally welcoming environment for domestic private and foreign investors.

It is apparent that these conditions are difficult to meet and therefore, debt/equity conversion schemes have to be tightly justified.

2.9 Unlike buybacks, collateralization and guarantees, debtors do not need additional foreign exchange resources in order to encourage debt equity conversion. However, the first two conditions cited above do involve the need for successful anti inflation and balance of payments adjustment measures. Moreover, under the longest established debt equity swap scheme (that of Chile) the most successful provision has been that encouraging a return of flight capital by residents rather than the provision relating to inward investment by foreigners. If an IMF Trust Fund were to provide borrowers with an additional incentive to adopt IMF programmes, it would clearly further encourage the return of flight capital and facilitate the use of debt equity swap programmes, for this purpose.

2.10 Debt equity swap arrangements have also been adapted to allow for cases where the external debt is exchanged for domestic assets which can be utilized to fund environmental schemes, and for cases where preference is given to swaps which facilitate export generating investments. There may be further scope for these kinds of arrangements.

e) Other Forms of Debt Reduction

2.11 All forms of debt reduction involve banks in the recognition of loss on part or all of their portfolio (with the possible exception of debt equity conversion[12] ). The Brady initiative accepts this result and envisages that the regulators and tax authorities will review their rules relating to the recognition of loss (in order to make it easier for banks to build their capital and provisions and to spread the impact on income). In combination with the waiving of sharing arrangements, this could provide banks with an incentive to enter into individual debt reduction arrangements with borrowers covering write downs of principal, interest rate reductions and so on.

2.12 It is impossible in advance of actual experience with debt reduction, to judge which of these various techniques will prove the most effective. There has been a strong case made on a priori grounds, that a given volume of resources provided for debt reduction, would give greater cash flow relief if used to achieve debt service reductions (for example, through collateralizing interest payments over a 3-5 year period) than if used for debt buybacks. However, it remains to be seen if this is the case in practice. It is not clear what debt service reductions can be negotiated in practice through collateralization. Moreover, this approach leaves impaired assets outstanding as a continued negative factor on the balance sheets of banks. If banks perceive a significant advantage to be gained in cleaning up their balance sheets, the discounts on buybacks may be larger than has been supposed and this suggests that debtors need to test the market for different options.

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[12] This is a possible exception because it involves a question as to the valuation of the investment and whether there is a presumption of loss.

2.13 An important assumption behind the Brady proposals is that debtors should negotiate debt reduction arrangements 'in the market', with banks being able to chose different mechanisms. This opens the possibility that different banks will choose different options and that some banks may not participate at all. This in turn opens the problems of 'free riders'. (By contrast, 'concerted' schemes envisage all banks being coerced into giving uniform debt reduction under a centrally managed common approach.) The problem of how to achieve a maximum participation of banks in debt reduction is discussed below.

## III. Participation

3.1 The approach to rescheduling and new money packages adopted since 1982 has involved the assembly of a 'critical mass' of banks to participate. The IMF and the authorities in creditor countries have played a key role in bringing 'suasion' to bear on the banks. Over time the difficulties of assembling the critical mass and in particular, of obtaining significant volumes of new money, have increased. 'Topping up' has been commonplace. The single most important reason for these difficulties has been the increasing divergence between the portfolio positions of different banks. Banks with small exposures[13] relative to their capital have a diminished incentive to participate and increasing difficulty in justifying new exposure to their shareholders. An appeal to their interest in the stability of the overall banking system and the need to avoid disturbances in the inter-bank market has had a declining force as the soundness of the overall system has increased with improvements in capital adequacy ratios.

3.2 The difference between banks according to their relative exposure is likely also to be a critical factor in debt reduction schemes. Banks that are in a position to accept income losses and the reduction in the value of their assets, may be attracted to debt reduction schemes so as to reduce their holdings of 'impaired' assets, and could improve shareholder perceptions by so doing. Banks with large exposure relative to their capital will have an opposite interest in delaying the recognition of loss and in gaining further breathing space to build up their capital base. Moreover, those banks with large exposure to developing countries make the case that they retain a long term commitment to the markets provided by the developing countries and that if they start to lower the book value of their assets outstanding to them, it will be impossible for them to consider new lending.

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[13] This includes not only small banks with small exposures but large banks with exposure which may be significant in face value but not in relation to capital.

3.3 The Brady initiative recognizes the crucial importance of these differences between banks and envisages that different banks can choose different debt reduction options, if they are offered, or that banks might not participate at all.

3.4 The implications of this approach are that some banks may not participate in debt reduction and yet would benefit, if, as a result of the participation of other banks, the value of remaining outstanding assets would rise subsequent to debt reduction. This gives rise to the so called 'free rider' problem.

3.5 There are various issues involved under the generic 'free rider' label. One issue is equity of treatment in a situation where some banks might benefit by not participating. A second concerns the cost of debt reduction schemes. Reluctant participants are likely to hold out for a much higher price for participation in debt reduction schemes and could increase the cost considerably.[14] A third concerns the prospective impact on the resumption of new lending (indicated above). A fourth relates to the boundary that exists for banking supervisors between 'suasion' and directives. A final consideration is that the volume of debt reduction could be inadequate if an insufficient number of banks participate.

3.6 A possible approach is to look not for uniformity of approach between different banks, but to look for 'equivalence'. One bank might accept a buyback, another a reduced but collateralized service stream and a third might prefer to make available an increase in its exposure limit and continue effectively to recycle interest. The benefit of these different approaches can be expressed in common terms of cash flow equivalence and this may provide an acceptable solution.

3.7 Even with banks able to choose between various options, the problem of non participation in any equivalent form could remain. The practice of trying to achieve a 'critical mass' should therefore remain an essential ingredient for debt reduction. In principle, all banks should participate. If the debt reduction options are indeed attractive to creditors and if 'equivalence' is sought rather than 'uniformity', the difficulties which have surrounded the attaining of a critical mass in the past could be overcome. 'Critical mass' thus should be retained as a key operational feature of debt reduction.

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[14] The use of a historical 'cut off' date for prices in the secondary market could be taken as a benchmark cost. However, for various reasons, such an approach may not be acceptable or would be acceptable only subject to bargaining.

3.8 The intent behind trying to attain a critical mass has, in the past, extended beyond the purpose of securing equal effort by all banks. It has provided the multilateral institutions with an assurance that their loans to the borrower would trigger commercial bank relief. It has provided the banking community with a link to the policy reform programmes of the multilateral institutions. The cost of assembling a critical mass has been the delays associated with these cross linkages. The Brady proposals envisage that these cross linkages be severed, so that, for example, the IMF could release its resources in advance of the critical mass being obtained. This proposal raises the question as to how to tie debt reduction efforts into the policy reform efforts supported by the IMF and World Bank.

## IV <u>The Link with Reform</u>

### a) <u>The Lead Role of the IMF</u>

4.1 The policy reform efforts of debtor countries remain crucial if they are to stabilize their situation and to lay the groundwork for a resumption in income growth. The Brady proposals envisage a role in debt reduction for both the World Bank and the IMF and thus a link with the policy reforms supported by each. While it is important that both institutions be used for debt reduction, a clear tie-in with the reform efforts of borrowers would be achieved if the IMF is clearly given the lead role. The Brady proposals envisage a 3 year framework for a major focus on debt reduction and this fits in well with the stabilization and balance of payments programmes of the IMF. It would give a new focus to IMF efforts in resolving debt problems and an additional incentive to borrowers to use IMF facilities. In addition, there is much to be said for making a distinction between the role of the Fund in the clearing up the external balance sheets of debtors as compared with that of the World Bank in focusing on longer term market imperfections.

4.2 If the Fund is to play this key role it needs additional resources. The Brady initiative envisages a consensus on an increase in Fund quotas by end 1989. In practice under US budget procedures, this would mean a quota increase would probably not be in place before October 1990 at the earliest and possibly not even then. This quota increase is critical. Therefore, resources for IMF funded debt reduction schemes should not wait for the quota increase and have to be sought also through supplementary channels.

4.3 An IMF Trust Fund Mechanism could be established immediately and could solicit resources on a voluntary basis. The prospects for separate and additional Japanese funding as part of the arrangement under which Japan would become the second largest member in the IMF would appear good. Japan and other countries in surplus could loan or deposit funds into a Trust Fund account which could be used to support the various techniques described above. An IMF Trust Fund arrangement would be no less efficient as a guarantee fund compared with a separately funded World Bank facility and it could avoid some of the questions related to the use of World Bank guarantees. Another possibility is for the IMF to borrow in the market (or from countries such as China/Taiwan) and to deposit the proceeds in the Trust Fund. Because an IMF Trust Fund would meet the banking community's requirements for a collateralizing agency, a supplementary alternative route would be for the agencies of countries in surplus to make loans directly to borrowers that would in turn deposit part of the loan proceeds into the Trust Fund to be held as collateral.

4.4 The fact that the Trust Fund could accept loans as well as deposits, and direct as well as indirect funding, means that resources could come from government agencies such as the Japan Export-Import Bank rather than from the central government budget.[15] This would mean that a quick start is possible. The use of 'off budget' vehicles, may also have some advantages from a strictly budgetary point of view and for timing for some other countries as well as Japan. A Trust Fund mechanism may therefore offer the best prospect for securing additional resources for debt reduction on a timely basis.

4.5 A vital point for borrowers concerns the terms for access to IMF resources for debt reduction. Since the Trust Fund could expect to provide resources alongside the use of Fund quotas, no additional macroeconomic conditions would need to be met for drawing. Normal conditions of the Fund would appear to insulate it from the risks of 'moral hazard'. But this would need to be reviewed in each instance. The terms of repayment would probably need to extend up to 10 years depending on the terms of the buyback or collateralization.

b) The Link with other Creditors

4.6 If the IMF is to play the leading role envisaged above, it not only must be provided with additional resources to support borrowers in their reform efforts and debt reduction, but also it will need to orchestrate the actions of other creditors. In particular, it will need to be able to help the borrower achieve

[15] Because the Export-Import Bank of Japan finances imports an indirect channelling of resources may be preferred under which an untied import loan would release a borrower's resources for buybacks or collateralization.

a comprehensive settlement with its commercial bank creditors in which the choices of the critical mass of banks for different forms of cash equivalent debt relief are meshed into a consistent overall programme.

4.7 In the past, the connection between the IMF's mobilization of the commercial banks and its reform programme was provided by linking the release of its own resources to the attainment of the critical mass of banks in support of rescheduling and new money. As mentioned above, the Brady proposal envisages that this link be broken. However, some link is needed. The crucial component would be an agreement between the Fund and the borrower, not only on the macroeconomic policies which the borrower was adopting, but also on the comprehensive package of debt reduction and new money measures which the borrower was aiming to achieve with its other creditors. The IMF would assess the debt reduction programme within the context of the balance of payments adjustment programme of the borrower and its cash flow needs. This IMF review would determine the eligibility of the country concerned for an internationally supported approach to debt reduction.

4.8 The Fund would not disburse its own resources to the borrower unless a comprehensive programme was set out in principle and unless the borrower was entering into a negotiation with creditors on the agreed basis. If the debt reduction programme and negotiating schedule were agreed with the borrower, the Fund could release a tranche of its resources. If, subsequently, commercial bank creditors hold back from arriving at a comprehensive package with the borrower, the likely consequence would be an accumulation of arrears to the banks. The IMF could allow this to happen. The accumulation of arrears and the suasion of the IMF would put pressure on the commercial banks to participate in a settlement. The fact that the borrower would have resources agreed from the Fund and partly in hand, which would enable it to finance debt reduction, would provide additional incentives for commercial creditors to reach an agreement. If, by contrast, the situation were one where the commercial banks were ready with a debt reduction and new money package that the IMF considered reasonable, but on which the borrower was reluctant to agree or negotiate, the IMF could withhold its resources from the borrower.

4.9 Thus, in order to achieve a link between macroeconomic reform policies and debt reduction and in order to ensure a comprehensive settlement with the commercial banks, the Fund will need in the first instance to agree on an outline debt reduction programme with the borrower. This would provide a basis for negotiation between the borrower and the commercial banks in which the IMF would mediate. The IMF would subsequently need to be flexible in the release of its own resources to assist in the reaching of the desired agreement. By withholding funds, it can put pressure on the borrower. By releasing funds to the borrower and accepting the build up of arrears to commercial bank creditors it can bring pressure to bear on the banking community.

## V. Debt Reduction and New Lending

5.1 In theory there is no conflict between effective debt reduction and the resumption of new lending. The result of debt reduction should be the clearing of the way for the borrower to resume its access to private sources of capital on a voluntary basis. New lending in this context should be sharply distinguished from involuntary new lending for the purpose of recycling interest. In practice, the process of a country restoring its access to markets is likely to be drawn out. There are two general reasons for this. First, the cost of debt reduction, as indicated earlier, is considerable and there may be shortfall in funds available for it leading to a lesser degree of debt relief than is desirable. Secondly, the need for policy reform in the highly indebted countries is fundamental to restored creditworthiness and some shortfalls in policy are inevitable. Even on the most optimistic assumptions about the debt reduction process, there are additional specific reasons why new lending will not restart easily:

- banks that remain after debt reduction (by themselves or others) with assets still outstanding to the country concerned will have difficulty in justifying new exposure if those remaining assets have to be counted at less than face value (otherwise the new assets might have to be booked at a loss);

- banks that have eliminated their holdings may be reluctant to return as lenders in the light of their past adverse experience (this is particularly the case of those banks that were participants in syndicated lending without a clear international strategy);

- official bilateral lenders (export credit agencies) still have some way to go in recognizing the full extent of their own losses through the Paris Club mechanism and this will effect the availability of bilateral credit cover;

- because risk perceptions of private and official lenders have been heightened by experience, lenders will both be more cautious on their future credit limits and look for different risk/reward relationships;

- while the process of debt reduction itself is being played out, lenders will likely hold back until the results begin to emerge.

5.2 Not all of these developments would be unwelcome. However, the end result of these and other factors is that, even in the best of circumstances, voluntary lending will not resume quickly or easily. In these circumstances, private lenders will continue to look to official sources of capital as the main financiers of the indebted countries. They will also look to ways to distinguish their new assets from the old.

5.3 The clearest way in which new assets can be distinguished from old is if the new assets are in some way 'enhanced'. Enhancement can take different forms. Guarantees provided by official multilateral or bilateral agencies is one form. Project lending whereby the returns are secured by the earnings of the project itself is another. Securitized lending whereby some of the risk can be laid off outside the banking community to institutional investors is yet a further avenue which could be exploited. There has been some experimentation with collateralized loans.

5.4 In the light of this scenario there is much to be said for reserving the credit enhancement capacity of the World Bank to the difficult task of restoring new flows. A selective use of guarantees in this context avoids the connotation of 'bailing out' lenders from past mistakes. Credit enhancement in connection with interest recycling is not appropriate. However, there are new areas of credit enhancement which have not been exploited in the past and which hold potential for the future. The use of co-guarantees with export credit agencies (such as the Japan Export-Import Bank) so as to facilitate trade related financing is one such area. The acceptance of contingent obligations in connection with securitized lending or the tapping of institutional markets is another.

5.5 In short, while the purpose of debt reduction is to restore creditworthiness, the results will not appear quickly or easily. The international community will need to continue to help in the process of restoring new flows beyond the process of debt reduction itself. Finally, it needs to be recognized that creditors and debtors will be better served in future if a significant part of new inflows take the form of non debt creating capital - namely private direct investment and portfolio capital.

# ANNEX 1
# DEBT REDUCTION AND THE USE OF GUARANTEES

In early discussion of debt reduction, emphasis was placed on the possible role of World Bank guarantees. Guarantees were held to be cheaper than other forms of debt reduction and more efficient in that they could be framed to provide relief in assured amounts for defined periods. These aspects are considered below.

## Costs

The World Bank counts one dollar guaranteed as equivalent to one dollar lent and a guarantee therefore represents the same claim against World Bank capital and the same opportunity cost as a dollar lent to finance buybacks. Moreover, an unconditional guarantee of interest would be more expensive because interest payments on the life of a loan will exceed the principal and will also be open ended (interest will be due on interest if there is a default). A guarantee of interest for a limited period (say 2 years) on a rolling basis, (i.e., if the guarantee is not called at one interest payment date it can be rolled forward to cover another interest payment due) would cut down the costs. However, it would also cut down the benefits since creditors would make a worst case assumption that the guarantee might be exercised early, leaving them exposed for the remainder.

It is also suggested that guarantees will likely not require cash outlays. This is because it is claimed that guarantees would be unlikely to be called because of the preferred status of multilateral institutions. Their capital backing therefore, would be unlikely to be required to meet payments. The probability of call would, however, rise in the event that guarantees were used on a large scale and because the portfolio would not be balanced between good and bad risks but concentrated on high risk cases. Moreover, the capital market would likely take into account the risk implications, with a resulting adverse impact on the normal borrowing costs of the World Bank. Cutting the link between a call under the guarantee and a general default to the Bank would create separate kinds of problems.

## Efficiency

In theory, guarantees are efficient means of enhancing the quality of credit risks because they can be defined to cover specific risks in specific circumstances. However, the more tightly they are framed, the less benefit they are likely to purchase. Moreover, in the context of negotiating with creditors and in the circumstances of negotiating a debt reduction package or addressing a roll over situation, the pressures for concessions on the World Bank would be considerable and exert their own risks. In addition, once guarantees come to be used on a large scale there could be perverse effects. For example, a large stock of 'old debt' that is preferred would effectively subordinate new claims and therefore discourage new lending. It could also distort the workings of the secondary market. Therefore, guarantees, if used at all, would need to be employed on a highly selective basis, probably outside the framework of the World Bank.

# SELECTION OF PRESS COMMENT ON WIDER'S PROPOSAL FOR IMF DEBT REDUCTION FACILITY

Extracts from:

*The New York Times,* June 19, 1989 Editorial Column

". . .Mr. Brady outlined his remedy in March: Third World debtors, overwhelmed by interest costs, need a chance to invest their export earnings in domestic growth. Since the loans won't ever be fully repaid anyway, he called on banks to write off part of the old debt or work out other arrangements for lower interest rates, or both, and to make new loans. The International Monetary Fund, the World Bank and Japan are helping, but these public resources alone are not enough. . . .

A reasonable new proposal from a study group headed by Johannes Witteveen, former Director of the IMF, would strengthen the Fund's authority to apply pressure on either side by granting or withholding aid. The Witteveen group, sponsored by the United Nations University's World Institute for Development Economics Research, also advocates heftier resources for the Fund, particularly from countries with large reserves - like Japan, which is helping already, and Taiwan, which isn't.

The criticisms of the banks by Mr. Brady and Mr. Camdessus are warranted, but their public exhortations underscore the need for stronger official direction. At present, the banks and each debtor government negotiate on their own. Until there is some outside enforcer, it will be impossible to achieve the only acceptable outcome - breathing room for the debtors."

*The Washington Post,* June 15, 1989 Hobart Rowen Column

"Bankers don't respond well to being told to be good citizens: they look at the bottom line. Thus, pressed to be more generous in dealing with Third World customers who need debt relief, the banking community balks.

'They ask us to cancel 50 per cent of our loans, and then expect us to put in new money with no guarantees. That's crazy!' a top banker exclaimed bitterly. The Chairman of one of the largest French banks, speaking on the promise that his name would not be used, told me at a bankers' meeting in Madrid: 'I would gladly forgive all of my existing loans in Latin American if they don't ask me for more.'

But with a certain amount of public force and plain talk not usually delivered by international civil servants, IMF Managing Director Michel Camdessus warned the other day that 'we are at a crossroads' in trying to solve the Third World debt dilemma.

'The first road' - doing the minimum - 'does not lead anywhere Camdessus said. 'The other road' - bigger discounts on old loans - 'may lead to a better future for countries which are your clients, for balanced world economic growth, and thus for your institutions.'

A week later, Treasury Secretary Nicholas Brady served the same notice at the Madrid meeting. 'I ask you to compare the risks of inaction with the benefits of concluding transactions that meet the tests of realism and reasonableness,' Brady said.

Almost everywhere, except in the banking community, there is widespread agreement with Camdessus and Brady. A report last week by an international group led by H. Johannes Witteveen, former IMF managing director, called for a speedy 'buy-back' of $125 billion of the $250 billion in non-guaranteed commercial bank loans to major debtors at 40 cents on the dollar. That would cost $50 billion in new debt relief resources for debtor nations, or about double what is contemplated under the Brady Plan."

*Financial Times,* June 10, 1989

"The International Monetary Fund should set up a special $50bn £29bn) trust fund to support much larger scale debt reduction than is currently envisaged, according to the report of a study group headed by Dr. Johannes Witteveen, the former managing director of the IMF.

The report argues that greater official resources are needed to secure a reduction of $125bn in the $370bn owed to commercial banks by the most heavily indebted middle income countries.

The key recommendation is the establishment of the $50bn trust fund by the IMF along the lines of the oil and supplementary facilities which Dr. Witteveen organised in the 1970s at the IMF. The money would be raised from Japan, West Germany, Taiwan and other surplus countries. To date only Japan has promised $4.5bn to assist debt reduction.

The report has been sponsored by the independent World Institute for Development Economics Research and the group also included Mr. Raymond Barre, the former French Prime Minister, Professor Robert Solow, the Nobel prize-winning economist, and Professor Jeffrey Sachs, a prominent advocate of substantial debt reduction. . .

Dr. Witteveen argued that the current efforts of the IMF and the World Bank in implementing the US-inspired Brady plan are on the right lines but 'a much more sizeable effort is needed'.

He argued that the more sizeable the suggested IMF trust was, 'the better the chance that it would succeed in reducing debts'.

Under the proposals, the IMF would retain a central role in negotiating programmes with debtor countries and in determining the eligibility of a country for financial support."

*The Hindu,* June 19, 1989, Editorial Column

". . .As the recently published report of the Helsinki-based World Institute for Development Economics Research (WIDER) envisages it, a 50 per cent reduction of the debt of the 17 highly indebted countries (including Nigeria, the Philippines and Yugoslavia apart from the indebted Latin American countries) — amounting to $125 billion — will provide the critical mass of the follow up action on global debt reduction. The WIDER report is significant not merely for its assessment of what in effect would work out as a 'pump priming' action in the face of a massive debt burden of the developing countries which exceeds $1.2 trillion. As between the IMF and the World Bank, contrary to the thesis publicly advanced of a symbiotic complementarity in the task of achieving a breakaway from incubus of debt, there has been an unmistakable trend (ever since the Baker Plan was unveiled in October 1985) for the World Bank to upstage the IMF in the matter of structural lending provided for the indebted nations. That this has been plainly inconsistent with the functional specialisation as between the IMF and the World Bank is widely known. It is this facet of the policy matrix of the international financial institutions which the WIDER report considers to be in clear need of rectification. . ."

*The Japan Times,* June 14, 1989

"Japan should supply more funding to highly indebted countries, a research organization affiliated with the United Nations University said Sunday.

The World Institute for Development Economics Research suggested that Japan make the added effort as part of its becoming the second largest contributor to the International Monetary Fund.

'Debt reduction on a large scale is essential for the health of the world economy and for broad moral and political reasons,' the report says.

The report calls for a $125 billion reduction in the debt owed to commercial banks by highly indebted countries.

It said the IMF should immediately set up a trust fund and take the lead in attracting the required resources.

'Japan and other countries in surplus could loan or deposit funds into the trust fund to support debt reduction,' it said. . ."

*Financial Times,* August 30, 1989 Olli Virtanen

". . . A reduction of $125bn in the private debt, according to the Wider plan, could be realised on resources totalling $50bn, which would equal a swap of 40 cents to the dollar. This proposal, says Dr. Jayawardena, goes twice as far as the Brady plan.

The proposal, published in June, was criticised for the lack of commitment by the bankers. In other words it failed to ask first the people who would eventually shoulder the costs.

Dr. Jayawardena counters the criticism by pointing out that Mr Leutwiler and Mr Witteveen, although not commercial bankers themselves, provided an insight to thinking in the financial community. In addition Mr Witteveen consulted extensively with top bankers around the world before the draft of the plan was written. . ."