FOR AGENDA

EBS/95/126

August 1, 1995

To: Members of the Executive Board

From: The Secretary

Subject: Private Market Financing for Devloping Countries and Their Debt Situation

Attached for consideration by the Executive Directors is a paper on private market financing for developing countries and their debt situation. Concluding remarks and issues for discussion appear on pages 12-14.

This subject, together with a background paper on private market financing for developing countries (to be issued shortly), is tentatively scheduled for discussion on Friday, September 15, 1995.

Mr. Dunaway (ext. 37343) or Mr. Ishii (ext. 37355) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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Department Heads

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Private Market Financing for Developing Countries and Their Debt Situation

Prepared by the Policy Development and Review Department

(In consultation with other departments)

Approved by Jack Boorman

July 28, 1995

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I. Introduction

The last comprehensive review by the Executive Board of progress under the debt strategy and the experience with private financing flows to developing countries took place in September 1994. 1/ Since that time, several additional countries have concluded debt deals with their commercial bank creditors and a few others have announced agreements in principle. It is encouraging that a number of low-income developing countries are among those making progress in restructuring their bank debts; however, further efforts are needed to deal with the problems of this group of countries, especially for those countries with relatively large commercial bank debt obligations.

With regard to private capital flows, the eruption of the Mexican crisis in December 1994 had a profound impact on all markets for developing country securities in early 1995. Subsequently, conditions have improved, reflecting the steps taken to deal with that crisis, the adjustment efforts of other countries encountering difficulties (supported in some cases by financing from the Fund), and the continued strong economic performance of many developing countries. The impact of the Mexican crisis across a broad range of developing country securities raises a number of issues regarding how the composition of the investor base may have contributed to the spillover effects observed. In the wake of the crisis, some questions are also raised regarding external debt management practices and the implications for macroeconomic policies of growing foreign borrowing by entities outside the government sector.

This paper is organized as follows. Sections II and III discuss developments and issues relating to the restructuring of commercial bank claims and to private financing flows to developing countries, respectively. Section IV presents some concluding remarks and issues for discussion.

II. Commercial Bank Debt Restructuring

1. Recent developments

Over the past year, significant further progress has been made in resolving the commercial bank debt problems of a number of developing countries. The Dominican Republic, Ecuador, and Poland concluded debt and debt-service reduction operations with their commercial bank creditors, and

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1/ Summing Up by the Chairman (Buff 94/92, September 9, 1994). Also see Financing for Developing Countries and Their Debt Situation, EBS/94/67, August 23, 1994. An update of progress on debt negotiations was provided to the Executive Board in Debt Situation - Recent Developments in Commercial Bank and Official Bilateral Debt Restructuring, EBS/95/41, March 17, 1995.

among low-income countries, São Tomé and Principe and Zambia conducted debt buybacks with assistance from the Debt Reduction Facility for IDA-eligible countries. 1/ As of end-July 1995, a total of 21 countries had completed debt and debt-service reduction operations, restructuring a total of $170 billion in commercial bank debt (Table 1). The original claims payable to the banks have been reduced by about $76 billion at a cost of $25 billion.

Several other developing countries have made substantial progress toward resolving their commercial bank debt problems. In May 1995, both Albania and Panama announced agreements in principle with their bank creditors. The first phase of a debt buyback by Sierra Leone financed by the IDA Debt Reduction Facility has been completed, and the second one is expected to take place shortly. 2/ In addition, Peru has renewed discussions with its commercial banks, presenting a proposal for a debt and debt-service reduction operation to the bank advisory committee in late May 1995. Viet Nam has made substantial progress in its discussions with its main creditors, and it is expected to conclude negotiations on a comprehensive package later this year.

Côte d'Ivoire has met with its commercial banks to reconcile debt stocks. Given the country's large stock of debt and the debt's relatively high secondary market price, however, the cost of a comprehensive buyback appears to be prohibitive. As an alternative, a Brady-type operation consistent with the country's limited debt-servicing capacity and the availability of financing for enhancements is under consideration. Similarly, progress on a debt buyback operation for Nicaragua is dependent on the availability of sufficient financing. With the IDA Debt Reduction Facility increasing its commitment to $40 million of the estimated $110-115 million cost of the operation and with a similar amount expected to be provided by the Inter-American Development Bank, the financing package for the deal is nearing completion. Requests for support in buying back commercial bank debt have also recently been made to the IDA Debt Reduction Facility by Cameroon and Congo. Other countries eligible for support from the IDA facility (including Ethiopia, Guinea, Mauritania, Senegal, Tanzania, and Togo) are still at early stages in preparing for buybacks of their commercial debts.

Algeria reached agreement in May 1995 with its commercial banks on a rescheduling of bank claims falling due through 1997, including amounts that were previously rescheduled. Following the resolution in October 1994 of the legal framework for negotiations, most notably the banks' requirement

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1/ Details on recently concluded bank debt deals and those currently in progress are provided in Chapter II of the forthcoming background paper, Private Market Financing for Developing Countries.

2/ For information on recent operations of the IDA Debt Reduction Facility, see Review of Progress Under the Debt Reduction Facility for IDA-Only Countries, World Bank, June 1995.

Table 1. Commercial Bank Debt and Debt-Service Reduction Operations 1/

(In millions of U.S. dollars)

		Debt and Debt-Service-Reduction (DDSR) 2/							
		Debt reduction		-service reduction		Prepayments			
	Debt Restructured Under DDSR Operation 3/ (1)	Buy-back (2)	Discount exchange 4/ (3)	Principal collateralized par bond 4/ (4)	Other par bond 4/ (5)	Through Collaterali-zation (6)	Total (7)=(2)+..+(6)	Total Debt and Debt-Service Reduction/ Debt Restructured (8)=(7)/(1)	Cost of Reduction 5/
				(Concluded agreements)					
Argentina (1992)	19,397	--	2,356	4,291	--	2,739	9,386	48.4	3,059
Bolivia	643	331	232	29	--	20	612	95.2	61
(1987)	473	253	182	--	--	7	442	93.5	35
(1993)	170	78	50	29	--	13	170	100.0	26
Brazil (1992)	40,600	--	4,974	3,996	337	3,891	13,198	32.5	3,900
Bulgaria (1993)	6,186	798	1,865	--	421	443	3,527	57.0	652
Chile (1988)	439	439	--	--	--	--	439	100.0	248
Costa Rica (1989) 6/	1,456	991	--	--	101	36	1,128	77.5	196
Dominican Republic (1993)	776	272	177	--	--	63	511	65.8	149
Ecuador (1994)	4,522	--	1,180	826	--	596	2,602	57.5	583
Guyana (1992)	69	69	--	--	--	--	69	100.0	10
Jordan (1993)	736	--	84	111	--	117	312	42.5	118
Mexico 6/	51,902	--	7,953	6,484	--	7,777	22,214	42.8	7,677
(1988)	3,671	--	1,115	--	--	555	1,670	45.5	555
(1989)	48,231	--	6,838	6,484	--	7,222	20,544	42.6	7,122
Mozambique (1991)	124	124	--	--	--	--	124	100.0	12
Niger (1991)	111	111	--	--	--	--	111	100.0	23
Nigeria (1991) 6/	5,811	3,390	--	651	--	352	4,393	75.6	1,708
Philippines	5,812	2,602	--	516	116	467	3,701	63.7	1,795
(1989)	1,339	1,339	--	--	--	--	1,339	100.0	670
(1992)	4,473	1,263	--	516	116	467	2,362	52.8	1,125
Poland (1994)	9,989	2,424	2,427	796	74	611	6,332	63.4	1,933
São Tomé and Príncipe (1994)	10	10	--	--	--	--	10	100.0	1
Uganda (1993)	152	152	--	--	--	--	152	100.0	18
Uruguay (1991)	1,608	633	--	160	--	95	888	55.2	463
Venezuela (1990)	19,700	1,411	511	2,012	471	1,639	6,043	30.7	2,585
Zambia (1994)	200	200	--	--	--	--	200	100.0	22
Total	170,243	13,956	21,759	19,872	1,520	18,844	75,951	44.6	25,212
				(Pending agreements)					
Memorandum items:									
Albania (1995) 7/	385	160	--	225	--	--	385	100.0	100
Panama (1995) 8/	2,010	--	181	467	84	270	1,002	49.8	252
Sierra Leone (1995) 9/	148	148	--	--	--	--	148	100.0	22

Sources: IMF staff estimates.

1/ Debt and debt-service reduction are estimated by comparing the present value of the old debt with the present value of the new claim, and adjusting for prepayments made by the debtor. The methodology is described in detail in Annex I of Private Market Financing for Developing Countries (Washington: International Monetary Fund, December 1992). The amounts of debt reduction contained in this table exclude debt extinguished through debt conversions. Year in parenthesis refers to the date of the agreement in principle.

2/ The figure for debt-service reduction represents the expected present value of the reduction in future interest payments arising from the below-market fixed interest rate path on the new instruments relative to expected future market rates. The calculation is based on the estimated term structure of interest rates for U.S. treasury bond at the time of agreement in principle.

3/ Excludes past due interest and includes debt restructured under new money options for Mexico (1989), Uruguay (1991), Venezuela (1989), the Philippines (1992), Poland (1994), and Panama (1995); the Philippines' (1989) new money option was not tied to a specific value of existing debt.

4/ Excludes prepayment of principal and interest through guarantees.

5/ Cost at the time of operation's closing. Includes principal and interest guarantees, buy-back costs, and for Venezuela, resources used to provide comparable collateral for bonds issued prior to 1990. Excludes cash downpayments related to past due interest.

6/ Includes estimated value recovery clauses.

7/ Illustrative scenario assumes that the par bond option maximum is binding.

8/ Illustrative scenario based on an allocation of exposure of 20 percent to the discount bond, 60 percent to the par bond, 15 percent to the FLIRB, and 5 percent to the new money option.

9/ Corresponds to the first phase of the buyback.

that Russia waive sovereign immunity, Russia and its commercial bank creditors agreed that $500 million would be paid with respect to 1992/93 interest arrears. This amount was placed in a trust account at the Bank of England by the end of June 1995 pending final agreement on a rescheduling. In March 1995, it was agreed that a further $500 million would be paid in settlement of 1994 arrears. An initial round of negotiations between Russia and the commercial banks on a debt-stock rescheduling was held in early July 1995, and a working group was formed to make proposals with a view to reaching a final agreement by the end of 1995.

Slovenia reached an agreement in principle in June 1995 with the coordinating committee of commercial bank creditors of the former Socialist Federal Republic of Yugoslavia (SFRY). Under the terms of the agreement, Slovenia accepts responsibility for 18 percent of the unallocated debt of the former SFRY, slightly more than Slovenia's share (16.3 percent) in the former Yugoslavia's quota in the Fund. The agreement calls for the exchange of par bonds for the commercial bank debt and past due interest and principal on the same terms as the loans that the bonds replace. Approval of the agreement requires acceptance by qualified creditors holding two-thirds of the debt. 1/

2. Issues

In last year's report, concern was expressed that future bank debt negotiations might be complicated by market speculation that a country would conclude a debt and debt-service reduction operation. Such "pre-Brady" speculation was seen as one of the factors contributing to a sharp run-up in secondary market prices of bank claims during the second half of 1993 and into early 1994. As a consequence, secondary market prices in several instances were not seen to be reflective of the countries' medium-term capacity to service their debts. In addition, the upfront costs of debt operations (especially straight debt buybacks) were bid up substantially. Subsequent developments (most notably the rise in world interest rates during 1994 and the Mexican crisis at end-1994) have contributed to large declines in the secondary market prices of developing country bank claims from their early 1994 peaks (Chart 1).

Current market conditions may provide a favorable opportunity for countries to make considerable progress in negotiations with their bank creditors. Progress in normalizing relations with the banks is important in helping a country to return to a viable external position over the medium term and to regain access to international capital markets. In turn, market access would be facilitated by sustained implementation of sound macroeconomic policies. Delaying agreement with creditors in anticipation of receiving better terms is unlikely to be advantageous, especially for

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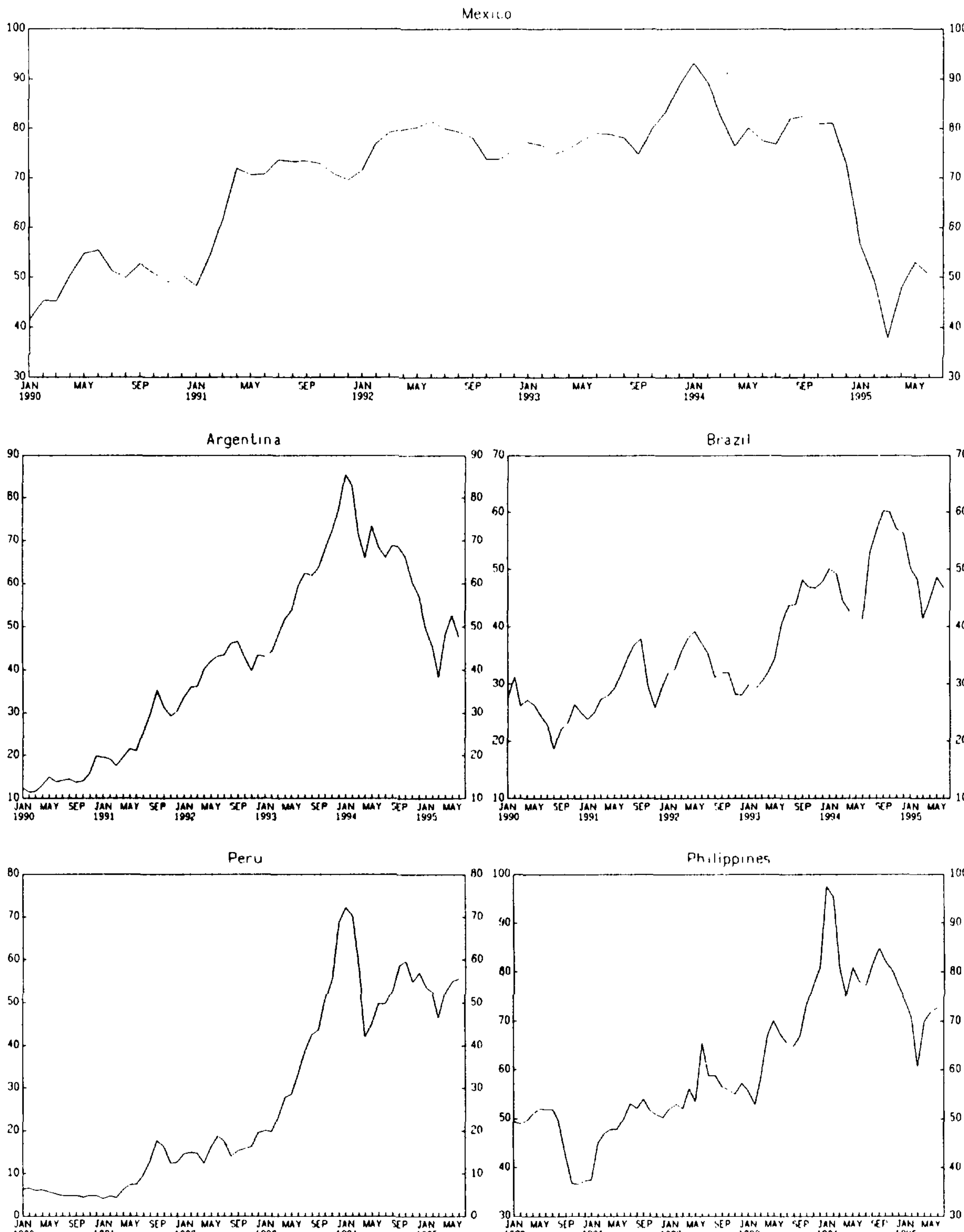
1/ Excluded from the agreement is debt held by "connected persons", defined as creditors owned or controlled by entities from the Federal Republic of Yugoslavia (Serbia-Montenegro).

Chart 1
Secondary Market Prices for Selected Bank Claims and Brady Bonds
(In percent of face value)



Sources: Reuters; and Salomon Brothers.

countries that are already implementing economic adjustment programs. Successful implementation of such a program would be expected to enhance a country's debt-servicing capacity over time.

With the adjustment in prices over the past year, there is less concern in some cases that high levels of secondary market prices will make it more difficult for countries to reach agreements with their creditors. Despite the general fall in secondary market prices, however, prices for the debts of many low-income developing countries have remained significantly above their levels in mid-1993 and potentially out of line with the ability of these countries to service debt over the medium term. Pre-Brady speculation also remains a potential concern, as evidenced by the recent run up in the price of Côte d'Ivoire's debt in advance of discussions between the country and its bank advisory committee. The commercial banks may need in some cases to show considerable flexibility, possibly entailing even steeper discounts on debt buybacks than those that they have accepted at times in the past.

Even at very steep discounts, the total amount of assistance that some low-income countries would require to buy back their commercial bank debt far exceeds available resources. In these cases, Brady-type debt and debt-service reduction operations may have to be considered. Key considerations in structuring such operations will be assessments of the country's medium-term debt-servicing capacity and the resources available to fund the upfront costs of the operation. In the assessment of debt-servicing capacity, the stream of resources to service commercial bank debt would be those available after allowance is made for payments on restructured debts to official creditors and on debts to multilateral institutions. The menu of options in such deals may entail, in addition to steep discounts on debt buybacks, sizeable discounts on discount bonds, par bonds with interest rates substantially below market levels, the write off of past due interest, and the provision of less than full collateralization of principal on bonds issued as part of the package. 1/

To meet the financing requirements for such operations, there will be a continuing need for substantial resources from multilateral institutions and bilateral donors. For its part, the World Bank is investigating means by which to make resources available to assist the heavily indebted low-income countries in financing these type of operations through the IDA Debt Reduction Facility and possibly through IDA itself. For the Fund, use of concessional resources to directly support a debt and debt-service reduction operation is not possible under the terms of the ESAF Trust. However, in

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1/ Full collateralization of principal would be a key issue in the case of a bank package including par bonds, owing to the relatively high upfront cost of providing such collateral. The commercial banks also may be extremely reluctant to accept less than full collateral. Therefore, it may not be feasible to include a par bond in the menu of options in debt and debt-service reduction operations for low-income developing countries.

association with an existing ESAF arrangement, the Fund could provide these countries with assistance under the present guidelines for Fund support of debt and debt-service reduction operations by means of a small stand-by arrangement to be augmented to support the debt operation. The provision by the Fund of nonconcessional resources for this purpose would need of course, to be consistent with the country's debt-servicing capacity. Continuing support for the country's adjustment efforts could be provided through the existing ESAF arrangement or a successor.

III. Private Financing Flows

1. Recent developments

Over the course of 1994, private market financing to developing countries declined from the level reached in 1993, reflecting in part a less favorable external environment (Table 2). 1/ The tightening of monetary policy in the United States early in 1994 set off considerable turbulence in world financial markets. As a consequence, there was a significant decline in developing country placements of bonds and equities in international markets from late February to April 1994. With the subsequent return to more stable conditions in the markets, new bond and equity issues by developing countries picked up sharply in the second half of 1994. Terms on new bond issues (interest rates and maturities), however, were generally less favorable than previously, and market access tended to be restricted to more creditworthy borrowers.

The Mexican crisis in December 1994 prompted a relatively broad sell off of developing country securities in late December and early January 1995. Selling pressures were concentrated in Latin American countries, and they continued with only brief respites until mid-March 1995 (Chart 2). Some Asian developing countries also experienced pressures in domestic financial markets in early January (Charts 3 and 4), but these pressures were short-lived, dissipating rather rapidly, and were generally followed by renewed inflows of portfolio capital. Recovery of prices in Latin American securities markets after April reflected market perceptions of improved prospects for Mexico, following the strengthening of its adjustment program, and for the other major countries in the region and the reported return to these markets of some investors who had exited earlier in the year. Early in 1995, issuing activity by developing countries in international bond markets was very weak and dominated by Asian entities,

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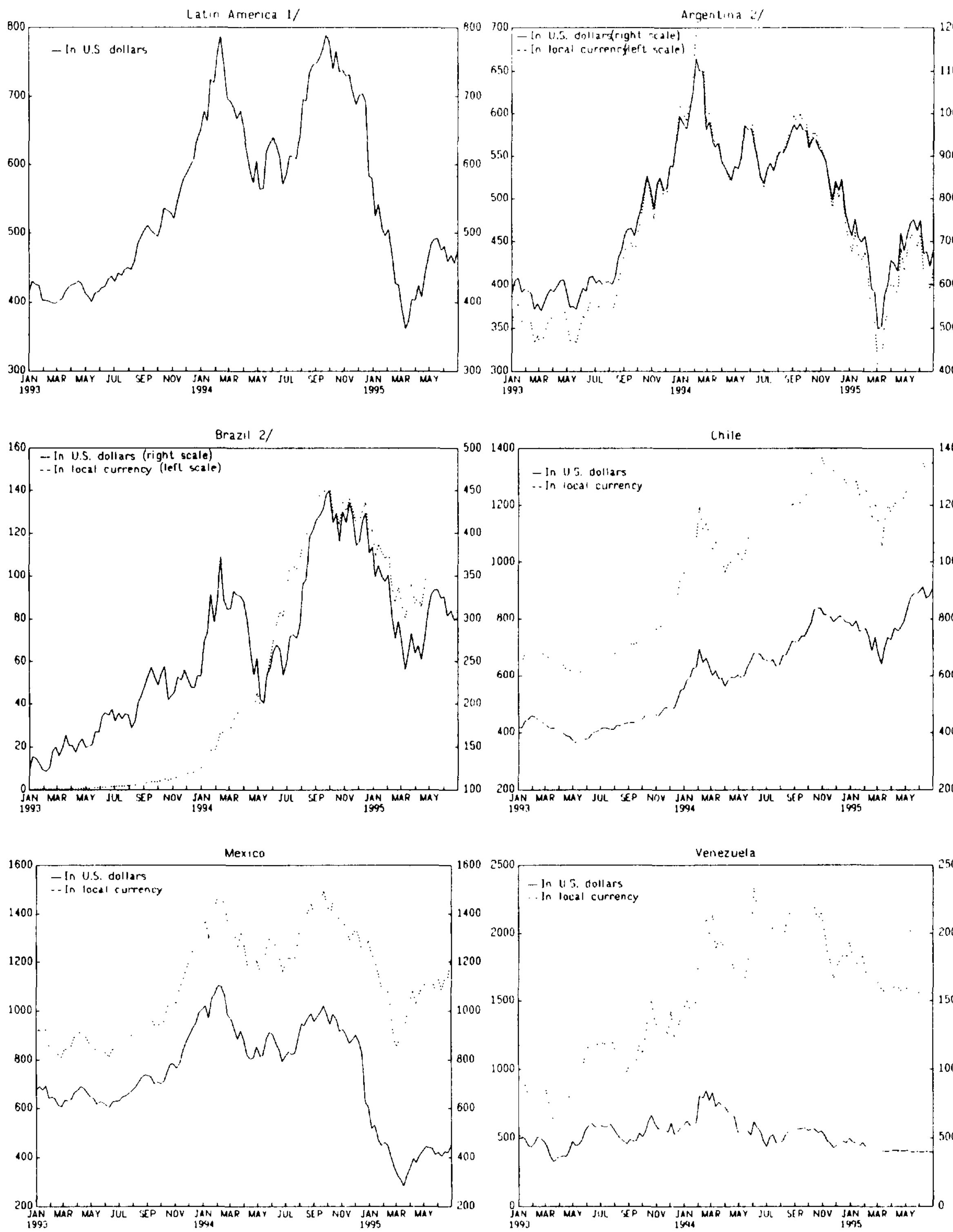
1/ Developments in private market financing flows to developing countries during 1994 and the first half of 1995 are discussed in more detail in Chapter III of the forthcoming background paper.

Chart 2

Share Price Indices for Selected Markets in Latin America

(IFC weekly investable price indices, December 1988=100)

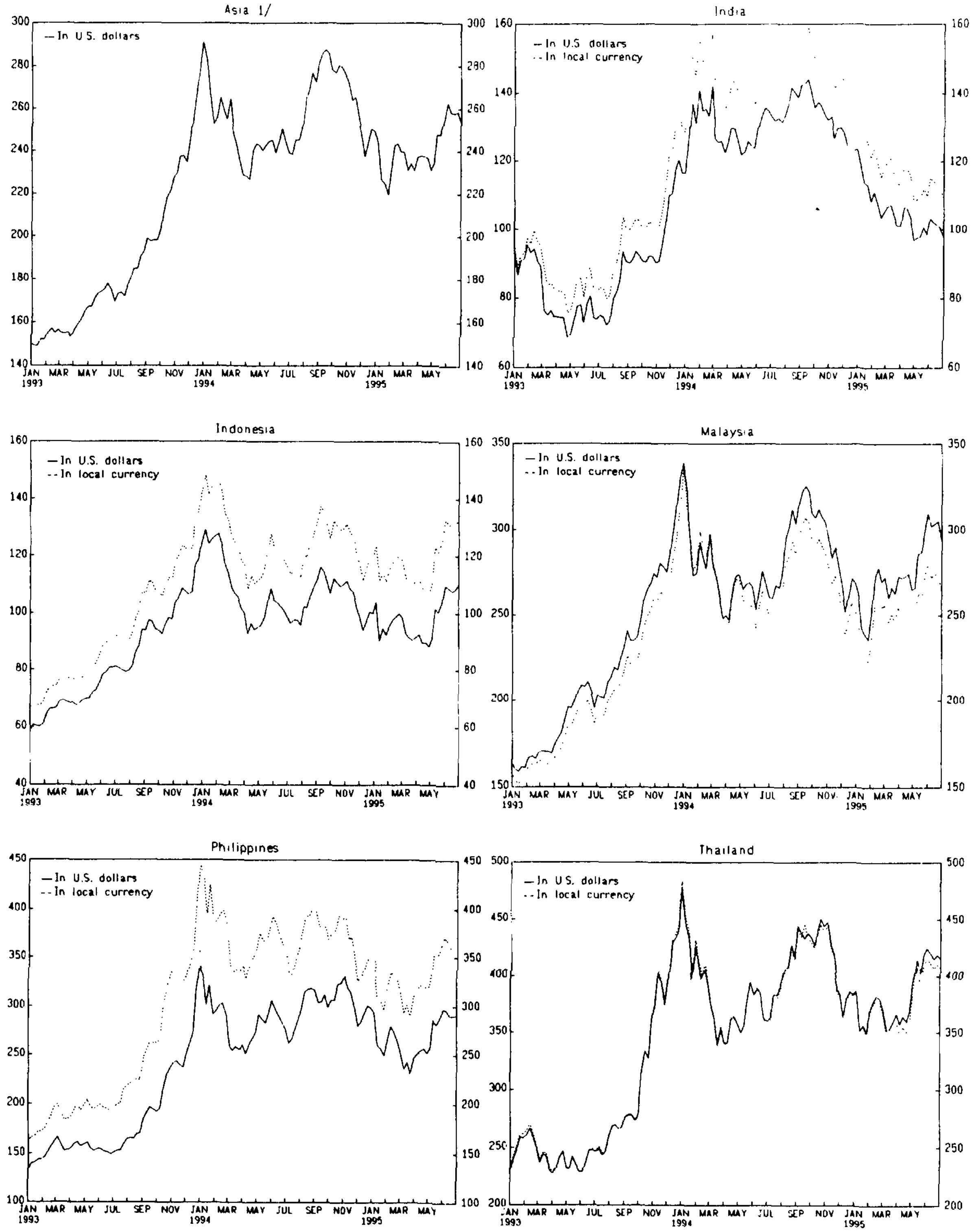


Source: International Finance Corporation (IFC), Emerging Markets Data Base.
1/ Argentina, Brazil, Chile, Colombia, Mexico, and Venezuela.
2/ The Argentine and Brazilian local currency indices have been divided by 10 million, and a thousand, respectively.

Chart 3

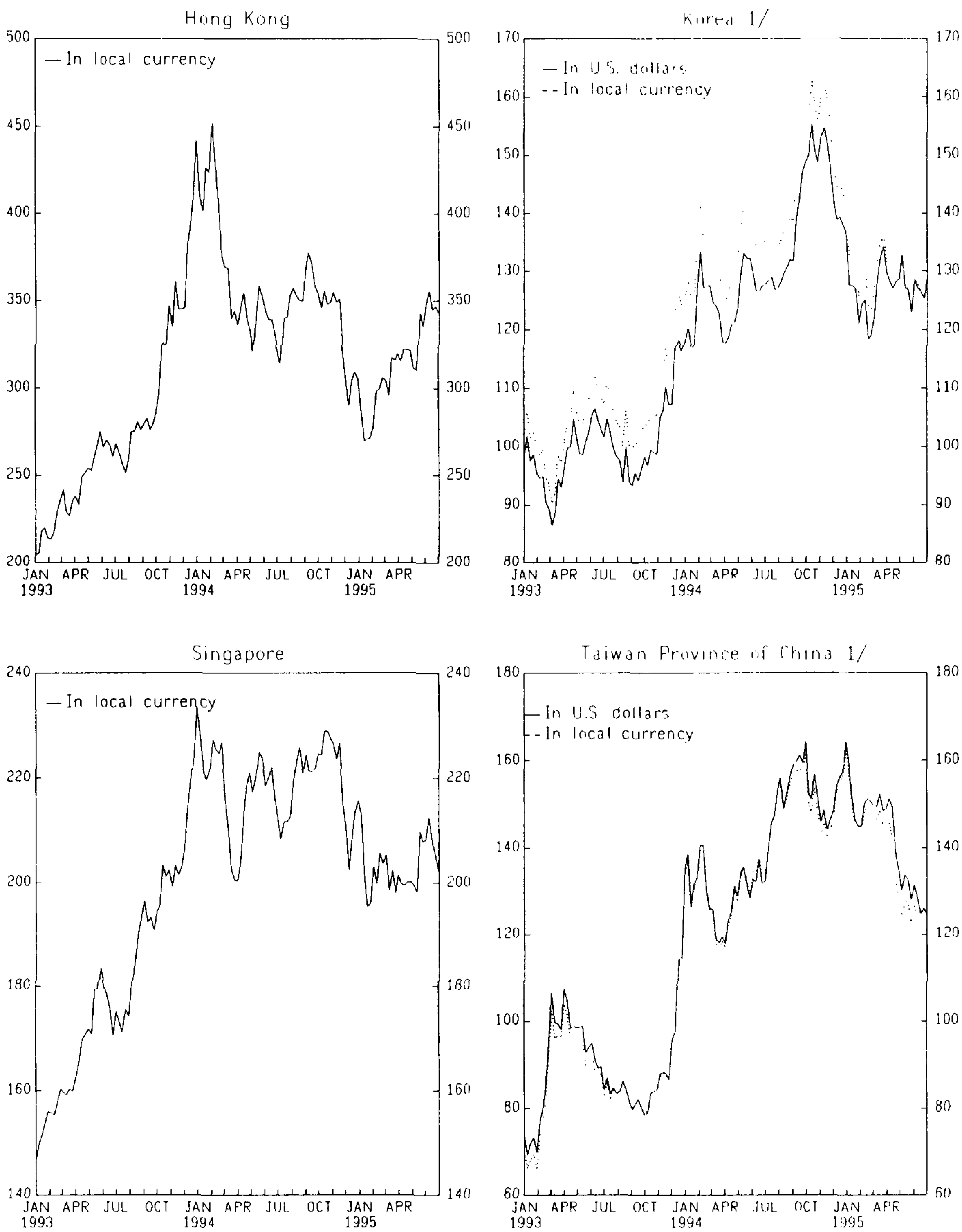
Share Price Indices for Selected Markets in Asia

(IFC weekly investable price indices, December 1988=100)



Source: International Finance Corporation (IFC), Emerging Markets Data Base.
1/ India, Korea, Malaysia, Pakistan, Philippines, Taiwan Province of China, and Thailand.

Chart 4
Weekly Share Price Indices for Asian NIEs
(December 1998=100)



Sources: International Finance Corporation (IFC), Emerging Markets Data Base; and Reuters.
1/ IFC Investable Index.

Table 2. Private Market Financing for Developing Countries

(In billions of U.S. dollars)

	1990	1991	1992	1993	1994
Net private capital inflows 1/					
All developing countries	13.6	51.7	93.7	149.3	119.0
Asia	19.8	40.3	30.1	62.0	63.0
Western Hemisphere	9.8	25.5	52.9	61.2	40.3
Europe/Middle East	-11.4	-13.1	5.6	27.9	9.3
Africa	-2.7	-1.0	5.1	-1.7	6.4
Of which:					
International bond issues					
All developing countries	7.9	14.0	24.4	62.6	58.6
Asia	2.6	4.1	5.9	22.0	29.9
Western Hemisphere	2.9	7.2	12.9	28.7	19.2
Europe/Middle East	2.3	2.5	4.9	11.7	6.7
Africa	0.1	0.3	0.7	0.2	2.7
International equity issues					
All developing countries	1.2	5.6	7.3	11.9	18.1
Asia	0.9	1.0	2.9	5.2	12.1
Western Hemisphere	0.1	3.9	4.0	8.0	4.7
Europe/Middle East	0.2	0.6	0.3	0.5	0.7
Africa	--	0.1	0.2	0.2	0.6
Memorandum items:					
New medium- and long-term bank loan commitments					
All developing countries	25.8	41.1	35.0	38.9	53.2
Asia	12.0	14.3	18.3	25.1	34.1
Western Hemisphere	2.4	5.1	5.5	7.0	3.7
Europe/Middle East	9.7	16.9	6.2	5.3	15.0
Africa	1.7	4.9	5.1	1.4	0.5
Bond redemptions					
All developing countries	2.4	3.2	5.1	8.1	9.8

Sources: World Economic Outlook database, and staff estimates based on Euromoney database; Financial Times; International Financing Review (IFR).

1/ Excludes capital exporting developing countries.

led by Korea; equity issuance came to a virtual halt. Beginning in April and continuing through July, international placements of bonds picked up. Although Asian issuers continued to dominate, non-Asian entities returned to the international markets.

2. Issues

The tumult in the markets for developing country securities precipitated by the Mexican crisis (sometimes referred to as the "tequila effect") demonstrates once again how returns on these securities become increasingly correlated in periods of stress in the financial markets. Following the Mexican devaluation in December 1994, the correlations among developing countries in total returns on Brady bonds rose sharply, particularly among Latin American countries. 1/ Similar behavior was observed in early 1994, as correlations in returns on Brady bonds rose *sharply in the wake of the initial increases in U.S. interest rates* beginning in February and remained high through April 1994 when more stable conditions were re-established in world financial markets.

Correlations in the returns on these bonds, especially among the Latin American countries, may in part be explained by the reported use by market participants of Mexican securities as benchmarks for the pricing of other developing countries' securities. Mexico was viewed as a prime example of successful economic adjustment and was generally considered to be one of the best risks among developing countries that did not have an investment grade credit rating, particularly among those countries that had previously rescheduled debts to private foreign creditors. The rise in the correlations in times of stress may in part reflect the composition of the investor base. A significant number of investors with similar characteristics (e.g., information sets and liquidity needs) and risk/return preferences have entered the markets for developing country securities in recent years; most notably among these were institutional investors (mutual funds, pension funds, and insurance companies). This development may have contributed to establishing conditions conducive to producing higher volatility in developing country securities markets. These investors would tend to react simultaneously in a similar manner to a shock affecting expected returns and the perceived riskiness of developing country securities. Such concerted movements by these investors, given the lack of substantial liquidity in most of these securities markets, would add to the volatility of these markets. Moreover, limited liquidity in developing country markets is likely to have led to a bunching of investments in a few markets and in only a limited number of security issues.

1/ For a complete discussion of correlations among returns on developing country securities, see Chapter III of the background paper.

The rule-based approaches to portfolio allocation generally followed by institutional investors may be another contributing factor. 1/ These investors appear to follow a two-step process in allocating their portfolios among various assets. Investible funds first tend to be allocated to different classes of assets, in part on the basis of fundamental economic factors determining expected asset returns, but the decisions of institutional investors are also influenced by other considerations, such as liquidity in the asset markets and diversification of the overall portfolio. Reflecting this behavior, institutional investors in recent years have come to identify developing country securities as a distinct asset class. Once investible funds have been allocated to a particular asset class they are then invested in individual securities in the asset class primarily on the basis of economic fundamentals affecting expected returns. 2/ Thus, there is the potential for a shift in investor sentiment away from developing country securities as an asset class to lead to the selling off of securities across a broad range of countries without a change in, or without fully reflecting, the basic economic fundamentals in the individual country cases. 3/ Such a shift in sentiment could be inspired by developments in one key country in the group, such as Mexico, with the impact of the shift spilling over to asset markets in all other countries. To some extent, such spillover effects might reflect a reappraisal by investors of countries with similar characteristics after the difficulties encountered by the major country; in the aftermath of the Mexican crisis, for instance, countries with relatively large current account deficits and fixed (or heavily managed) exchange rates regimes were tested. In general however, selling pressures across the full range of country asset markets would not be expected to persist for a prolonged period, because, to the extent that the selling behavior of institutional investors in individual country markets pushed prices significantly out of line with expectations based on economic fundamentals in those countries, profit opportunities would be created and are likely to be exploited by other investors. Moreover, an improved flow of information on economic conditions in developing country markets would be expected over time to moderate inconsistencies between the prices of developing country securities and their underlying fundamentals.

1/ An analysis of the influence of institutional investors on the pricing of developing country equities in domestic stock markets is presented in Chapter IV of the background paper.

2/ Although as noted above, liquidity constraints in developing country securities markets may limit the ability of investors to fully achieve an optimal allocation.

3/ It should also be noted that there are some differences in behavior among institutional investors. Pension funds, in particular, are viewed as being somewhat longer-term investors and less prone to very rapid shifts in portfolio allocations among assets classes. In contrast, open-ended mutual funds may be more likely to shift allocations reflecting the ability of the holders of these funds to readily redeem them.

The short-lived selling pressures experienced in Asian markets after the Mexican devaluation support the view that such pressures will not persist in the absence of changes in fundamentals. The ability of Asian countries to weather these pressures largely reflected their basically strong economic positions, underscoring the importance for countries to consistently implement sound macroeconomic and structural policy programs. 1/ Implementation of such policy programs also will serve to ensure that access to foreign capital will be maintained on reasonable terms. Maintaining access to international markets is particularly important since a number of developing countries are now entering a period of significantly rising debt amortizations as bullet repayments on bonds issued in the late 1980s and early 1990s are beginning to come due (Chart 5).

Developments over the past year and a half point to the general resilience of the market for developing country securities and provide reassurance that market access can be maintained. The resilience in part reflects the continuing strong economic performance of many developing countries. It also reflects the economic adjustment efforts of authorities in countries experiencing difficulties. Latin American securities generally have posted strong gains in the past few months, and Brazil was able to return to the international financial markets in May 1995 with a new bond issue. Mexico itself made a dramatic return to the international bond market in July 1995 with a large issue that was doubled in size from its original offer owing to strong demand. This contrasts with the scenario which could have developed if, short of decisive action, Mexico and others had had to resort to moratoria. The external environment also is more favorable with the recent declines in U.S. long-term interest rates improving prospects for capital flows to developing countries. Moreover, the Mexican crisis appears to have produced only a temporary disruption to the general trend toward globalization of financial markets and diversification of investors' portfolios.

Nonetheless, some questions remain about the level of flows to developing countries in the near term, reflecting the fact that thus far in 1995 generally only the most creditworthy developing country borrowers have had substantial access to the dominant dollar segment of the international bond market, while other borrowers have largely been able to place issues only in the other currency segments of the market, which tend to be less liquid. Although portfolio capital flows to developing countries in 1995 are likely to be significantly below their levels in 1993-94,

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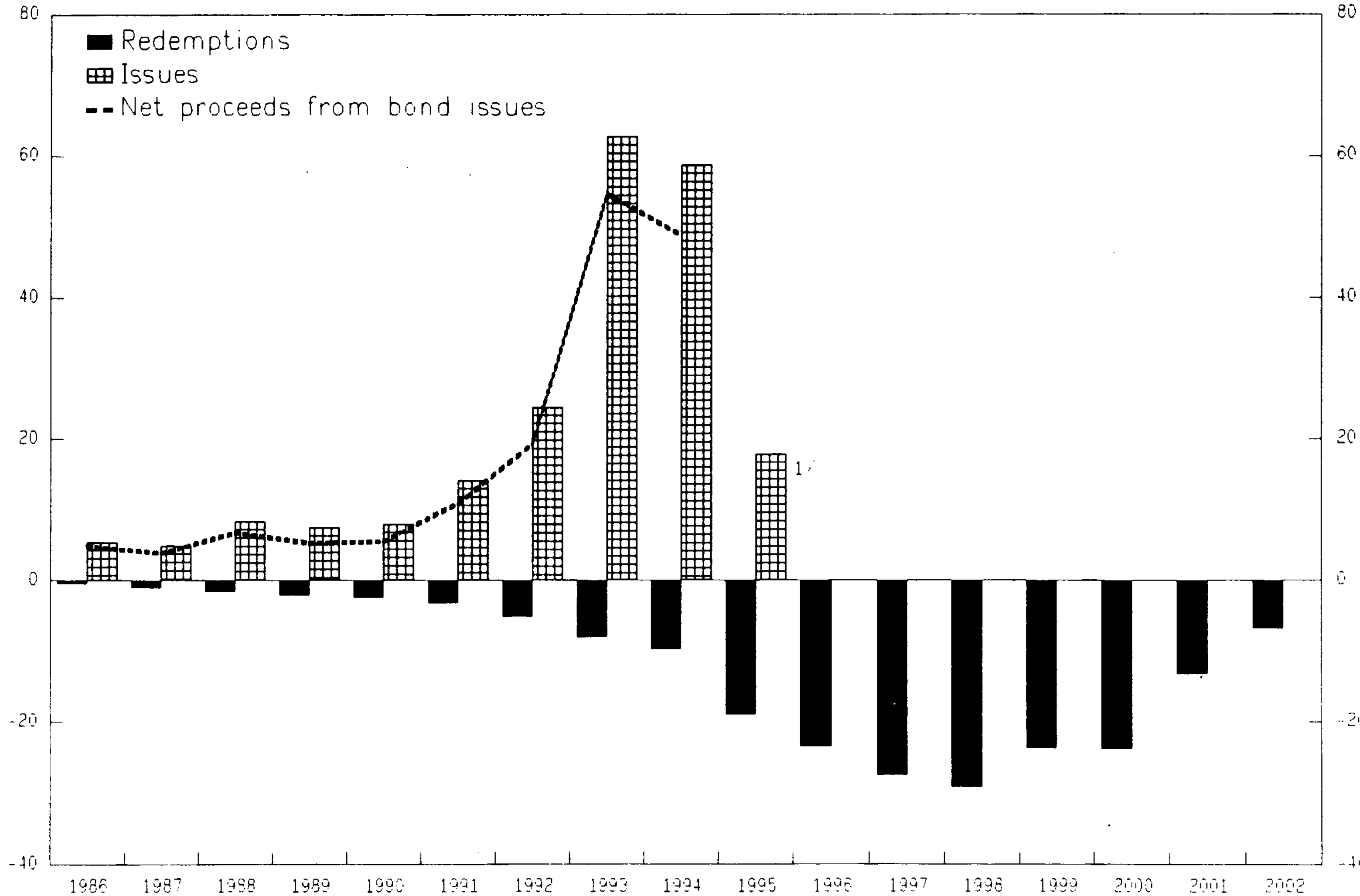
1/ For a description of events in a number of developing countries after the Mexican devaluation, see Chapter II of International Capital Markets - Developments and Prospects and Key Policy Issues - Background Material Part I - The Crisis in Emerging Markets - Background Paper Part I (SM/95/101, May 4, 1995).

Chart 5

International Bond Issues and Redemptions by Developing Countries

(In billions of U.S. dollars)



Sources: Staff estimates based on EuroMoney Database; and International Financing Review.

1/ First six months of 1995; future redemptions reflect the maturities of new bond issues in the first half of 1995 and valued at the exchange rates prevailing at end-June 1995.

sizable flows are likely to continue over the medium term as portfolio diversification continues and provided that developing countries sustain strong economic policy performances and adjustment efforts.

In the aftermath of the Mexican crisis and renewed concerns about the volatility of capital inflows, questions have been raised regarding external debt management practices. 1/ In managing the government's debt, the Mexican authorities prior to the crisis took actions that entailed the shortening of maturities and indexing of part of Mexico's debt to the U.S. dollar. These actions appear to have complicated the situation by creating conditions conducive to short-term liquidity problems. The currency composition of government external debt has also created some difficulties for developing countries that borrowed in yen owing to that currency's recent sharp appreciation against the U.S. dollar. This situation illustrates the need for a country to carefully assess the cost, including the foreign exchange risks, when borrowing in foreign currency. Such risks should be adequately hedged, either indirectly by keeping the currency composition of foreign borrowing in line with the composition of foreign exchange earnings or explicitly through the use of financial market instruments, such as foreign currency swaps. Otherwise, what might appear to a country's authorities to be a cheap source of funds owing to low interest rates may turn out to be rather expensive as a consequence of the foreign currency exposure acquired.

In many countries, the more active role of the private sector and the public sector corporations in tapping international capital markets raises a number of additional issues for external debt management. While these entities should be held accountable for their own debts, difficulties encountered by the Government can negatively affect their ability to service debts, adding to the severity of a financial crisis. The situation in Mexico following the devaluation provides a good illustration of this point, as some commercial banks found themselves unable to roll over short-term foreign currency debts and the Government stepped in to provide the necessary foreign exchange to avert a further crisis in the banking system. At the same time, problems in the private sector and the public sector corporations can quickly pose significant challenges for macroeconomic policies. This may especially be the case if the banking sector has borrowed heavily abroad to fund its domestic lending and important segments of the sector encounter difficulties in meeting their obligations. Weakness in a country's financial sector seriously inhibits the ability of the authorities to conduct monetary policy and may entail significant fiscal costs. Debt-servicing problems of nonfinancial corporations may also have spill-over effects on the Government's conduct of economic policy if major corporations are the source of the difficulties, owing to the impact that

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1/ A more complete discussion of considerations in a country's management of external debt is provided in Chapter V of the background paper.

failure of a major corporation could have on the domestic economy and negative consequences of such a failure on the ability of the Government and other borrowers to maintain access to international financial markets.

In dealing with the external debt of the private sector and the public sector corporations, it is crucial for the Government to carefully monitor debt flows in order to maintain timely information on the economy's overall foreign exposure. Such information is critical to the authorities' ability to accurately assess the appropriateness of macroeconomic policies, and it fits with the authorities' responsibilities to collect and publish accurate statistical information on the state of the domestic economy and the country's external position on a timely basis. As the capital account is liberalized, it is important that the ability of nongovernment entities to access foreign markets does not outstrip the ability of the Government to monitor these activities, particularly in countries in the process of stabilizing their economies.

Beyond simply monitoring flows, it is especially important in the case of intermediation of capital inflows through the domestic banking system that the Government provide for adequate supervision and regulation of the banks. As the principal shareholder in the public sector corporations, the Government has the responsibility to oversee the corporations' activities and to ensure that the Government achieves an adequate return on its equity interest with an acceptable degree of risk and that the national interest is served. In the case of private sector nonfinancial corporations, the most appropriate role for the Government would be to put in place adequate standards and requirements for public financial reporting of the activities of these corporations.

Measures to restrain foreign borrowing by the private sector may be found useful in a few instances. For example, measures to limit the intermediation of capital flows by the banking system might be a appropriate response in instances where supervision and regulation of the banks may be weak. These type of measures, however, may not be effective beyond the short run, especially in relatively open economies. Furthermore, they impose costs on the economy, particularly in the sense that some significant opportunities may be foregone by restricting capital inflows. In the end, successful management of external debt by the private sector rests on the sector's ability to develop and employ appropriate business practices. Capital controls would tend to impede this development.

IV. Concluding Remarks and Issues for Discussion

Executive Directors may wish to comment on the following observations.

1. Over the past year, the framework for resolving bank debt problems, with the flexibility entailed in the menu approach, continues to prove its effectiveness in dealing with these problems on a case-by-case basis.

2. Indebted developing countries which have not yet normalized their relationships with their commercial bank creditors are urged to take advantage of relatively favorable current market conditions to make progress in resolving their debt problems. Further delay in anticipation of receiving better terms is likely to only slow a country's return to a viable external position. Also, better terms are unlikely to be produced by a further delay while a country successfully implements an economic adjustment program, since over time the country's debt-servicing capacity would be expected to improve.

3. Further progress has been made in dealing with the commercial bank debt problems of low-income developing countries. However, for a few of these countries the size and the secondary market prices of their debts make straight debt buybacks prohibitively expensive, even at particularly steep discounts. For these countries, it will be necessary to design debt and debt-service reduction operations consistent with the countries' medium-term capacity to service bank debt and consistent with available resources. Some progress on this score has been made in the case of Côte d'Ivoire. Successful conclusion of such operations will depend on the availability of the required resources from the multilateral institutions and bilateral donors. The World Bank is investigating means of providing concessional resources for this purpose. While the ESAF cannot be used for such operations, the Fund could support debt operations for these countries under its current guidelines through the provision of a small stand-by arrangement, to be augmented in support of the operation, in conjunction with an ESAF arrangement. Such support would be structured so as to be consistent with a country's medium-term debt-servicing capacity, and continuing support to the country could be provided through ESAF.

4. Disruptions arising from the crisis in Mexico spread across the markets for a wide range of developing country securities. These so called "contagion effects" appear to have reflected some of the characteristics of foreign investors in these securities and the generally less developed state of these security markets. Nonetheless, the experiences in Asian markets suggest strongly that ultimately basic economic fundamentals affecting asset returns are the primary factors determining investors' behavior and point to the importance of countries consistently implementing sound economic policies.

5. The Mexican crisis represents the most severe test in the recent past of the ability of developing countries to maintain access to international sources of private capital. Continued strong performance by a number of countries and the determined adjustment efforts of those that have encountered difficulties, accompanied by timely assistance provided by the Fund in key cases, appear at this juncture to have sustained investor interest in developing country securities. While for 1995 as a whole portfolio capital flows to developing countries are likely to be significantly less than in the past two years, a pick up in inflows is expected over the second half of the year.

6. Recent developments also point to the need for countries to pay more attention to the management of external debt. The authorities not only have to ensure that the Government's own external debt position is properly managed, but they also should be well informed as to the foreign borrowing of the private sector and should facilitate the timely provision of information in general on this sector's activities. It is particularly important that the foreign funding activities and lending practices of the domestic banking system are carefully supervised and regulated. Financial difficulties in this sector can limit the authorities' ability to conduct monetary policy and can entail significant budgetary costs.