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To: Members of the Executive Board

From: The Secretary

Subject: A Fund Facility to Help Members Meet Increases in
Interest Costs - Main Issues

Attached for consideration by the Executive Directors is a paper on main issues with respect to establishing a Fund facility to help members meet increases in interest costs. This subject has been scheduled for discussion on Wednesday, March 26, 1986.

Mr. Hood (ext. 8977) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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Department Heads



INTERNATIONAL MONETARY FUND

A Fund Facility to Help Members Meet Increases
in Interest Costs--Main Issues

Prepared by the Research Department

(In consultation with other departments)

Approved by Wm. C. Hood

February 25, 1986

This paper is one in a series prepared in response to proposals made in one or both of the 1985 reports by the G-10 and by the G-24 on the functioning and improvement of the international monetary system. 1/ The proposal considered in this paper is that a Fund facility be established that would provide members with financing to help meet increases in interest costs on their external debt. The need for such a facility is emphasized in the G-24 report but is not considered in the G-10 report.

The first chapter of the G-24 report entitled "Summary and Recommendations" provides, in paragraph 27, a brief rationale for such a facility. "In view of the large variability in interest rates, a new facility to provide financing for interest rate increases needs to be introduced. This facility could also be a part of a facility which may cover deficits resulting from any exogenous factor that is reversible." In paragraph 116 of the same report it is argued further that such a facility "would help countries to manage their economies rationally and to provide a counter-cyclical influence on the world economy." Finally, the proposed facility is referred to in the appended "Revised Program of Action" in paragraph 28 of Chapter VI as follows: "A Task Force should be established within the framework of the Development Committee to study all aspects of the debt problem, including the feasibility of a special facility for alleviation of the debt burden arising from increases in interest rates."

1/ "The Functioning of the International Monetary System: A Report to the Ministers and Governors by the Deputies of the Group of Ten," June 1985 (circulated as EBD/85/154, Supplement 1). "The Functioning and Improvement of the International Monetary System: Report of the Deputies of the Group of 24," August 21, 1985 (circulated as EBD/85/228).

The G-24 report also comments on a more general need for mechanisms for dealing with historically high levels of real interest rates. This is referred to in paragraph 145 of Chapter VIII which reads as follows:

Multi-year restructuring of bank debts has been a helpful development since it prevented a bunching of maturities. However, it does not by itself solve the debt problem, since, after restructuring, debtor developing countries are left with a major resource transfer problem due to debt servicing requirements, a result with severe adverse effects on their economies. Moreover, this outcome also poses serious questions on the stability of the international monetary system. In this connection, urgent consideration may have to be given to evolving mechanisms that would roll over or refinance a certain proportion of interest payments, i.e., those above the long-term trend real rate of interest.

The purpose of this paper is to focus on broader features of an interest cost facility, the contributions that it might make to the better functioning of the international monetary system, and possible problems to which it might give rise. Attention is drawn to a number of specific issues which would need to be decided were a facility to be established, but these issues are not examined in detail in this paper.

The paper has three main sections. In the first, four aspects of a facility are discussed. These include the nature of the interest cost increases that might be relieved through the facility, the broad order of magnitude of the demands that might be made on it, implications for the design and operation of a facility of the relationship of changes in interest costs to developments in other items of the balance of payments and, finally, questions pertaining to the conformity of the facility with the Articles and current practices of the Fund.

In the second section, the potential advantages to members of the Fund and to the system as a whole are taken up. Potential problems or disadvantages are surveyed in the final section.

I. Aspects of an Interest Cost Facility

1. The increase in interest costs to be relieved through a facility

In the broadest terms, the purpose of an interest cost facility would be to assist members in financing that part of a balance of payments need that could be attributed to the impact of increases in international interest rates on their debt servicing costs. Perhaps the most natural focus for the facility would be the increases in nominal

interest costs payable to foreigners on outstanding debt. A number of rather specific questions would need to be considered in this connection in fixing details of the facility. For example, what would be the definition of the eligible debt? Would it be all outstanding debt or only debt issued after a certain date? Would it include all short-term debt as well as all long-term debt? Would particular categories of debts be excluded? Would interest rate increases arising from restructurings and/or rollovers be included? Would use of the facility be accompanied by any restrictions or incentives on the contracting of new floating rate debt?

A further operational question relates to the type of formula that might be applied to determine the total amount of an increase in interest rates that could be considered eligible for relief. For example, would the total increase in a specified period on the prescribed debt outstanding as of a base date be eligible? Or would it be more suitable if the eligible increase were defined in relation to the increase of interest costs over some average cost in a prescribed period? Should relief be provided for the total of eligible costs or only some fraction of the total?

It has been suggested that the facility should be targeted not on increases in interest costs that result from increases in nominal interest rates, but rather on those that result from increases in real (inflation adjusted) interest rates. Such a suggestion was made, for example, in paragraph 145 of the G-24 report cited above. Many of the questions raised above in connection with increases in nominal interest rates would need to be addressed in connection with the design of a facility focused on real interest costs. In addition, targeting on real interest costs would raise the technically difficult question of the definition of real interest rates to use and the associated question whether the same definition would be appropriate in the case of all members or whether in administering the facility, more specific definitions would need to be devised to recognize differences among countries in the interest rates they pay, in the appropriate price index to apply as a deflator, the currency denomination of debts and the pattern of exchange rate changes. The behavior of real interest rates may be different for different choices of the deflator to be used in converting nominal rates. In Chart 1, two measures of the inflation-adjusted values of short-term dollar interest rates are exhibited. In one case the nominal rates are deflated by an index of dollar prices of the exports of capital-importing developing countries. By this measure, real interest rates have moved over a range of about 60 percentage points in the 1970s and early 1980s. In contrast, the use of an index of prices in the United States provides a measure of real interest rates that covered a range of about 15 percentage points over the same period.

Attention may be drawn to one further aspect of the definition of the increase in interest costs that would need to be addressed in designing a facility. Would the increase in interest costs (nominal or real) to be relieved by the facility, in whole or in part, be defined retrospectively or prospectively, or both? If the increase in interest costs that is to trigger a drawing under the facility is defined retrospectively, then the member would base its drawing on cost increases that had already accrued. If the relevant increase in costs were defined (even partly) prospectively, then forecasts of interest rates and possibly the pertinent price indexes would be required. Such forecasting would be difficult technically, and would also be a sensitive matter for particular creditor countries should the facility be designed so as to require explicit estimates of the prospective course of interest rates in particular creditor countries.

2. The order of magnitude of demands upon the facility

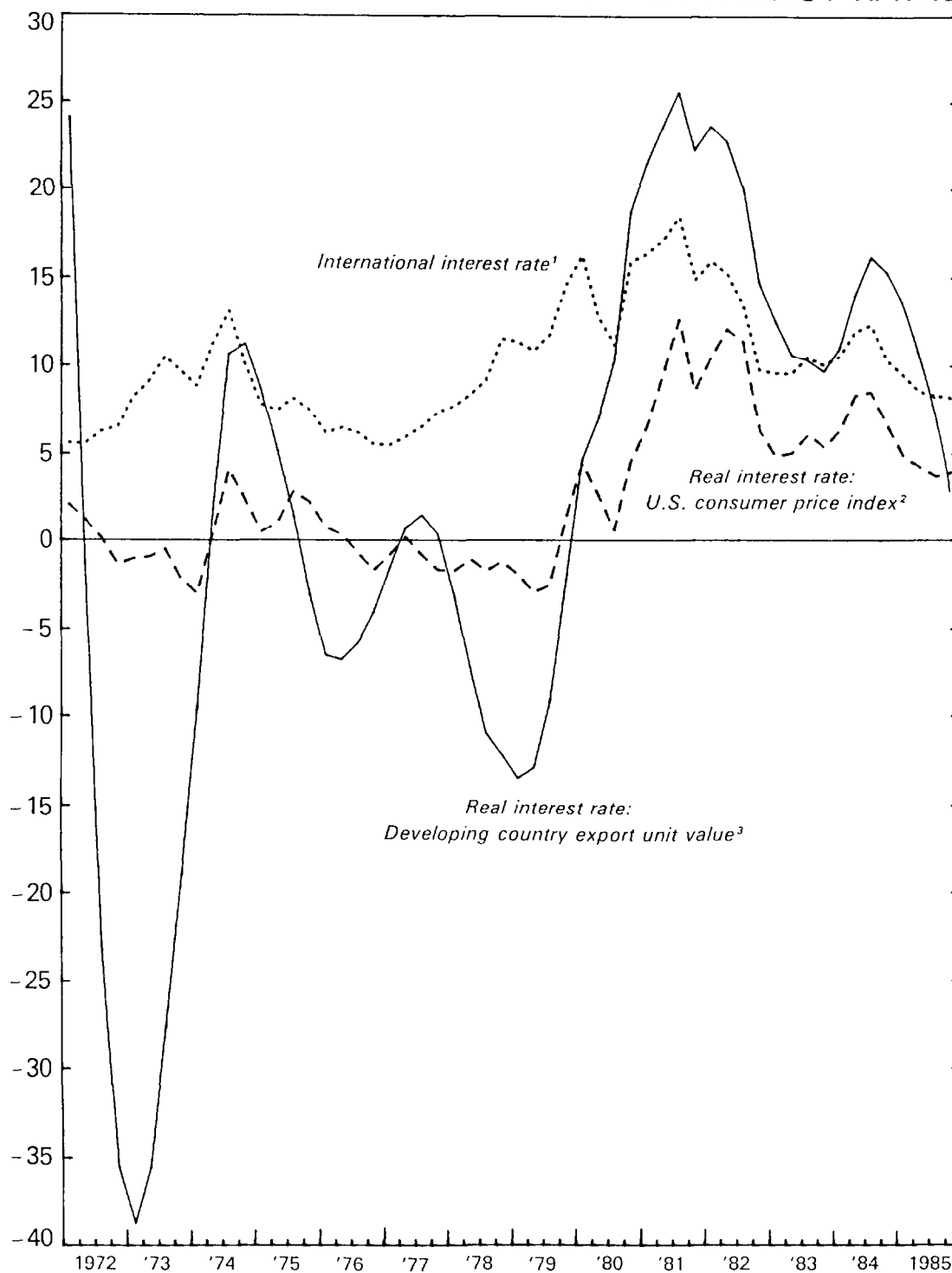
It is, of course, not possible at this stage to make a systematic estimate of the size of the demands that could be expected on the facility. The characteristics of the facility are not sufficiently defined to permit that. It is, however, possible to set out some considerations that could be helpful in forming an impression of the order of magnitude of such demands. That is what is attempted in this subsection.

Perhaps the most useful starting point for such an attempt is to calculate what would be the increase in annual interest costs on the debt of capital-importing developing countries that was outstanding at the end of 1985 if interest rates in international capital markets should rise by 1 percentage point.

For capital-importing developing countries as a group, the amount of debt outstanding at the end of 1985 was \$878 billion. Given that about 15 percent of this debt is in short term form and that about 45 percent of the long-term debt has been contracted at variable interest rates, it is calculated that a 1 percentage point increase in international interest rates applied to that debt would generate about \$4 3/4 billion increase in gross interest costs during the first year following the increase. This calculation is based on the assumption that all short-term and long-term debt with variable rates would carry the higher rate for the entire year. ^{1/}

^{1/} It is also assumed that interest rates on maturing fixed-term debt, which is largely due to official creditors, would not respond to an increase in interest rates during the first year. In many cases the terms on such lending are set by prior commitments. Moreover, the relatively long maturity of fixed-term debt means that a small share would mature during the year. Even if all rollovers carried the 1 percent higher interest rate, it would add only about \$0.1 billion to the estimate of the increase in interest costs from capital-importing developing countries.

CHART 1
NOMINAL AND REAL INTERNATIONAL INTEREST RATES



¹Quarterly average of London interbank offer rate on six month U.S. dollar deposits.

²London interbank offer rate adjusted for average change in current and two following quarters' consumer price index for the United States.

³London interbank offer rate adjusted for average change in current and two following quarters' export unit values for indebted developing countries.



This figure of \$4 3/4 billion may be taken to represent the upper limit of the increase in interest costs resulting from a 1 percentage point increase in interest rates for which financing might be sought from the Fund. Two general questions arise at this point: (1) what factors might serve to reduce the amount of financing sought in the case of a 1 percentage point increase in interest rates? and (2) what might be the magnitude of an increase in international interest rates in any particular year?

As to the first of these questions, the facility might be designed so as to limit the eligible cost increases to some fraction of the increases experienced or expected. Second, some portion of the increase in interest costs might be financed from other sources. Thirdly, some indebted members of the Fund may not seek to draw from the facility in the face of an increase in interest costs. It may be noted that of the \$4 3/4 billion cited above, the countries with recent debt servicing problems ^{1/} who might be thought to be the most prone to seek to use the facility would account for \$3.3 billion.

As to the second question--the extent of an increase in interest rates that might be expected in a given year--the following is instructive: if one calculates, for the periods of rising short-term Eurodollar interest rates since the beginning of 1963, increases in the level of such rates over successive four-quarter periods, one finds that the maximum increase was about 7 1/4 percentage points, and that the average such increase was about 2 percentage points.

To this point, the discussion has considered the possible extent of demands on a facility to deal with nominal increases in interest costs. The historical record would suggest that a facility to deal with increases in real interest costs could face larger or smaller demands depending in particular on the deflator used to define the real interest rate. As may be gauged from Chart 1, the rates of increase of real interest rates, where the measure is short-term Eurodollar interest rates deflated by changes in the U.S. consumer price index, have been comparable to the rates of increase of the nominal rate since the early 1970s. (1980-81 is an exception.) On the other hand, real interest rates defined in relation to an index of developing country export prices show much sharper rates of increase during intervals of rate increase in this same historical period.

A final observation may be made in connection with the demand for the facility. There could be more of a bunching of demands for the use of the interest facility than has been the experience with respect

^{1/} This group of countries is defined, as in the World Economic Outlook, as those countries which incurred external payments arrears or rescheduled their debt in the period 1983-85.

to the CF facility. Although there is a tendency for demands on the CFF to vary systematically with commodity prices and with the business cycle in industrial countries, it may be that changes in interest rates would affect members more uniformly than do the factors affecting export earnings and thus lead to a greater bunching of demands upon the facility.

In this discussion of the potential demand for the facility attention has been focussed on the demands that could be made by capital-importing countries. Of course, in principle, the facility would be available to all members of the Fund having a balance of payments need and satisfying the provisions of the facility itself. Were it to be decided to study the idea of an interest cost facility further, it would be essential to examine in detail the potential implications of such a facility for the Fund's liquidity and financing requirements as well for potential access under other Fund policies.

3. The relevance of other changes in the balance of payments

The purpose of this subsection is to raise questions concerning the relevance to the design of an interest rate facility of changes that a member may be experiencing in other balance of payments flows at the time the member is having to meet higher interest costs. Two other classes of flows in particular will be referred to: interest earnings and export earnings.

An increase in interest costs associated with increases in international interest rates would be accompanied by an increase in interest receipts on some portion of debtor countries' external claims. In order, for example, to limit any effect of an interest cost facility in inducing excessive borrowing, it may be thought useful to net increases in a country's interest receipts against increases in its interest costs in determining the basis for a drawing under the facility. If it were decided to give effect to this idea, it would be for consideration whether all of a country's interest receipts, public and private, should be taken into account in netting, or only some portion of them, for example receipts received by the public authorities, or receipts earned on the investment of official reserves.

Another form of netting that might well be considered in designing an interest rate facility would be netting against increases in export earnings. The relationship between changes in interest rates and changes in export earnings varies with circumstances in the international economy. Thus it is often the case that the later stages of a cyclical expansion in the industrial countries are featured by rising prices, growing imports and rising interest rates. In such circumstances, debtor countries' increased interest costs may be matched by some increase in their export earnings. On the other hand, there are circumstances in which inflation

in the industrial world, or parts of it, has proved obstinate. This fact may well be reflected in rising interest rates. Moreover, efforts to master the inflation through policy measures may well for a time exacerbate the increase in interest rates and simultaneously restrict the growth of the affected economies and the growth of their imports. In these circumstances, indebted countries may find that the increase in their interest costs is accompanied by diminished growth of export earnings or even a decline in export earnings. These considerations are relevant to the design of an interest rate facility. For example, they would be relevant in deciding whether the interest costs to be targeted would be defined as nominal increases or real increases. This matter is not pursued further here. The interrelations of interest costs and export earnings are also important in deciding whether to net interest costs against export earnings. The fact that the burden of an increase in interest costs may sometimes be lightened by the concomitant movement of export earnings and may at other times be made more severe, would argue for a form of netting so as to help to ensure that the facility would provide greater relief when the burden is greater.

This line of thought would suggest that detailed consideration could be given to the advantages and disadvantages of integrating, in some way, the interest rate facility with the CF facility. Some of the requirements for access to the CF facility would be readily applicable in the case of an interest rate facility. Others might not. For example, where the increase in interest costs was due to an increase in interest rates and not risk premia reflecting loss of creditworthiness, it would not seem difficult to demonstrate that the origin of the problem was beyond the control of the debtor. On the other hand, it might be very much more difficult to demonstrate that the circumstance giving rise to the problem could be expected to be "reversed" in the near term. These and other technical matters would need to be examined before a final decision as to whether and how to integrate an interest facility with the CFF could be made.

The logic that has been pursued in this section leads naturally to the inquiry whether it would be sensible to expand the domain of netting even further to include not only interest earnings and export earnings but other flows in the balance of payments. The idea that the burden of an increase in interest costs needs to be assessed in relation to other flows has no logical limit short of assessing that burden in relation to developments in the rest of the balance of payments as a whole. Were this position to be taken, of course, there would be no case for a special interest cost facility. The case must therefore rest on some special features of the pattern of interest costs or the pattern of interest costs in relation to some subset of the other flows in the balance of payments.

4. The conformity of an interest cost facility with the Fund's Articles and practices

In developing an interest cost facility in the general resources account, a number of questions would need to be addressed that relate to designing and operating such a facility in conformity with the Fund's Articles and practices. The purpose of this subsection is to bring to attention examples of such questions. Some of them would have to be examined in considerable detail in arriving at decisions concerning such a facility.

Drawings on the Fund under the facility could only be made by a member having a balance of payments need. This is a general requirement under the Articles that applies in respect of all uses of the Fund's general resources.

Access to the facility would be related to a member's quota. If the facility were integrated with the CFF, then access to these two facilities would have to be related to each other in a suitable manner. In any case, it would be for decision whether a member's rights of access to the Fund's resources within the tranches or under the Extended Fund Facility would be affected in any way by the exercise of drawing rights under the interest cost facility. At present, exercise of access to the CFF (cum cereal facility) does not limit access to resources of the Fund under other arrangements; of course any financing provided under the CFF is taken into account in assessing a member's balance of payments need of access under other arrangements.

In view of the revolving feature given to the Fund's general resources, one required feature of an interest cost facility would be that drawings under it would become payable within a prescribed time. It would be for consideration what the outer limit of that time period might be. A very important, though more specific, matter which arises in this connection concerns whether a member should be subject to an expectation of repurchase or even a requirement of repurchase should that member experience a reduction of interest costs before the end of the period of repurchase that was established at the time of a drawing. It might be argued that access to the facility should only be available if increases in interest costs are expected to be temporary. It follows from this principle that at the time access to the facility is granted some reduction in interest costs is anticipated in the near future. It further follows that it would be for decision whether realized declines in interest costs beyond those expected when access to the facility was granted, should give rise to an expectation or a requirement of early repurchase of drawings.

Perhaps the most difficult question to be dealt with in the group raised in the present subsection concerns the judgments to be made by the Fund as to the state of the balance of payments of a member seeking to

use the facility and the degree of concern to be expressed by the Fund. Put more concisely, what should be the degree of conditionality attaching to the use of Fund resources under the facility? The Fund operates from the basic position that it makes its resources available to members whose balance of payments prospects are such as to indicate a capacity to make necessary repurchases on schedule. In other terms the Fund generally wishes to be assured that a member's payments position is sustainable or that policies are in place leading to such a situation before permitting that member to use Fund resources. How best to conform with this practice of the Fund in administering an interest cost facility will require extensive examination. If the higher level of interest costs is expected to be prolonged, a country will need to adjust to that fact and if it needs assistance in these circumstances it should be expected to avail itself of access to the Fund's credit tranches. If the higher level of interest costs is expected to be temporary, but nonetheless creates a balance of payments need, access to the facility could be sought. It would be important that financial relief be provided promptly. Equally, it would be important to support rather than weaken any adjustment programs that the affected member may already have in train, whether with the support of other Fund resources or not. To find the right prescription of operating procedures for the facility that will adequately serve these objectives would require careful study and difficult choices.

II. Potential Advantages of an Interest Cost Facility

It is proposed in this section to list potential advantages that have been or could be cited in advocating an interest cost facility. The list is probably not comprehensive, but hopefully no major point has been overlooked.

If nominal interest costs rise at or above the rate of inflation, the debtor's position is adversely affected. In the first case, where nominal interest costs rise at the rate of inflation, the debtor must increase the amount of money he puts up to service his debt. It is true that he experiences a commensurate fall in the real value of his obligation. In effect the debtor is required to reduce the average "duration" of his outstanding debt and to the extent that this requires him to arrange extra financing on less favorable terms his position is adversely affected. The creditor is fully protected from the effects of the inflation upon his interest earnings and capital. In the second case, where nominal interest costs rise in excess of the rate of inflation, the debtor must put up even more money to service his debt. If the rate of inflation is the same as in the first case, the fall in the real value of his obligation will be the same, and the reduction in the average "duration" of his outstanding debt will be the same, but the debtor will have made a real transfer to the creditor. In the first instance the

purpose of the facility would be to relieve any burden of arranging the extra financing entailed in the shortening of the debt's duration; in the second instance, the purpose would also be to relieve the additional burden of making a real transfer to the creditor.

It is demonstrable that an increase in interest rates would produce a serious balance of payments disturbance for indebted countries. The 15 most heavily indebted countries now incur interest costs that amount to roughly one quarter of their exports of goods and services. An increase in international interest rates would raise their interest costs by some \$3 billion for each 1 percentage point increase in rates.

The disturbance to the balance of payments may be even greater if the increase in interest rates is coupled with a slower growth or even decline of export earnings. Such an adverse combination of circumstances is not a mere theoretical possibility. It has occurred in the recent past.

Even though a capital-importing country may be embarked upon an adjustment program and even though in planning that program allowance has been made for some unexpected adverse developments, an increase in interest costs could well exceed the reasonable allowances made, and not match the changes in the country's debt-servicing capacity that are evolving in accordance with its adjustment program. Real interest rates that exceed the real growth of export markets or the potential growth of the domestic economy become the enemy of economic growth itself.

If suitably structured, an interest cost facility could be activated quickly and thus could permit countries to maintain the momentum of their adjustment efforts and, sooner than would otherwise be possible, achieve a viable balance of payments position.

Not only could such a facility permit the maintaining of an adjustment effort in the face of adverse movements in interest costs, it could positively encourage countries to persist with their adjustment programs rather than to weaken or abandon them.

To the extent that interest rate changes reflect policy choices of other countries, the relief of the damage they inflict is at least in some measure a matter of concern to the international community. An effective means of meeting that concern would be to establish an interest cost facility in an international body such as the Fund that is supported by debtors and creditors alike.

An interest cost facility would serve not only the needs of individual countries that are adversely affected by higher interest costs; it would assist in maintaining or promoting the stability of the international monetary system at large. It would do this in at least two ways. To the

extent that the resources it might supply would prevent the curtailing of adjustment efforts and economic growth of debtor countries, it would contribute to the health of the international monetary system. In addition, to the extent that the momentum of adjustment and growth were maintained and the servicing of debts sustained, threats to the financial integrity of institutions in creditor countries and the potential danger to the system emanating therefrom would be diminished or removed.

III. Potential Problems or Disadvantages of an Interest Cost Facility

A number of problems or disadvantages may be seen in the concept of an interest cost facility. A list of such possible disadvantages is provided in this section. This list, as was the case with the list of advantages set out in the last section, is probably not exhaustive, but it is hoped that it may nevertheless be useful to all participants in the discussion of the interest cost facility idea.

One potential disadvantage could be that such a facility would be unnecessary; not because the difficulties it is intended to relieve would not arise, but because it would in some sense be redundant. It could be argued that the Fund is now providing resources to debtors who need to finance balance of payments adjustment. If it is felt that the resources of the Fund would be pressed because of the demands that could arise from the effects of rising interest costs, then the response should be in the form of increased resources for the Fund and access to them, rather than a new facility in the Fund.

To the extent that the Fund were to provide financing specifically to meet the costs of debt servicing arising from higher interest rates, it would do so on a temporary basis. Ultimately the drawings would have to be repaid. It is the case that the international system is now providing such a service to a degree. Presumably, where warranted, this service could be continued or extended by the other creditors involved. Accordingly, the use of a Fund interest cost facility would have the effect of substituting loans from the Fund for loans now being made or that could otherwise be made by the market or by governments. Such a use of Fund resources could be seen to be redundant and a disadvantage arising from an interest cost facility. 1/

1/ It is also the case that, at least to a limited extent, the market is prepared to provide hedging services to debtors with floating rate debt who wish to hedge against rising interest rates.

The variable interest instrument that is now widely used in effecting international capital movements has appeared in order to facilitate the practice by creditors of funding longer-term assets with shorter-term liabilities. To the extent that the Fund undertook to finance higher interest costs on variable rate instruments, it would be encouraging this practice of financial institutions of operating without a match between the term of their assets and the term of their liabilities. To provide such a service should be no part of the Fund's responsibilities, it could be argued.

It might be suggested that to provide a facility that would relieve debtors of some portion of an increase in interest costs would inhibit interest rates from performing the functions they are expected to perform in the economy. One purpose of higher interest rates is to discourage borrowing for less productive uses; they will not do that if the borrower need not pay. *Indeed, there is some possibility that the very existence* of an interest cost facility might encourage some members to incur a larger debt than they might otherwise have done in circumstances in which the member expects further increases in interest rates. Another purpose of higher interest rates is to give effect to monetary policy. The larger is the segment of the market that is protected from rising interest rates, the higher must rates rise if the potency of monetary policy is not to be reduced.

The Fund now has a facility to provide relief against certain losses of export earnings. It has extended that facility to provide relief for shortfalls in earnings from certain increases in services and for excesses in the costs of cereal imports. If the Fund extends the list of specific payments for which it is prepared to provide special financing, it may lose sight of its major role, which is to finance the adjustment of the balance of payments as a whole or, alternatively, it may lose support for the special facilities which have heretofore served a useful purpose.

When debtors are faced with rising interest costs, the likelihood is that this condition will be a reflection of inflation in the world and in particular in the creditor countries. The fundamental approach might therefore be thought to be to attack the problem at its root rather than to develop palliatives. In other words, efforts should be directed to good economic management under firm surveillance rather than to the multiplying of facilities to deal with the problems that arise from the failures of policy and the inadequacies of surveillance.