FOR AGENDA

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July 31, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Financing for Countries with Payments Difficulties - Recent Experience and Possible Adaptations

Attached for consideration by the Executive Directors is a paper on financing for countries with payments difficulties, which has been scheduled for discussion on Friday, September 4, 1987.

Mrs. Junz (ext. 8849) or Mr. Kincaid (ext. 7356) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Financing for Countries with Payments Difficulties: Recent Experience and Possible Adaptations

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(In consultation with other Departments)

Approved by L.A. Whittome

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Financing for Countries with Payments Difficulties: Recent Experience and Possible Adaptations

I. Introduction

It has become clear that the resolution of the debt problem will involve a considerably longer effort than had earlier been hoped and the Executive Board, in reviewing debt issues, has emphasized the importance of basing solutions of debt-servicing problems on coordinated policies in creditor countries and strong growth-oriented adjustment policies in the debtor countries 1/ (Table 1). The roots of the problem lie largely in the excessive borrowing of the 1970s which substituted for domestic resource mobilization and facilitated both unsustainably high consumption and heavy investment in activities which, in current circumstances, cannot pay their way. The shift of resources necessary to provide the basis for healthy growth thus involves a more far-reaching effort than might have appeared necessary in the early stages of disinflation.

This paper attempts to summarize the main changes that have been occurring and surfaces some questions as a background to a forthcoming discussion by Executive Directors. 2/ It is accompanied by papers on capital markets developments and export credit activities. 3/

II. Recent Approaches

Recently, a number of adaptations have been made in the ways rescheduling and new money packages have been put together. These changes reflect primarily a desire on the part of both debtors and creditors to introduce a greater degree of flexibility into the process and to speed the assembly of financing from banks in support of essential policy reforms. Some of these changes have consequences that may be more than technical.

A major force behind these changes has been the more explicit recognition that debt problems can only be resolved over a relatively long time period. This has motivated creditors to stretch out maturities. In the case of the poorest countries, official creditors have extended maturities over periods of up to twenty years. In the

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1/ Discussion of "Implementation of the Debt Strategy--Current Issues" (EBS/87/38, 2/20/87; EBM/87/49, 3/17/87 and concluded at EBM/87/50, 3/18/87).

2/ A further discussion of these issues is foreseen later in the year on the basis of a forthcoming paper on "Issues in Managing the Debt Situation."

3/ "International Capital Markets--Developments and Prospects, 1987" (forthcoming) and "Officially Supported Export Credits: Developments and Prospects" (forthcoming).

case of commercial bank packages, changes have been more broadly based. The 1982-83 round of bank financing typically involved one- or two-year consolidation periods, maturities of up to ten years, and spreads of about 2 percent. New money was largely in the form of general balance of payments financing with the government or the central bank as obligor. By 1986, financing approaches had evolved so that the 1986-87 package for Mexico incorporated a multiyear consolidation period, with maturities extended to 20 years; sharply reduced fees and spreads; and a variety of mechanisms for diversifying the nature of banks' claims, including an expanded debt-equity scheme that operates to reduce external debt. The new money mechanism included contingency arrangements, a medium-term trade facility, on-lending provisions, and partial World Bank guarantees.

Still more recently, the package for Argentina explicitly adopted the "menu" approach, i.e., provision of options tailored primarily to satisfy differing interests of creditors. Thus, it included three new features: a special fee for early participation; a limited amount of securitized new money claims; and optional "exit bonds" (Alternative Participation Instruments--APIs--with long maturities and below-market interest rates). Over the past years, financing has also been provided, on occasion, in forms other than new money: for example, for Chile, interest payments were retimed in part to avoid increases in bank exposure.

One important aspect of the increasingly innovative techniques for bank financing is their differential impact on countries' stock of debt and future payments obligations. Some approaches, including most obviously new money, add to the stock of debt. Others involve debt redemption and/or tend to limit countries' debt-servicing obligations. These latter include lower interest spreads, retiming of interest payments, conversions of debt to equity or to residents' local currency claims, and the potential substitution--on a small scale--of low coupon bonds (APIs) for some existing bank claims.

Another aspect is the degree to which certain categories of debt, mainly trade-related and newly contracted claims, have been differentiated from other claims in an attempt to encourage new flows. In this process, trade loans often have carried higher spreads. In some cases, they have been kept out of formal restructurings, although in others they have been grouped in special facilities and included in the new money base; in general, they have been serviced more consistently than other debt. New money maturities often have been shorter, and carried higher spreads, than restructurings. Banks have pressed for--and in a few cases obtained--official guarantees on some portion of new money. The Argentina package provided, through APIs, for the transformation of some old debt into claims bearing a below-market interest rate, while banks expect securitized new money claims, given their bearer form and limited scope, to prove exempt from rescheduling. However, banks' attempts to draw a distinction between existing and new claims have not been given legal substance, reflecting the difficulties of structuring a credible means of voluntary subordination of "old" debt that is capable of catalyzing new flows.

Official creditors, since 1984, have stressed the importance of maintaining the cutoff date in reschedulings, so as to draw a clear distinction between "old" and "new" debt. Thus, priority of servicing medium- and long-term credits contracted after a specified cutoff date was added to that already accorded to short-term debt. Largely as a result of this debt subordination strategy, export credit agencies tend to maintain short-term cover for rescheduling countries and are now more likely than in the past to reopen medium- and long-term cover after the signing of the bilaterals from a debtor's first Paris Club rescheduling. Moreover, for debtors that have been implementing their previous rescheduling agreements and following through on their adjustment efforts, most agencies now tend to remain on cover during negotiations for further reschedulings.

The role of the World Bank and other multilateral development banks has become increasingly important for the financing of middle-income countries, particularly through policy-based loans. In 1986, disbursements from the multilateral development banks to the heavily indebted countries increased by about one third. In addition, the development banks have catalyzed financing from other sources, including commercial banks, through forms of cofinancing that--in a limited number of cases--included guarantees as well (Table 2).

The Fund, working with the World Bank, has remained pivotal in coordinating financial support. Creditors continued to link both bank and official reschedulings, as well as new money packages, to countries' pursuit of Fund-supported programs, although recently they have in some cases accepted linkage to enhanced surveillance by the Fund, rather than to an upper credit tranche arrangement.

In the case of the poorest debtors, creditors have begun to recognize that solutions that create additional debt on traditional terms may not be productive. For these countries, official debt predominates and Paris Club reschedulings have been relatively comprehensive, both with regard to categories and amounts rescheduled, and to final maturities. Thus, in mid-1987, Paris Club creditors agreed on a final maturity of 15 years for Zaire, Mauritania, and Uganda, and, for Mozambique and Somalia, the final maturity was extended to 20 years, with 10 years' grace. However, debt originally contracted on commercial terms has generally been rescheduled on commercial terms. This has given added impetus to the growth of indebtedness associated with the rescheduling of interest. Recognizing that for the poorest countries no improvement in creditworthiness can be expected from continued rescheduling at market-related interest rates, some bilateral creditors have forgiven debt and a number of Paris Club creditors have indicated their willingness to contemplate interest rate concessions. But no general approach to this problem has yet been agreed.

In the case of these countries, bank creditors generally continued to hold back from rescheduling on concessional terms, although they agreed, in the cases of a few countries experiencing protracted difficulties, to defer or capitalize interest. Recently, commercial banks agreed, in an innovative move, to allow Bolivia to buy back its debt at a discount. However, the buy-back option was predicated on funds being made available from donors for this explicit purpose, so that Bolivian reserves and current account earnings would remain unimpaired with respect to debt service. In this case, the Fund played a catalytic role in temporarily approving arrears to commercial banks while negotiations on a financing package were underway.

Multilateral development bank financing for low-income countries has been almost entirely on highly concessional terms, with the emphasis shifting toward support of growth-oriented adjustment programs. This has applied particularly to support through IDA and through the World Bank's special facility for Africa. Regional development banks continue to make mainly project loans to these countries. In addition, both multilateral and bilateral development assistance has increasingly been made available in the form of quick-disbursing, policy-based concessional loans and grants designed to support economic adjustment programs.

The Fund's Structural Adjustment Facility (SAF) was created to broaden access to Fund resources on appropriate terms for the poorest countries. Both banks and the Paris Club have now rescheduled on the basis of a SAF. Following the Venice Summit, the Fund launched an initiative to increase financing available in conjunction with the SAF, and on highly concessional terms, by SDR 6 billion.

III. Questions Concerning the Scope of Adaptations

Recent adaptations reaffirm the basic approach to debt problems that has governed actions in recent years, while, at the same time, reflecting some shift in concerns. The basic approach that has been confirmed is that debtor countries have continued to eschew sovereign defaults in recognition of the consequent economic dislocation; and the financial community has supported such efforts in the recognition by individual institutions that their self-interest was promoted by a collaborative approach. Moreover, efforts to relieve countries' debt problems have continued to be based on a case-by-case approach. This approach has been accompanied by a significant strengthening of the commercial banking system. However, whereas concern about the fragility of the commercial banking system has abated, concern about the adequacy of securing development finance, that will sustain economic adjustment, persists.

Over the course of the past two years, participants in the debt strategy have increasingly emphasized that the resolution of debt-servicing difficulties must be seen in a medium-term context. It must be based on growth-oriented adjustment backed by adequate financing and supported by a world economic environment that is conducive to its success. The effort to sustain adjustment and to restore creditworthiness for individual countries further involves difficult issues regarding the reasonable apportionment of the dividend of adjustment between debtors and creditors.

Recent developments have illustrated market participants' doubts about the present outlook. Banks in many industrial countries have now established loan-loss reserves equivalent to 25-35 percent of the principal value of claims on rescheduling countries. Loan claims, on middle-income countries have been transacted, in admittedly thin markets, at discounts that have clustered around 30 percent in some cases and around 40-55 percent in others. For some low-income countries with severe debt-servicing difficulties, such discounts have exceeded 90 percent.

The implicit yields on discounted debt are an indication of the obstacles faced by debtor countries in attracting financing for new investment. Earlier overinvestment and misinvestment contributed to the present debt difficulties. Given this background and uncertainty about economic prospects, potential domestic and foreign investors in many countries require relatively high returns on new investment. This would seem especially appropriate when production is being diversified and entry into highly competitive markets and activities is sought. It may be held that some fall in investment/GDP ratios is--at least for a time--compatible with a satisfactory rate of growth as resources are released from uneconomic activities and appropriate new investment improves the quality of the capital stock. But there are also risks that adjustment may be underfinanced, not least because the re-establishment of a satisfactory domestic savings and investment balance--including a reversal of capital flight--may be slowed by the existence of apparently excessive claims on present and future profits to service existing debt.

These considerations naturally have raised a number of questions about ways in which the debt strategy can be adapted to couple renewed growth with financing that is adequate both in terms of cash relief and in reflecting realistically countries' evolving capacity to service debt.

A first question is whether a more generalized approach is desirable. The fact is that countries' economic situations and prospects vary widely, and so do the interests of different creditor groups. With the evolution of the debt strategy, the case-by-case approach has been reaffirmed; if anything, the predominant view is that this approach needs to become yet more diversified. The various schemes that seek a generalized solution for countries' debt difficulties have not found favor. They do not appear to offer the flexibility required to tailor financing flows to the particular needs of individual countries and may not provide a safeguard against a loss of access to unguaranteed bank flows for a number of years. Further, most generalized debt relief plans that have been put forward would involve considerable actual or contingent official financing; at present discounts, the valuation of medium-term, unguaranteed bank debt of the 15 heavily indebted countries is well in excess of $100 billion. Such an approach also raises the question whether it is optimal to use scarce official resources to liquidate--or guarantee--the banks' portfolios of existing debt, while only providing limited cash flow relief to debtor countries.

A second general question is whether for some countries with protracted serious payments difficulties, an approach based on meeting adverse developments by increasing the level of indebtedness can provide a viable solution. Views differ widely, of course, on how many countries are in--or may fall into--a situation where increased indebtedness is inappropriate. Indeed, one serious concern about some calls for debt relief is that these could damage the interests of, for example, those middle-income countries that can realistically hope to recover normal access to financial markets over a period of years, or even of countries that have made great sacrifices to retain such access.

However, this issue clearly needs to be faced in the case of the poorest countries with a high debt burden. For some of these, it may be unrealistic to suppose that access to significant spontaneous commercial flows can be regained, even after a period of structural reform. Therefore, some more imaginative forms of financial relief may need to be sought. Agreement between creditor and debtor, and more broadly in the international community, on the need for a break with the past could perhaps open the way for a negotiated reduction in contractual debt claims.

On the part of commercial banks, concessional financing or debt relief could be provided in a number of forms. Buy-backs of existing debt are one option that may be applicable for some low-income countries with steep discounts on their debt and available donor funds. Concessional interest rates, below the cost of funds, would also reduce the debt burden if commercial banks were persuaded that this was the appropriate way of regularizing their relations with some countries.

Countries that see reasonable prospects of spontaneous access to credit in the future have a common interest with creditors in rebuilding their market acceptability. Debt relief plans that force creditors to realize losses may be counterproductive in view of the flows of financing that will be needed in the future. As noted above, some losses have already been taken--and, in some cases, mitigated by their effect on tax liabilities--generally, however, without benefit to debtors. Countries' access to normal capital flows will depend ultimately on establishing the conviction that such indebtedness will be serviceable in the medium term. In so doing, some mutually agreed mechanisms to reduce the debt burden may be appropriate. The further development of financing options--such as debt-equity conversions--that reduce external debt claims while enabling debtor countries to benefit, at least in part, from the discount at which their debt is trading could assist.

However, the scope for such schemes is of necessity limited. Moreover, debtors have expressed concern that they may not add to (or could reduce) available foreign exchange resources, while causing difficulties for monetary management. Nevertheless, in Chile, it has proved possible to retire as much as 12-15 percent of external bank debt through such schemes. Such arrangements, however, need to be adequately monitored by debtor countries, to assure that the prime benefit does not accrue to the middlemen, or that they do not encourage resources to be channeled into investments that may not be remunerative in the long run.

A further way of reducing contractual obligations could be found in widening the scope for exit bonds, such as APIs, by increasing acceptance of long-term, low coupon bonds. This could have the added attraction of reducing to a more manageable number the banks involved in financing packages, and excluding some that have preferred to ignore calls for new money and, thereby, have obtained a "free ride" on full interest receipts. So far, however, banks have been very reluctant to take up APIs.

This raises a third question, regarding the extent to which the *"menu" approach can embrace options that help induce reluctant banks to* participate in financing for countries that pursue sufficiently effective policies to justify the assumption of new debt. This concern may be sharpest in the case of countries whose level of debt is high in relation to their resources, but of relatively moderate weight in creditors' portfolios. Menu options that allow banks to pursue diversified domestic business opportunities in developing countries, or act as intermediaries in, for example, debt/equity swaps, are particularly attractive for large banks with a commitment to international business. It will be important that some other options be available to broaden the appeal of the menu.

A number of banks would seek the inclusion of voluntary options to defer or capitalize interest, as an alternative to new money. There is a question whether, given strong pressure on reluctant banks, resistance to new money calls could perhaps be converted into negotiated acceptance of APIs. So long as such options are relatively limited in scale and arrived at on a negotiated basis, they would not raise systemic concerns; rather, they could be helpful in avoiding a breakdown in the financing process. More generalized interest capitalization--aside from its debt-creating aspects--could, however, interfere with the efforts to increase liquidity in the debt markets through securitization, as the latter depends upon maintenance of an income stream.

A fourth question concerns the vulnerability of countries to an unexpected worsening of the economic environment (for example, a rise in interest rates) as it could derail both the financing and the adjustment programs. Broader development of interest rate and exchange rate options to allow countries to hedge against such risks would be desirable. Although options to convert debt to the domestic currencies of major lenders, as well as fixed rate options for some currencies, have become increasingly prevalent in recent restructuring agreements, they generally are available only at the creditors' initiative. While interest rate swaps for 15-20 year sovereign debt may not be marketable, options to fix the interest rate for at least the grace period can be obtained in the market.

A fifth question is to what extent, even if new flexibility in private sector funding is fully exploited, increased official funding will be needed. Although the export credit agencies of major industrial countries have employed increasingly flexible cover policies for countries that have maintained, or restored, contractual relationships with their official creditors, the fall in import demand, particularly for large-scale projects, has led to significant underutilization of available credits. In this environment, balance of payments financing will have to rely on other sources of official support, in particular from multilateral development banks.

As regards the Fund, the SAF initiative is designed to provide resources at concessional rates and longer-than-normal maturities to low-income countries suffering from protracted payments difficulties. The SAF also is intended to catalyze a restructuring of official and private debt. More broadly, the Fund can play, through the consultation process, a key role in helping countries develop realistic scenarios for external debt service and can assist in appraising the viability of restructuring debt on different terms, including through innovative approaches. In some cases where creditors are seeking to develop innovative arrangements to tackle debt problems the Fund may need to approve a temporary buildup of arrears and play a role in facilitating solutions acceptable to all parties.

IV. Concluding Observations

The success of the debt strategy depends fundamentally on the design of economic programs with an adjustment path sufficiently steep to restore countries' creditworthiness over a reasonable time frame, but not so steep that it becomes unsustainable. To the extent that countries' current account adjustment so far has enabled them to continue regular debt service payments, creditors have tended to receive the lion's share of the adjustment dividend. A sustainable debt strategy will depend on maintaining a consensus on the sharing of this dividend in the future.

Strong adjustment policies remain the cornerstone of the debt strategy. But political support for such policies needs to be underpinned by the provision of adequate financing on realistic terms. The need to consider further adaptations in the implementation of the debt strategy is sharpened by the background of continued subdued growth of world markets, cyclically low commodity prices, intensified protectionist tendencies, a danger of further rises in short-term interest rates and uncertainties regarding exchange rates.

The ultimate objective of the debt strategy--a return to normal capital flows sufficient to sustain balanced growth and provided on a voluntary basis (including reflows of resident capital)--will depend on there being conviction that a country's indebtedness will be serviceable over the medium term. In some cases, conflict between countries' immediate financing needs and their longer term debt-servicing capacity may pose a dilemma. Further diversification of lending options should assist in the provision of bank finance, with additional options tailored to the needs of individual debtors and responsive to those of different creditors and investors. In the latter respect, the support of the regulatory and tax authorities would be needed to help ensure that lending flows and modalities can increasingly reflect economic rather than tax or accounting considerations.

Some evolving financing options will continue to add to countries' indebtedness. The alternative approaches, from a present perspective, while not offering a general solution, can be important at the margin. Among these mechanisms, debt conversions--to equity or local currency obligations--have been most prevalent. However, it has come to be recognized that these can offer only a partial solution, because of the concern that investments so induced may not be optimal, and that the early repayment of debt should not reduce available resources. In this respect, involvement by the World Bank and IFC may well be helpful, particularly in the area of privatization. Schemes to buy back debt at discount may be appropriate at least for some countries whose debt stands at a very steep discount, but who are servicing it, at least in part, or need to do so in order to unlock other financing.

Inevitably, assumption of additional debt will continue to be important in financing the adjustment process. However, given the already heavy debt burdens of many countries, new indebtedness needs to reflect the growing capability of servicing such debt. Official sources of financing, including export credit agencies, can continue to help catalyze new flows. More generally, the flow of official financing from multilateral development banks and bilateral creditors should continue to expand. For some low-income countries with protracted payments difficulties, a renewed emphasis on concessional flows--largely from official sources--will be needed.

Paris Club creditors are considering how best to help this latter group of countries, for many of whom the repeated rescheduling of commercial debt on commercial terms has only produced an increasingly unrealistic debt-service profile. This approach, which does not hold forth the prospect of restoring creditworthiness, is seen by at least some creditors as providing little incentive to adjustment and, possibly, as undermining the integrity of the rescheduling process itself. Bank creditors, who have generally resisted direct debt relief, may also find that it is more desirable to vary their treatment in a limited number of special cases than to risk provoking a more widespread buildup of payments arrears. It will be essential that efforts to provide more realistic rescheduling terms for these countries be in addition to, rather than instead of, increased aid flows, and that they be complemented by greater lending in support of needed policy reforms by the multilateral development banks.

Given the weak prospects for an early return to spontaneous market access for heavily indebted countries, the Fund's financial involvement in the implementation of the debt strategy will remain important and the use of Fund resources may be larger than earlier contemplated. While the Fund needs to respond flexibly and imaginatively to the problems of its members, it cannot do so without the strong commitment and financial support of other parties to the debt strategy. Thus, a crucial task for the Fund is to appraise candidly the timing and nature of a return to normal flows by individual countries, and the implications of this for the support needed from creditors. This will be important both to assist countries realistically, and to assess the scope and time period of the Fund's own involvement.

Table 1. Developing Countries with Recent Debt Servicing Problems
Summary Indicators--1982-87

(In billions of U.S. dollars unless otherwise noted)

	1982	1983	1984	1985	1986 1/	1987 1/
I. Domestic Economy						
Real GDP (% change)	-0.3	-1.9	3.0	2.7	3.5	3.4
CPI (% change)	49.2	69.2	83.4	91.1	62.7	78.9
Fiscal balance (% of GDP)	-6.1	-5.6	-4.0	-3.8	-4.8	-4.4
Gross capital formation (% of GDP)	22.8	19.6	18.9	18.3	19.2	19.5
II. Balance of Payments						
Current account balance 2/	-66.7	-23.4	-10.0	-6.4	-22.2	-20.3
Excluding interest payments 3/	-6.2	32.0	50.4	51.6	31.2	31.3
Net external borrowing 4/	65.9	37.9	27.5	13.8	14.4	24.4
Of which official creditors, long-term	18.1	22.1	19.4	16.4	13.4	25.5
Non-debt creating flows	11.7	8.8	9.5	10.6	10.2	11.2
Fund credit	4.0	7.8	3.9	1.6	-1.2	-0.7
III. Debt and Debt Service						
Total debt	526.5	546.6	569.7	586.2	621.0	678.1
Of which financial institutions, long-term 5/	152.8	187.4	200.2	227.5	235.1	255.0
Short-term	119.5	92.2	93.1	68.4	69.2	68.9
Debt service payments	88.0	78.4	81.8	81.7	86.5	81.9
Of which interest	52.8	50.5	53.5	52.9	47.9	44.4
IV. Reserves	28.8	32.6	46.0	46.7	39.7	46.1

Source: World Economic Outlook as of end-July 1987.

1/ Partially estimated.
2/ Includes official transfers.
3/ Includes dividends and other returns on investment.
4/ Excluding Fund credit.
5/ Public and publicly guaranteed debt.

Table 2. Summary of Lending Activities of Multilateral Development Banks, 1981-86 1/

(In billions of U.S. dollars)

	1981	1982	1983	1984	1985	1986
			(Own lending activities)			
To All Members						
Commitments	17.2	17.2	20.6	19.2	22.4	20.3
Gross disbursements	9.7	11.8	13.1	14.8	14.7	17.3
Net disbursements	7.6	9.4	10.2	11.3	10.6	11.4
To Highly-Indebted Countries 2/						
Commitments	5.7	6.0	7.9	5.7	7.9	9.2
Gross disbursements	3.3	3.8	4.7	6.0	5.6	7.5
Net disbursements	2.4	2.7	3.4	4.3	3.6	4.7
				(Cofinancing)		
Commitments						
All lenders 3/	11.0	15.0	12.5	13.5	16.2	12.1
MDB's own resources	6.5	6.6	6.7	7.5	9.5	6.7
Commercial lenders 4/	1.3	1.4	1.3	1.5	1.5	0.6

Source: Multilateral developments banks.

1/ The World Bank (IBRD plus IDA), the Inter-American Development Bank (IDB), the African Development Bank Group (AfDB), and the Asian Development Bank (AsDB).

2/ Argentina, Bolivia, Brazil, Chile, Colombia, Cote d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, Yugoslavia.

3/ Includes MDB's own resources. A certain degree of double-counting may remain as these amounts may not have been fully adjusted for commitments made by MDBs for cofinancing arranged by other MDBs.

4/ Excludes cofinancing of commercial banks with ADB, which is small.