FOR
AGENDA

EBS/88/159

CONFIDENTIAL

August 4, 1988

To: Members of the Executive Board

From: The Acting Secretary

Subject: Issues in Managing the Debt Situation

Attached for consideration by the Executive Directors is a paper on issues in managing the debt situation, which has been scheduled for discussion on Friday, August 26, 1988.

Mrs. Junz (ext. 8849) or Ms. Atkinson (ext. 7359) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

INTERNATIONAL MONETARY FUND

Issues in Managing the Debt Situation

Prepared by the Exchange and Trade Relations Department

(In consultation with other Departments)

Approved by H.B. Junz

August 3, 1988

I. Introduction

In discussing this subject last March, Directors stressed that restoration of normal debtor-creditor relations was, in the first instance, dependent upon effective implementation of comprehensive economic programs. They recognized that in order to counter adjustment fatigue, the authorities in debtor countries must be able to demonstrate that there is light at the end of the tunnel. The latter can be defined as restoring adequate, sustainable growth while returning countries from a debtor-creditor to a borrower-lender relationship in the markets, i.e., regaining appropriate access to international capital markets on nonconcerted terms. This, in turn, depends upon restoration of confidence on the part of both foreign and domestic savers, including a return of flight capital. Policy efforts of highly indebted countries have increasingly been oriented toward that end; however, for many the resolution of the debt problem remains remote.

The fact that more than a decade of inflation-generated misallocation of resources takes more than five years to correct is in itself not surprising. The question, however, is whether sufficient progress has been made and to what extent the current claims on resources of debtor countries are balanced in a way that would allow countries to grow out of debt. At the same time, lending fatigue on the side of private sector creditors may in itself undermine achievement of the objective. The initial cohesion within and among the various categories of creditor groups, that had been forged by the crisis environment, is loosening increasingly. This, in part, reflects the positive effects of the current strategy in that systemic threat has receded allowing banks' individual interests to resurface. Such interests, however, still tend to be excessively focused on the short term and, therefore, do not always reflect the mutual medium-term interest of debtors and creditors. The further evolution of the debt strategy, thus, must be viewed against the (1) current and prospective strengthening of the underlying economic positions of highly indebted countries; and (2) the conditions under which their prospects may so improve as to promise regained mastery over their financial decisions within a reasonable period of time.

Countries' initial policy response to their debt problems aimed at a rapid shift in the external current accounts. As a consequence, there was a heavy focus on compression of domestic demand and imports, a focus that could not provide a sustained basis for longer term adjustment. More recently, in a basic shift, policy has aimed both at facing the effects of past policy mistakes and preventing their recurrence. Key aspects of policy formulation--if not always of implementation--are to curtail deficit financing, and to move away from inward-looking policies, from the maintenance of inappropriate relative price structures and from support of inefficient public enterprise sectors.

What does the balance sheet of the past six years of adjustment effort tell us?

--The initial positive shift in current account positions, excluding interest, of the major highly indebted middle-income countries was generally maintained as they moved from a deficit equaling about 8 percent of exports of goods and services in 1981 to a surplus equivalent to about 20 percent in 1986-87.

--In real terms, this shift of resources was even more impressive as adverse price developments cut into the value of net exports. The cumulative deterioration in the terms of trade of the highly indebted countries amounted to about one quarter over the period 1983-86. This, however, reflected in the main the correction to the excessive inflationary environment of the 1970s. This correction now may well have run its course with the terms of trade improving since 1987; the level of both export and import unit values--especially for oil-importing countries--currently is not far out of line with that recorded in 1978--before the second oil shock.

--There remains the question whether world commodity price levels, after disinflation, are such as to generate cash flows that are compatible with realistic assumptions about external financing. This is a particularly pressing question for countries still largely dependent upon natural resource and low value-added exports. Obviously, efforts to diversify and upgrade the export base cannot come to fruition in the short term and are likely to be delayed if investors do not view prospects favorably. In this respect, the fact that debt service ratios have only recently begun to ease, while in many countries the weight of debt on the economy has continued to rise, has underscored the causes of adjustment fatigue.

Although the negative GDP growth of the earlier crisis years has turned around on average, growth rates achieved so far appear in many cases unsatisfactory in relation to the pressure of population and the need to improve standards of living. This raises the question whether the compression of investment that has accompanied the adjustment efforts is eroding growth potential. Investment in the highly indebted countries has declined from an average of about 25 percent of GDP in 1980-81 to 17 percent in 1985-87. Obviously, if this trend reflects a release of resources from unremunerative activities to high quality new investment, it represents a necessary and desirable development. The evidence, however, is that current constraints on investment financing could generally be eased significantly by greater release of resources from inefficient investment. Nevertheless, it is clear that in many cases healthy investment opportunities are not being exploited for lack of access to funds.

While it is important not to underestimate the degree of progress actually achieved, not the least in terms of containment of the crisis, these developments put in question the sufficiency of progress toward financial viability six years after the onset of that crisis. Any assessment of this progress must take account of the growing tendency for banks to withdraw from general purpose medium-term lending, at least for their own portfolio investment purposes. In addition, the period when new concerted financing could be expected to be provided by original claimholders may be at an end. Thus, medium-term projections must not casually postulate the resumption of such flows. While some countries may work out of the debt restructuring treadmill within a 3-4 year time horizon, others may not, requiring a policy framework that addresses this problem.

II. Adequacy and Modalities of Financing Flows

The perceived changes in economic realities have led to significant changes in financing terms and conditions, partly reflecting increasing difficulties in catalyzing of bank financing. Financing options have multiplied and come to include some debt reduction instruments; maturities have lengthened; and spreads have been reduced (Table 1). But many of these changes merely increase the reluctance among creditors to extend financing in traditional modalities, while debtors are increasingly concerned about taking on additional debt. For bank creditors, market and regulatory considerations have placed a growing premium on reducing exposure, even though some banks were not well placed to do so. As a result, there has been a tendency to swap assets to rationalize portfolios, and some institutions have been liquidating their exposure to those countries where they do not have continuing business interests. This has led to greater concentration of claims. For example, the share of the money center banks in U.S. banks' exposure to Western Hemisphere countries rose from 61 percent in 1982 to 67 percent in 1987, with larger increases recorded in exposure to the major debtors. (Table 2).

Over time it clearly was desirable that the creditor group lose its "tail" of small or noninterested lenders. But the reduced cohesion among banks also has led to rising delays in assembling financing packages, especially for smaller countries. While delays undoubtedly also reflect banks' skepticism regarding policy implementation, the situation has given rise to a vicious circle of both creditor and debtor

Table 1. Selected Bank Reschedulings: Main Terms of First and Latest Rescheduling 1/

	Maturity		Grace Period		Interest Rate Spread	
	First	Latest	First	Latest	First	Latest
	(In years)				(In percent)	
Cote d'Ivoire	7-8	14 1/2	2-3	5	1 5/8-1 7/8	1 1/4
Philippines	10	10-17	5	6-7 1/2	1 5/8	7/8-1 3/8
Yugoslavia	6	18	3	5	1 3/4-1 7/8	13/16
Argentina	10-12	12-19	3	5-7	1 3/8	13/16
Brazil	8	19	2 1/2	6	2-2 1/4	13/16
Mexico	8	20	4	7	1 3/4-1 7/8	13/16

Sources: Restructuring Agreements.

1/ Generally 1983 and 1987/88.

Table 2. Concentration of U.S. Bank Exposure to Developing Countries, 1982, 1985, and 1987 1/

(In percent)

	1982	1985	1987
Nine money center banks' share in total claims			
Africa	72.7	74.0	75.6
Asia	66.0	62.2	63.1
Of which: Philippines	69.3	69.9	72.8
Western Hemisphere	61.1	64.4	66.6
Of which:			
Argentina	64.7	71.0	72.7
Brazil	64.5	67.2	70.8
Mexico	53.9	56.6	59.8

Source: Federal Financial Institutions Examination Council, Country Exposure Lending Survey.

1/ Adjusted for guarantees and other risk transfers.

fatigue. By contrast, the Paris Club (surely no less concerned about policies) has still moved swiftly and operated effective de minimus rules.

On the debtor side, interest arrears have been emerging increasingly as an ad hoc financing technique. In fact, in 1987-88 most new money packages essentially regularized interest arrears. A continued drift toward arrears as a more generalized financing instrument not only could lead to a worsening of the financial environment, but also would exacerbate the stop-go aspects of policy performance. Effective growth policies require adequate financing; conversely, the claims on future output generated by new financing are justified only in support of such policies, as is the provision of debt relief. The adequacy of both policies and of the financing approach need to be viewed in light of the basic payments situation of the country in question. Appraisal of medium-term scenarios for selected indebted countries suggests that major differences among countries may be illustrated by examination of three stylized cases. Particularly at issue is the degree to which economic growth resumes sufficiently to absorb existing unemployment and projected increases in the labor force.

--In Case I situations, the absence of a financing gap reflects a country's ability to finance over the medium term--defined as 3 years to 4 years--a gradual improvement in growth and a rebuilding of international reserves (Table 3). However, the growth financeable in these cases still may not suffice to take up slack in the labor force, especially in the near term. Accordingly, political cohesion in support of adjustment may come under pressure before adjustment gains have been consolidated. Moreover, this scenario implies maintenance of significant current account surpluses, a situation not normally appropriate for developing countries. Whereas it is not a given that more financial resources necessarily mean more growth, there is a presumption that with sufficient up-front economic adjustment, greater leeway to manage resources can help assure the steadiness of the adjustment path. This may require continued negotiations with creditors.

--In Case II situations, adequate growth rates are postulated; but even if accompanied by stronger adjustment, growing out of debt at current levels of indebtedness lies beyond the projection period (Table 4). Accordingly, a return to normal financial relations may be remote--and the continued need for negotiated financing may become a political burden on the adjustment process.

A third set of cases is represented by countries that are close to re-entering the market for voluntary financing. For these countries, the ability to resume normal borrower/lender relations may, however, falter because of banks' attempts to reduce their exposure to a region and also because of lingering doubts regarding sustainability of their re-emerging creditworthiness.

Table 3. Case I: Medium-Term Scenarios

	1988	1989	1990	1991	1992	1993
			(1988=100)			
Current account	100	90	85	85	85	90
Of which: Interest payments	-100	-100	-105	-105	-105	-110
Capital account						
Multilateral and bilateral creditors (net)	100	55	65	85	50	95
Of which: Amortization to bilateral creditors	-100	-120	-100	-85	-135	-120
Other capital (net)	-100	-60	-60	-70	-50	-60
Of which: Amortization to banks 1/	-100	-400	-1,050	-1,200	-1,300	-1,300
Increase in reserves (-)	-100	-70	-80	-90	-80	-100
Financing requirement	—	—	—	—	—	—
Residual gap (as percent of financing requirement)	—	—	—	—	—	—
			(In percent)			
Memorandum items:						
Real growth rate	2.0	3.0	3.3	3.5	4.0	4.0
Current account ratio to GDP	1.1	0.9	0.8	0.7	0.7	0.6

Source: Fund staff estimates.

1/ After already agreed rescheduling.

Table 4. Case II: Medium-Term Scenario

	1988	1989	1990	1991	1992	1993
			(1988=100)			
Current account	-100	-80	-80	-75	-65	-50
Of which: Interest payments	-100	-95	-95	-100	-95	-90
Capital account						
Medium- and long-term	-100	295	35	-115	-125	-140
Of which: Amortization	-100	-65	-90	-95	-90	-90
Other capital	100	95	115	135	145	155
Increase in reserves (-)	-100	-335	-130	-85	-160	-240
Financing requirement	100	—	20	30	30	25
Residual gap (as percent of financing requirement)	100	—	100	100	100	100
			(In percent)			
Memorandum items:						
Real growth rate	5.0	3.5	3.5	3.5	3.5	3.5
Current account ratio to GDP	-5.0	-3.7	-3.3	-2.8	-2.2	-1.5

Source: Fund staff estimates.

The range of circumstances described above underscores the continued validity of a case-by-case approach both to adjustment and to the resolution of financing problems of highly indebted countries. The key financing issue thus is what instruments are most appropriate in each particular circumstance and what support the international community can provide to smooth the process of their adoption.

Debtor countries and their leading banks already have collaborated on important innovations in financing options, to better suit these more closely to individual needs. These range from instruments that involve concessional terms (including 20-year maturities and interest rates close to funding costs) to approaches such as buy-backs or asset exchanges that are fully fledged market operations; the latter constitute important steps toward normalization as they reincorporate market price signals. These approaches differ in the timing of the cash flow they generate--generally there is a trade-off between the amount of immediate cash flow and the extent of enduring positive impact on the balance sheet of the debtor.

New money provides cash up front to the debtor. From the point of view of bank creditors, it can help avoid recording impairment of assets--although in almost all countries banks perceive a need to reserve against new money as against old claims. Initially closely market based, new money has come to involve interest rates well below those needed to raise additional finance on market terms, given that risk perceptions have increased. Nevertheless, for many debtors, restructuring rates still seem too high in relation to current earning capacity. Thus, the menu has evolved, in part, to incorporate indirect price incentives for banks and debt reduction for debtors.

Debt/equity conversion is clearly market related. It offers to the debtor a measure of balance sheet restructuring and provides some incentive for direct investment. To less exposed creditors it provides a legitimate exit instrument and to banks with a continuing local business interest the possibility of recapitalizing these at a favorable cost. A number of drawbacks to debt/equity swaps are well known: it may be difficult to achieve positive net cash flow, after allowing for a prepayment of debt that otherwise would not have occurred; a "subsidy" (provided by existing external creditors) generally becomes available for investment only in those sectors of the economy that are of immediate interest to foreigners; they necessitate domestic refinancing with possible problems for monetary policy; they involve payments restrictions to minimize early outflows and, over time, the foreign exchange returns to equity investors would normally be expected to be higher than those on claims on the sovereign borrower.

Debt buy-backs are direct market transactions. The opportunity for buy-backs is created by the difference between the basic premise in the debt strategy that the face value of debt remains intact and the perception of some market participants that it will not. To the extent that expectations in the market fall short of the debtor's intention to service claims, buy-backs offer the debtor country a high yielding investment alternative together with the opportunity to reduce net external debt. For creditors, they offer both an exit mechanism and liquidity. The approach is limited, however, as the debtor needs cash up front to effect a buy-back. Thus, an important condition for buy-backs is that additional financing be available in adequate amounts, and at a cost that compares favorably with the market yield on outstanding claims--so that this investment represents optimal use of scarce resources. This condition will be influenced particularly strongly by the volume of the outstanding debt and the secondary market price.

Debt/asset exchanges seek to ameliorate the cash requirement problem inherent in a buy-back in that they attempt to leverage immediate cash expenditure by combining it with some enhancement of the new claim. The experience with the Mexican asset exchange shows that this is not easy to achieve. Clearly, this is an area in which there is likely to be experimentation with formulae that go beyond simple collateralization of principal 20 years out. In particular, extending some security to the income stream, for example through 2 or 3 year rolling interest rate caps and/or sinking funds for interest payments, may be a more powerful form of credit enhancement than securing principal; current regulatory or accounting frameworks may mandate a combination of both. Such exchanges offer the possibility of transforming a larger volume of old debt than buy-backs. By also moving toward more market-related terms than those attached to new money, they combine elements of a broader balance sheet restructuring with market re-entry. A further potential of debt/asset exchanges, that would constitute a significant step toward normalization, would be to bring in--over time--nonbank portfolio demand for such assets.

Debt/export conversion schemes appear more problematic than the above options. In essence, they allow certain exporters to increase their profitability as the proceeds of the market discount on sovereign debt are shared between the original claim holder, the exporter and possibly the debtor government. As such they provide an indirect export subsidy and introduce elements of a multiple currency practice.

On the above basis, it may be possible to identify some natural fit between the characteristics of the main financing options and a particular payments situation as discussed in the stylized country cases above.

--For Case I situations, all the main debt reduction items--e.g., buy-backs, debt exchanges and debt/equity--offer the possibility of slowing debt accumulation and service while embarking on a higher growth path. As long as the latter was perceived to be soundly based, it would affect spontaneous refinancing possibilities positively by enhancing the credibility of a stable policy environment.

--For Case II situations, the key options are: (a) For long-term creditors or donors to provide sufficient new money to allow the debtor to effect a buy-back at an appropriate discount, thereby improving the restructuring process, while reducing net debt. Where no early return to the market is in prospect and the level of bank debt is small, a relatively large scale buy-back may be possible and desirable, particularly if a high level of reserving and a steep discount make general new money packages unviable; (b) To negotiate a progressive and more fundamental exchange of claims comparable to that in a corporate reorganization. It is noteworthy that U.S. corporations sometimes use debt exchanges rather than bankruptcy procedures to restructure their balance sheets. For sovereign debtors, this analogy does not hold fully because of difficulties in subordinating old debt; thus, they and their creditors may need to address the issue of designing a debt workout that might include some possibility of emulating the setting aside of assets to protect both the debtor and the new investor.

A country's readiness to set aside national assets to enhance the debt service on the new claims resulting from the re-organization of its debt would be a clear indication of its intention to service these debts. Thus, it would represent a fundamental step toward re-establishing creditworthiness after a debt workout. Similarly, creditors would need to recognize that the soundness of their portfolio is improved by the use of such assets in support of a debt workout.

For middle income countries generally, the crucial issue is how to blend different debt management techniques in ways that achieve optimal external financial and domestic economic and political support for the adjustment process. To this end, it is important to identify impediments or inducements to market acceptance of instruments adequate to the task. One constraint lies in the circumstances under which bank creditors have so far permitted debt buy-backs or exchanges. In the case of Bolivia, banks were prepared to allow buy-backs to be funded by contributions from bilateral official creditors, that were truly additional and dedicated to that purpose. This constraint defeated the argument that the money could have been used, instead, for servicing debt. In the cases of Chile and Mexico, bank creditors in effect conceded that higher-than-expected reserve accumulation--in these cases due to higher commodity prices--could be used for market operations. But at present it is difficult and cumbersome to obtain agreement from bank creditors for debt-reducing market transactions as these may be at odds with banks' payments sharing provisions. These difficulties have stimulated a growing countertrade in sovereign claims, in which sovereign debtors buy each other's debt in the secondary market and settle mutual trade claims with the discount profits. This problem has given rise to a lack of transparency of various transactions that aim to reduce the level of outstanding debt. Thus, relatively artificial arrangements, such as debt/export swaps, have been fashioned under circumstances where a straight buy-back or asset exchange might achieve the underlying objectives of the debtor with less risk of distorting effects on economic activity.

A second set of obstacles, or incentives, may lie in regulatory, accounting and tax provisions, although the relevant authorities have tended to be flexible with respect to specific innovations.

-- For heavily exposed banks, loan sales have been inhibited in some countries by concerns of "contamination," i.e., the need to mark their entire portfolio of claims on a debtor to the sale price of a few. However, authorities have shown flexibility in this respect, most notably in the case of the Mexican debt exchange.

-- In some cases national banking policy may inhibit banks from participating in certain types of transactions, e.g., in the United States such inhibitions were lifted to promote debt/equity conversions.

-- Tax questions normally are resolved only case-by-case and with delays. In the case of the Bolivian buy-back, the Japanese authorities confirmed the tax validity of these losses up front. An impediment to loss-taking, however, is that in an increasing number of countries banks can establish large tax losses without the need to dispose of claims, an incentive structure that may be at odds with the evolution of the menu approach.

-- Banks may abstain from new trade financing, or retard countries' re-entry into the market, by pressures for undifferentiated, increasing and irreversible provisions against all types of claims on a debtor country. Some national authorities see a legitimate need to differentiate between types of exposure and to recognize the possibility of improvement as well as deterioration in creditworthiness. But the newly published G-10 capital adequacy rules depart from this view as they divide countries into two basic groups, 1/ each of which is apt to include a considerable range of risk situations.

Continuing developments in the menu approach may benefit from some adjustment of selected regulatory provisions and from greater consistency across countries and predictability. In particular, it is important for creditors to know what regulatory, auditing and tax treatment will be accorded various innovations well in advance of a negotiation between debtor and creditor. Another important issue is an early recognition of a basic improvement in the creditworthiness of a country. Overall, however, it would be incautious to advocate or rely on regulatory actions that in reality conflict with economic or market fundamentals; indeed, that would be inconsistent with the emphasis in the debt strategy on a market-related approach.

1/ Full members of the OECD plus Saudi Arabia--which are classified minimal risk--and other countries--which bear full commercial risk weighting.

Improvements in market mechanisms mainly will benefit countries that normally should have access to financial markets and that would finance themselves on commercial terms. For the poorest countries, the official community is of overriding importance. In their case, official creditors already have agreed to increasingly comprehensive debt consolidations and significantly longer grace and repayment periods. In addition, a consensus has been reached to introduce a menu of options with considerable imagination so as to tailor it to the needs of both creditors and debtors. These options, while still being finalized, contain elements of interest concessions, debt forgiveness, and longer maturities. Official creditors are increasingly forgiving ODA loans for the very poorest, and as noted earlier, donors have provided buy-back funds for Bolivia. Further substantial amounts of new resources have become available through the establishment of the Fund's ESAF, the World Bank's special program for Africa, the replenishment of IDA, the augmentation of loanable funds at the regional development banks. In addition, the general capital increase was agreed for the World Bank this spring.

Resources to support adjustment and development efforts of the low-income countries thus have been expanded broadly; nevertheless, they continue to face competing needs so that their effective use is of prime importance. In this context, more effective coordination among those who provide concessional financing is needed so as to ensure that adequate financing is made available on a timely basis for the support of necessary policy adjustments in recipient countries. The policy framework process associated with the SAF/ESAF can play an important role in this respect, but it seems clear that consideration should be given to whether and to what extent additional mechanisms might be required. But in the last instance, it lies with the countries in question to implement policies that effectively use these resources to raise investment and achieve higher levels of growth.

III. Future Developments

Policies in debtor countries remain at the heart of the debt strategy, and a well-recognized principle is the importance creditors accord to phasing financial support in parallel with monitored policy implementation. Most forms of financial support can be phased effectively--including outright reductions in debt through market mechanisms.

To pursue sustained adjustment, countries need to perceive the possibility of establishing financial viability, including release from creditor tutelage, within a reasonable period of time. In this connection, it is desirable to broaden the possibilities of blending new money with means of reducing debt. In essence, the menu that can meet the needs of debtor countries in different payments situations can be classed in terms of three generic items:

--Instruments that maintain the face value of the original claim on banks' books and are accompanied by additional financing to fill payments gaps, or involve some degree of interest remission or deferment.

--Instruments that offer banks enhanced certainty and/or liquidity, but involve taking a loss on principal and which may, in turn, carry an interest rate closer to true market rates on the reduced value.

--Debt/equity conversion that offers an exit opportunity for some creditors, and allows others to recapitalize their financial operations in the debtor country.

The various instruments that have been developed to complement traditional new money need to be broadened and deepened. So far, debt reduction techniques, of their nature, can only have limited scope at any moment in time. If employed in a concentrated manner, the debt reduction possibility would disappear as prices would move closer to original face values. Thus, a spacing over time tends to be useful together with ways and means that allow the seizing of opportunities as they arise. In this respect, restructuring agreements would need to incorporate up-front a broad range of waivers so as to provide sufficient leeway to both debtors and creditors to exercise their portfolio preferences. This might be particularly important as buy-back opportunities may be enhanced in the period ahead by banks' need to reorder their portfolio preferences in light not only of market, but also of regulatory changes.

The blending of cash up front with debt reducing mechanisms must continue to represent a further move toward resurfacing of long-term business interests. Thus, creditors wishing to remain "in" must acknowledge that their longer term position is enhanced by loss-taking by exiting creditors; to that extent it may be in their own interest to make a larger cash contribution earlier. In addition, such long-term stake holders, with a view to improving the quality of their existing claims, have shown an increasing readiness to pursue approaches that contain elements of both debt reduction and cash flow relief. Thus there is growing recognition that it can be of mutual benefit to debtors and creditors if loan sales are facilitated in a way that strengthens the balance sheet of the debtor. Moreover, such mechanisms may well fit relatively more comfortably with current microprudential concerns of regulators.

Effective improvements in countries' balance sheets accompanied by rationalization of creditors' portfolios raise the problem that has come to be referred to as moral hazard. On the side of creditors, this involves free riders; on the side of the debtor, this would imply manipulation of those variables through which broader debt relief could be obtained. Despite strong efforts to reduce the number of free riders, it may not be realistic to think they could be reduced to zero; the ultimate "free ride" would be paralysis in the banking community.

In some cases, working within the menu, creditor banks have looked for disincentives to free riders. In a three-pronged approach, the development of participation incentives for early subscribers to new money packages has been matched by offering better designed exit instruments and by experimental approaches to penalizing would-be free riders. The latter involve means to reduce effectively the secondary market value of claims held by nonsubscribing banks, either by excluding them from access to debt/equity conversions (Mexico, 1987) or by lifting participating banks out of payments sharing agreements through novation (Côte d'Ivoire, 1987). The latter maneuver, however, may be hard to generalize as it may not be upheld in some national jurisdictions. In some European jurisdictions, banks are beginning to believe that courts may support the pro rata payment of banks that have failed to contribute to financial reconstruction of a country's economy, i.e., that payment-sharing clauses could not be enforced against participating banks if there is genuine incomparability of benefits and burdens. The route would still be open for disaffected banks to engage in legal suits against the debtor country.

With regard to the success of further developments of the debt strategy, the inevitable uncertainties in the economic environment, perhaps especially concerning interest rates, remain important. It is, therefore, prudent that debtor countries should avail themselves of available techniques to protect their economies against exogenous shocks. Many commodity exporters already use sophisticated market instruments to reduce their risk exposure and this is spreading more broadly, with Chile recently hedging a portion of its exposure to U.S. dollar interest rate risk.

However, readily available instruments (contingency loans or futures) offer reasonable protection typically only up to between six months and one year ahead. Longer term hedging possibilities do exist, including medium-term interest rate swaps and caps. The swaps market, for example, is particularly deep; but in the case of less creditworthy borrowers collateralization is necessary as swaps involve a two way credit risk. Creditors could contribute in various ways, including providing resources or (as in Chile) allowing the use of official resources, to collateralize margin lines or to hedge in other ways. Moreover, within the restructuring framework, creditor banks may be prepared to negotiate interest rate caps.

In the period ahead a key function of official sources of longer term financing remains to bridge the period when market perceptions lag the adjustment effort and to supply funds in support of adjustment programs as appropriate, in addition to effecting resource transfers for policy reasons. Public funds need to be channeled to the investments with the highest market and/or social returns; this could include, under the proper circumstances, debt buy-backs. It remains true that the ultimate purveyor of funds should be the market, and official policies need to avoid giving signals to the market that would bias the future allocation of resources. This could occur if official sources of financing failed to reflect positive developments in the country (e.g., remaining off cover when appropriate policies are in place), or if the use of public funds were too severely restricted.

IV. The Role of the Fund

The role of the Fund in facilitating the necessary financing to support strong adjustment programs for both low- and middle-income highly indebted countries was set out in some detail in EBS/88/55 dated March 9, 1988. The main lines of that discussion have become yet clearer. The policy approaches adopted by the Board have improved the Fund's ability to support countries' efforts to face deep-rooted structural problems at the same time as they need to reorganize and strengthen their external balance sheets. This support is facilitated through the revitalization of the EFF and the introduction of the ESAF, while adjustment programs now can be shielded from being pushed off track by external shocks not only by prudential efforts on the part of the country itself, but also through external contingency financing from the Fund.

In the period ahead, especially as the menu of financing options becomes more complex, the Fund's role in helping a country to devise a medium-term financing plan that optimizes market opportunities, while reflecting appropriately the concerns of the financial and regulatory authorities in creditor countries, is likely to be critical. As debt management policies need to parallel the medium-term adjustment of countries with sizable financing gaps, the provision of carefully constructed medium-term scenarios remains important. Directors agreed last March 1/ that the Fund should assist members in this respect and that it should continue to support approaches voluntarily agreed between debtors and creditors that would help bring restoration of creditworthiness within a reasonable time frame. With the evolution of the menu approach, it is clear that further lending by some creditors would be consistent with facilitation of debt reduction by others. The Fund itself has a strong interest, as a monetary institution, in seeing the effective restructuring of international assets and liabilities in ways consistent with balance of payments performance that will not need to rely on sustained use of Fund resources.

In some cases, it may be helpful in the effort to rationalize a country's balance sheet for the Fund to be prepared, in addition to providing advice and technical assistance, to find other ways to facilitate that effort, for example by establishing trust accounts as was done in the case of Bolivia. Such readiness also would be consistent with the Fund's catalytic role.

1/ EBM/88/55 (3/31/88).

The Fund's essential role would be to bring parties together in a cooperative strategy, although a seal of approval of the policies would primarily be given through the commitment of its own resources. The Fund, together with the World Bank, would continue to support countries' adjustment efforts through catalyzing new lending. For cases with particularly great needs or threshold problems and with strong adjustment records and programs, provision of parallel financing from various sources could, of course, provide an important complement to the Fund's own support.

Within this overall approach, the Fund on occasion may need to support a member country on the basis of financing assurances that should be evaluated in more qualitative rather than in the quantitative terms of the past, although such evaluation would be no less demanding. In particular, in cases where debt reduction by some creditors is blended with new money provision by others, "critical mass" loses its original meaning. In order to support the broadest possible financing framework, provision of both commitments and waivers by the banking community will be necessary across a broad range of market operations. The questions that arise for the Fund in the context of a broadening financing spectrum, in particular for cases where adjustment programs go hand in hand with efforts to restructure a member country's balance sheet, would need to be considered over the coming months.

Table 5. Adjustment Paths in Selected Heavily Indebted Countries 1/

	Argentina	Brazil	Chile	Ecuador	Mexico	Peru	Cote d'Ivoire	Ghana	Nigeria	Philippines
Merchandise imports (US$ billions)										
1975-78 (Avg.)	3.4	12.5	2.0	1.4	6.4	2.1	1.4	0.7	8.6	3.9
1981	9.4	22.1	6.5	2.4	24.0	3.8	2.1	1.0	18.4	8.0
1982	5.3	19.4	3.6	2.2	14.4	3.8	1.8	0.6	14.9	7.7
1987	5.8	15.1	4.0	2.0	12.3	2.8	1.7	0.9	5.8	6.4
Ratio of exports to GDP 2/ (in percent)										
1975-78	14.3	7.5	21.0	24.3	9.3	16.2	42.1	13.5	24.1	18.2
1982	16.6	13.0	21.2	26.1	16.9	20.4	37.6	4.8	14.7	20.1
1984	15.4	15.0	25.0	28.2	18.7	23.3	44.3	7.9	13.2	25.4
1987	11.5	10.8	34.3	25.8	22.3	19.4	33.0	17.8	31.4 3/	27.1
Ratio of interest payments due to exports 2/ (in percent)										
1981	33.3	38.3	34.6	23.0	27.6	...	...	11.4	...	15.9
1982	51.5	53.5	44.6	30.4	40.9	27.4	17.4	13.5	7.4	24.9
1984	55.1	37.2	44.8	28.7	35.9	33.5	18.2	18.2	17.2	28.3
1987	49.1	31.1	25.6	32.8	26.4	35.8	14.7	15.4	27.1	24.2
Debt to GDP ratio (in percent)										
1981	62.9	43.2	47.6	58.5	30.0	49.0	71.8	37.8	12.3	55.0
1982	76.2	45.6	69.6	60.1	54.6	55.8	89.7	42.5	16.0	62.7
1984	71.1	50.4	95.7	70.4	52.2	74.1	97.0	34.9	20.4	77.8
1987	77.3	45.2	99.6	103.0	71.3	82.2	86.6	49.7	111.6 3/	81.8
Fiscal balance 4/ (percent of GDP)										
1981	-16.4	-5.9	-1.2	-5.6	-11.3	-8.8	-11.6	-6.7	...	-5.5
1982	-16.1	-8.3	-5.5	-6.7	-7.2	-9.1	-16.1	-4.6	-7.4	-7.0
1984	-13.1 5/	-2.7	-5.8	-0.6	1.0	-8.2	-1.7	-1.8	-4.2	-8.3
1987	-9.0 5/	-5.5	-1.6	-10.8	1.5	...	-7.5	0.5	-13.0	-3.2
Gross investment 6/ (percent of GDP)										
1975-78	26.9	22.6	16.1	27.5	20.1	15.7	24.9	9.3	27.0	29.2
1981	18.2	21.0	22.7	23.2	27.4	22.2	27.2	4.6	22.8	30.7
1984	14.5	15.5	13.6	17.2	19.9	15.8	10.9	7.2	6.5	17.4
1987	14.2	19.7	15.3	22.9	17.6	12.6	12.9	10.8	8.0	13.8
Real GDP growth (in percent)										
1975-78	1.0	6.1	1.8	7.0	5.4	0.9	7.3	-1.4	2.6	6.3
1982	-5.0	1.1	-14.1	1.2	-0.6	1.0	0.2	-6.9	-0.2	2.8
1984	2.5	5.7	6.3	4.2	3.6	4.8	-2.0	8.7	-7.4	-6.0
1987	1.6	2.9	5.4	-3.1	1.4	6.9	-2.7	4.8	2.7	5.1

Sources: IFS and Fund staff estimates prepared in connection with the August 1988 WEO.

1/ The data shown in this table are to facilitate intertemporal rather than intercountry comparisons as definitions, particularly of fiscal balances, tend to differ among countries.

2/ Exports of goods and nonfactor services for Argentina and Ecuador; merchandise exports for Ghana; and exports of goods services for the other countries.

3/ Reflects a sharp drop in GDP measured in dollars due to a substantial exchange rate depreciation.

4/ Argentina—public sector balance on a commitment basis; Brazil and Mexico—operational balance of the public sector; Chile—public sector borrowing requirement; Ecuador and Peru—nonfinancial public sector balance; Philippines—public sector borrowing requirement plus the losses of public financial institutions; Ghana—Central Government balance, excluding capital expenditures financed through external project aid; Cote d'Ivoire—Central Government balance on the basis of payments orders issued; Nigeria—Central Government deficit on a commitment basis.

5/ On a cash basis, the overall nonfinancial public sector deficit plus losses of the Central Bank was 10.8 percent in 1984 and 7.1 percent in 1987.

6/ Fixed capital formation for Brazil.