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AGENDA

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October 26, 1988

To: Members of the Executive Board
From: The Secretary
Subject: Lending Parallel with Fund Arrangements

Attached for consideration by the Executive Directors is a paper describing lending in parallel with Fund arrangements, which will be brought to the agenda for discussion on a date to be announced.

Mr. Boorman (ext. 7858) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

INTERNATIONAL MONETARY FUND

Lending in Parallel with Fund Arrangements

Prepared by the Exchange and Trade Relations Department

(In consultation with other Departments)

Approved by L.A. Whittome

October 25, 1988

I. Introduction

At the recent meeting of the Interim Committee in Berlin, the Alternate Governor of the Fund for Japan announced that as its further contribution to promoting growth in developing countries and thereby helping to resolve the debt problem, Japan is prepared to extend additional financing to developing countries in the form of loans in parallel with the Fund's extended or stand-by arrangements. Executive Directors were informed of this intention of the Japanese authorities and the broad features of parallel lending prior to the Annual Meetings by the Executive Director for Japan. At that time, the Managing Director indicated that a paper on the modalities of parallel lending would be presented to the Executive Board for discussion shortly after the Annual Meetings.

Parallel loans will be extended by the Export-Import Bank of Japan ^{1/} ("the lender") on a case-by-case basis, mainly to middle-income developing countries. The Japanese authorities have indicated that parallel lending is to be additional to financing, including that from Japan, that would otherwise be provided to the recipient country and that it is intended that making such loans in parallel with Fund arrangements would permit lending that could not otherwise be justified. They have stressed that the availability of parallel loans should not lead to reduced financing from other sources, and hope that this view would be reflected in the decisions of other creditors,

^{1/} The Export-Import Bank of Japan is an independent governmental financial institution. Its activities include the provision of export credits; financing for imports by corporations in Japan and overseas direct investments by Japanese firms; untied loans to foreign governments, governmental institutions, and financial institutions, and to multilateral development banks; and guarantees for loans by Japanese private institutions. The primary source of funding for these activities is borrowings from the Japanese government's Fiscal Investment and Loan Program which is funded primarily by postal savings. The Export-Import Bank of Japan is committed to lend up to SDR 2.2 billion to the ESAF Trust (EBS/88/69, 3/28/88).

including in particular commercial banks. Parallel loans will be disbursed in tandem with a Fund arrangement; no policy conditions will be required by the lender other than adherence to policies which would permit it to make drawings under the arrangement. The experience with parallel lending will be assessed by the Japanese authorities and the lender in two to three years' time, in order to determine whether its continuation would be appropriate, in light of factors such as Japan's balance of payments position and the situation facing the Fund membership at that time.

In discussions with the staff, the Japanese authorities and the lender have indicated to the staff the modalities on the basis of which parallel loans will be made available. The staff has described to the Japanese authorities the nature and scope of assistance that it could provide to the authorities and the lender under the Fund's current practices. The attached note (see Appendix) records the understandings of the Fund staff, the Japanese authorities, and the lender on these matters. These understandings are consistent with existing Fund policies and practices, and do not constitute an agreement creating binding obligations.

The main elements of these understandings are described in Section II, on the basis of the Appendix and of information provided by the Japanese authorities. The role of parallel lending and its implications are discussed in Section III, while Section IV provides a brief conclusion.

II. Parallel Lending

1. Eligibility

The Japanese authorities and the lender intend to consider the possibility of parallel lending on a case-by-case basis for countries entering into extended or stand-by arrangements with the Fund. The lender will decide whether or not to offer a parallel loan in each case on its own criteria. For instance, a parallel loan might be judged appropriate where the adoption of Fund-supported programs was thought to have improved the creditworthiness of the borrowing country sufficiently to justify additional financing by the lender and where the program would be strengthened through the availability of additional resources. One element in this decision would, of course, be the ability of the potential borrower to service the additional borrowing on the terms envisaged. Parallel lending could be considered inappropriate where the lender is already extending large amounts of finance and/or there is no strong need to provide additional financing.

Parallel lending in association with extended arrangements would normally best accommodate the intention of the authorities to provide support for medium-term programs of macroeconomic and structural adjustment. However, a stand-by arrangement having a strong medium-term structural content could also be supported by such lending. The terms

of parallel loans are not expected to be appropriate for many low-income countries, which normally can obtain highly concessional financing from other sources, including the ESAF. For this reason, the authorities consider that parallel lending should be made available primarily to middle-income developing countries.

2. Forms of parallel lending

Parallel lending would be extended in the form of a bilateral loan, normally to the central government or central bank. Such loans would be intended to provide import financing and would require appropriate import documentation. ^{1/} However, to facilitate timely disbursements in connection with purchases under Fund arrangements, the lender would provide considerable flexibility. Specifically, parallel loans may be used to reimburse previous import payments, and may also be disbursed in some cases against future imports. Eligible imports will also be defined very broadly, normally by specifying only a few items (such as ammunition and illegal narcotics) as ineligible. Finally, financing will not be tied in any way to imports from Japan.

3. Amount and terms of loans

The amount and terms of parallel loans will be determined by the lender and the borrower based on their own criteria. The amount of loans will be decided on a case-by-case basis, taking into account, inter alia, the financing needs of the borrowing country, the borrower's debt servicing capacity, and the amount of financing to be provided by the Fund as well as that of all other creditors. The Fund staff would provide assistance to the lender and the borrower in the assessment of financing needs.

Loans in parallel with extended arrangements would normally carry maturities similar to those of the Fund's ordinary resources provided under the arrangement. Although loans in parallel with stand-by arrangements would in principle carry maturities similar to those of the Fund arrangement, the lender intends to ensure an element of flexibility. Thus, maturities longer than those of stand-by arrangements may be considered, when appropriate, in light of the country's debt service profile.

Loans will, in principle, be denominated in yen. While SDR denomination of some loans is not precluded, this would be acceptable to the lender only if it considered that its risk in entering into arrangements to hedge against exchange rate fluctuations were minimal.

^{1/} The Export-Import Bank of Japan is authorized by its statute to extend untied loans only to finance "undertakings" or imports. Undertakings are normally project or business-related activities; the ESAF Trust also qualified as an undertaking.

Yen loans will be extended at a fixed rate of interest, somewhat below the long-term prime lending rate of private banks in Japan. The current long-term prime lending rate of private banks in Japan is 5.7 percent. The cost for developing country sovereign borrowers placing yen bonds at similar maturities has generally been somewhat higher than the long-term prime rate.

4. Conditionality and association with Fund arrangements

A parallel loan will be provided in support of the adjustment program supported by a Fund arrangement, and the loan commitment will generally come into effect upon approval of the Fund arrangement by the Executive Board. No policy conditions will be required by the lender apart from those included in the Fund arrangement. The conditions of the Fund arrangement will be determined by the borrowing country and the Fund in accordance with the policies of the Fund.

Disbursements will normally be made on a schedule closely approximating that of the disbursements under the Fund arrangement, except that disbursements of parallel lending would normally be semiannual. Phasing would follow broadly that of the Fund arrangement. A disbursement would take place in conjunction with the approval of the Fund arrangement, and subsequent disbursements would generally be made only upon continued satisfactory performance under the Fund arrangement, as evidenced by the entitlement to drawings from the Fund.

In the event of an interruption in drawings under the Fund arrangement, the disbursement under a parallel loan associated with the interrupted drawing would normally be made with a commensurate delay. If the interruption were prolonged, the lender would determine the appropriate response on a case-by-case basis, after discussion with the Fund staff. In the event that the Fund arrangement were cancelled, the parallel loan agreement would be terminated.

5. Cooperation by the Fund staff

The Fund staff will assist borrowing countries to obtain access to parallel loans and will also assist the Japanese authorities in their consideration of parallel loans. All staff contacts with the Japanese authorities and the lender will be consistent with the existing practices of the Fund, and due consideration will be given to confidentiality between the Fund and borrowing members.

It is envisaged that the possibility of a parallel loan and the procedures that would be followed in connection with such a loan will be discussed by the Fund staff with potential borrowers at an early stage. For those potential borrowers who express an interest in parallel financing, the Fund staff will provide to the office of the Executive Director for Japan periodic indications of countries that might request extended or stand-by arrangements over the next six months. The Japanese authorities will then decide upon the countries

for which a parallel loan could be considered, based on the criteria discussed above. The Fund staff would provide a tentative indication of each country's balance of payments prospects, financing requirements and possible sources of finance, and the broad outlines of the adjustment program.

During the period of implementation of the Fund arrangement, the Fund staff will provide the Executive Director's office with information on the entitlement of the member to disbursements from the Fund necessary for the execution of the parallel loan. The current economic situation of the member could also be discussed with the Executive Director's office, consistent with existing Fund procedures (as described in Section III). After expiration of the Fund arrangement and while the parallel loan remains outstanding, the Fund staff would be available, at the request of the Executive Director's office, to discuss economic developments that are likely to affect the discharge of obligations under the parallel loan.

The lender will inform the Fund staff of the existence and amount of any overdue obligations that might occur with respect to parallel loans. The staff would discuss these overdue obligations with the authorities of the borrowing country, as is the case with regard to arrears to other creditors on which information is available to the staff. The staff would indicate to the authorities of the borrowing country, in line with the practices and policies of the Fund, that such overdue obligations are inconsistent with the maintenance of orderly relations with creditors, that they should be eliminated as soon as feasible, and indeed that a program for the elimination of any overdue obligations, including those to the lender, would need to be adopted in the event that the borrowing country wished to make subsequent use of Fund resources. When these or other arrears have important implications for the analysis of the external position of the borrowing country, information on the arrears would be included in staff reports to the Executive Board on that country.

III. Role and Implications of Parallel Lending

In recent Executive Board discussions of the debt strategy and in the September 1988 meetings of the Interim and Development Committees, it was stressed that the lack of adequate and timely availability of external resources has made the adjustment process more difficult for a number of developing countries. ^{1/} Although multilateral development institutions appear to be prepared to increase their lending in support of structural adjustment, commercial banks remain reluctant to extend new loans and, in many cases, are seeking to reduce their portfolios

^{1/} See EBS/88/55, 3/9/88, and Buff 88/69, 4/5/88; EBS/88/159, 8/4/88, and Buff 88/172, 9/2/88; IMF Press Release No. 88/33, 9/26/88; and Development Committee Press Communiqué, 9/26/88.

vis-à-vis developing countries experiencing debt servicing difficulties. The Fund has the scope under current access policy to provide relatively large amounts of resources in most individual cases, but the determination of access must take account of the needs to preserve its capacity to meet the needs of all members, to safeguard the revolving character of its resources, and to apply the access policy in an even-handed manner. It has become increasingly difficult in some cases to secure the financing necessary to assure the viability of growth-oriented adjustment programs supported by Fund arrangements. Parallel lending is intended to help address this problem by providing additional financing that would be available on an assured basis.

The Japanese authorities have indicated that parallel lending will be additional to financing, including that from Japan, that would otherwise be provided to the country involved, and also that it would be in addition to the financing originally envisaged under the "recycling" plan initiated by former Japanese Prime Minister Nakasone. The authorities have stressed that the availability of parallel loans should not lead to reduced financing from other sources, and hope that this view would be reflected in the decisions by other creditors, including in particular commercial banks. They have requested that Fund management do all it can to ensure, in the assessment of financing needs and the preparation of financing packages, that financing from other creditors is not reduced due to the availability of parallel financing. As a practical matter, it would not be possible for the staff to establish conclusively that financing from a particular creditor was additional or that aggregate financing was larger than would otherwise have been the case. However, the staff would intend to prepare a tentative program, assess the appropriate level of access to Fund resources, and seek maximum support from all creditors and donors, including the banks, ^{1/} on the assumption that no parallel lending would be available. The staff would incorporate, when appropriate, any additional financing that became available through parallel lending into the program in ways designed to enhance further the prospects for achieving sustainable growth.

The additional resources could permit a higher level of investment, and thus a higher level of potential output, as well as more rapid implementation of policy reforms (such as import liberalization) that

^{1/} The difficulty of defining and measuring the adequacy of a financing package and the appropriate contributions of various creditor groups has been discussed by the Executive Board on several occasions. "The increasing diversity of ways to provide debtors with needed cash flow, coupled with the growth of secondary markets for rescheduled sovereign debt--a healthy development--requires that the existing approach to burden-sharing within and among creditor groups be looked at again . . . the method of measuring contributions by changes in exposure is becoming less relevant." (EBS/88/55, 3/9/88, pages 6-7.)

would tend to require temporarily larger external financing. As parallel loans could also free resources that would otherwise be used to finance imports, borrowing countries could have greater flexibility to use existing reserves in managing their external debt situation in ways that would accelerate the restoration of access to commercial credit markets. Finally, the availability of additional financing should provide greater assurance both that the program can be growth-oriented and that it will be based on a level of reserves adequate to help assure timely payments of external payments obligations. This greater degree of confidence should enable commercial banks to come forward more readily with their own financing.

Parallel lending will be structured to facilitate timely disbursements in conjunction with disbursements under Fund arrangements. The authorities of the borrowing countries could thus rely on the timely availability of this source of financing as long as the program was implemented as envisaged. It may be recalled that disbursements by bilateral and multilateral donor agencies are often difficult to predict, in part because of administrative requirements. The availability of this predictable source of finance would lessen the risk that shortfalls in external financing will contribute to interruptions in the implementation of the program.

There are already many instances of linkage to Fund arrangements of decisions by donors and creditors; indeed, such linkages are a major channel through which Fund arrangements have served to catalyze additional resources. A number of official and commercial creditors have for some time required a satisfactory macroeconomic setting for their lending and have used approval of a Fund arrangement or entitlement to disbursements under an arrangement as providing the required assurances for this purpose. ^{1/} The linkage to Fund arrangements envisaged with respect to parallel loans is akin to that used by commercial banks in connection with concerted lending. It is simpler and more direct than that used at times by other official lenders, in that the Japanese authorities and the lender do not intend to require any policy conditions other than approval of the Fund arrangement and continued entitlement to make drawings under the Fund arrangement. Neither the Japanese authorities nor the lender has any intention of seeking to intervene in the negotiations between the Fund and the

^{1/} Formal linkages to Fund arrangements of loan approvals and disbursements by commercial banks have been frequent, particularly in recent years. Discussions on a rescheduling of debt service obligations under the auspices of the Paris Club are not normally undertaken in the absence of a Fund arrangement with the borrowing country. A number of major national agencies have provided bilateral financing in support of structural adjustment on an ad hoc basis in individual cases, linking their commitments to approval of a Fund arrangement and disbursements to elements of the policy program supported by the arrangement.

borrowing country on an adjustment program to be supported by a Fund arrangement.

The Fund staff's assistance in seeking to assure adequate external financing for Fund-supported adjustment programs has entailed contacts with various creditors, including commercial banks, the Paris Club, and other official creditors and donors. On several occasions, the Executive Board has discussed the nature and scope of such assistance which includes: in the case of commercial banks, a sharing of information about policy measures undertaken and the broad policies to be pursued under the Fund-supported programs, discussion of the implications of alternative levels of financing, and provision of indications of the ability to make purchases from the Fund 1/; in the case of Paris Club, informal communications and exchanges of view among the official creditors, the debtor countries, and Fund staff, including in some cases the economic implications of alternative levels of debt relief 2/; and vis-à-vis donor governments and agencies, visits to the capitals of one or two key donors to discuss the main elements of the authorities' policy program, contacts with Executive Directors representing donors with a particular interest in a given recipient country, and convening ad hoc multilateral meetings of donors to consider providing additional balance of payments support. 3/ The assistance to be provided by the staff in connection with parallel lending is consistent with these Fund practices.

The procedure to be followed in the event of arrears on parallel loans will provide the lender with a channel to bring the issue of such arrears to the attention of the Fund and its members. Once such information is received, the staff will follow the procedures that it has normally used with respect to information on arrears to other creditors; in cases where relevant information on arrears to creditors is available, the Fund staff has discussed the matter with the authorities of countries that have arrears in Article IV consultation and other missions, and, where appropriate, has included references in staff reports. The lender believes that this would assist it in obtaining prompt settlement of such arrears, but the Japanese authorities and the lender are not expecting preferential treatment from the Fund in this regard.

1/ "The Role of the Fund in Assisting Members with Commercial Banks and Official Creditors" (EBS/85/173, 7/23/85), pages 6-7.

2/ EBS/85/173, 7/23/85, page 7.

3/ "The Policy Framework Paper (PFP)--Seminar on the PFP and Aid Coordination and Related Issues" (EBS/88/65, 3/23/88), page 8 and "Consultative and Other Aid Groups" (SM/82/91, 5/6/82), page 10. In discussing such practices, "Directors thought that closer staff contact with donor representatives would be useful for some purposes, particularly when it can contribute to mobilization of larger financing flows." (Buff 88/92, 5/13/88.)

IV. Conclusion

The availability of parallel financing involves a number of advantages for borrowing countries and for the Fund. The Japanese authorities have undertaken to extend financing that is flexible, untied, and available on a timely basis. It is intended that parallel loans be additional to existing lending to developing countries, including that of Japan, and that such loans should not enable other creditors--including the commercial banks--to reduce their involvement. Parallel loans will provide urgently needed additional financing to middle-income developing countries in support of economic adjustment, which will mean that adjustment programs can aim at an acceleration of some economic reforms, higher levels of imports and investment, and higher economic growth than would otherwise be possible. The catalytic role of the Fund will be enhanced, as the Fund arrangement would lead directly to timely and predictable disbursements of additional lending to the borrowing country, easing the financing constraint and reducing the danger that policy reforms will be hampered by a lack of adequate and timely external support. This will also tend to strengthen the debt strategy and the positive role that the Fund can play in that strategy.

It should be emphasized that the Fund will not incur any financial obligations as a result of parallel lending, and in particular has extended no express or implied guarantees. The decision whether or not to offer a parallel loan will be made by the Japanese authorities and the lender, and such loans will be extended bilaterally by the lender. The amounts, terms, and conditions of parallel loans will be determined by the lender and the borrowing country.

The understandings between the Fund staff and the Japanese authorities with respect to parallel lending, including those relating to linkage with Fund arrangements and the provision of information by the Fund staff, are consistent with the existing Fund policies and practices. The initiative of the Japanese authorities demonstrates how these policies and practices can be built upon to strengthen the ability of the international community to promote growth-oriented adjustment and thereby to contribute to the resolution of the debt problem. In the view of the staff, this initiative is clearly a welcome development.

Note on Lending in Parallel with Fund Arrangements

This note reflects understandings of the Japanese authorities and the Fund staff concerning the financing that the authorities wish to make available to Fund members in parallel with the Fund's financial assistance to these members under extended or stand-by arrangements. Such financing will be provided by The Export-Import Bank of Japan, hereinafter referred to as "the lender". The authorities have indicated that such financing could be considered on a case-by-case basis mainly for middle-income countries that are not in arrears to the lender, and that this financing would be additional to any financial assistance expected to be made available to these countries in the absence of this operation. The terms and conditions of such loans would be discussed and determined by the borrowing country and the lender, based on their own criteria. The implications of this lending for the program supported by a Fund stand-by or extended arrangement would be examined in the context of the ongoing relationship between the borrowing country and the Fund.

I. Modalities of Parallel Financing

The modalities on the basis of which the authorities have indicated that the lender intends to make the parallel financing available are described below.

A. Loan agreement with recipient

The terms and conditions of lending in parallel with an extended arrangement or with a stand-by arrangement would be described in a loan agreement between the lender and the borrowing country. In particular, the agreement would contain a commitment by the lender to provide a given amount of resources by specific dates subject to certain conditions, and would include a description of how disbursements on the bilateral loan would be linked to developments under the Fund arrangement.

B. Form of parallel lending

Parallel loans would be provided in support of policies and measures supported by the Fund extended or stand-by arrangement. Disbursements of parallel loans would be made directly to the borrowing country in tranches subject to specified conditions. It is expected that these conditions may include the provision of appropriate documentation by the borrowing country to the lender evidencing imports or other eligible expenditures of a value at least equivalent to the amount of the disbursement. Imports to be financed by the parallel loan need not originate from Japan. With a view to ensuring that disbursements would take place as scheduled, eligible expenditures would be defined in fairly general terms (e.g., short negative list) and

disbursements would generally be made on a reimbursement basis; provision could also be made for advance payments, insofar as the lender considers it appropriate.

C. Amount of loans

The amount of loans in individual cases would be decided on a case-by-case basis by the lender and the borrowing country. The amount and phasing of disbursements would take into account the recipient's liquidity needs during the course of the Fund arrangement. Disbursements would generally be made on a schedule closely approximating disbursements under the Fund arrangement. Provision could be made for some flexibility in the disbursement schedule to allow disbursements to be advanced or delayed by short periods (e.g., one month), if considered appropriate by the lender. Disbursements would generally occur on a semiannual basis, but quarterly disbursements could also be considered.

D. Terms of loans

1. Repayment period

The maturity of loans would be determined so as to ensure consistency with the objectives of the adjustment program supported by the Fund arrangement. Loans made in parallel with Fund extended arrangements would in principle carry maturities similar to drawings from the Fund under those arrangements. Loans made in parallel with stand-by arrangements could carry maturities similar to drawings from the Fund under those arrangements, but longer maturities would be considered by the lender if appropriate in light of the country's external debt service profile or other considerations.

2. Currency of denomination

In principle, loans would be denominated in the currency of the lender. Foreign currency or SDR denomination would also be considered when, inter alia, the lender is able to arrange the necessary forward cover.

3. Rate of interest

The interest rate would be determined by the lender on a case-by-case basis. The interest rate would be below the long term prime lending rate of private banks in Japan.

E. Conditions of association with Fund arrangements

The loan commitment by the lender would generally come into effect on approval by the Fund Executive Board of an arrangement with the borrowing country. Disbursements by the lender would generally be made only upon continued satisfactory performance under the Fund arrangement, as evidenced by the entitlement to disbursements from the Fund.

II. Working Procedures

A. Consistent with the existing practices of the Fund on the provision of information to members, and in order to provide the information necessary to facilitate the parallel lending, contacts with the authorities would take place as follows:

1. On a regular basis, the Fund staff would provide the Executive Director's office with information on countries for which parallel lending might be considered over the subsequent six-month period. In each case, the Fund staff would provide information necessary for the lender to make a preliminary assessment of the appropriateness of the parallel loan. A tentative indication of potential access under the Fund extended or stand-by arrangement could also be provided. If necessary, discussions with the Fund staff could take place either at Fund headquarters or, when appropriate, in Tokyo.

2. After interest has been established by the lender, following discussions with the Fund staff, to provide assistance to a particular member, the lender would proceed to discuss the bilateral loan agreement with that member. If the discussions proceeded satisfactorily, the lender would provide a preliminary indication to the Fund staff that the parallel loan would be extended if the Fund arrangement for the member was approved by the Executive Board. When required under the usual Fund practices regarding financing assurances, a firm indication would need to be provided before approval of the arrangement by the Fund.

3. In accordance with the Fund's practices, during the period of implementation of the arrangement, the Fund staff would provide to the Executive Director's office information essential to the execution of the parallel loan. After the expiration of the arrangement and while the parallel loan remains outstanding, in addition to the normal documentation provided to the Executive Board of the Fund on the borrowing country's economic situation, the Executive Director's office could request a discussion with the Fund staff of economic developments that are likely to affect the discharge of obligations under the parallel loan.

B. In cases where overdue obligations occur in respect of the parallel loans, the lender would inform the Fund staff of the existence and amount of such overdue obligations. In line with the practices and policies of the Fund, the following actions would be taken by the Fund staff. These overdue obligations would be discussed, together with the relevant information available to the staff on arrears to other creditors, with the authorities of the borrowing country and it would be indicated that (a) the existence of such overdue obligations is not consistent with the maintenance of orderly relations with creditors; (b) a program for the elimination of any overdue obligations, including those to the lender, would need to be adopted in the event that the country intended to make subsequent use of Fund resources; and (c) when appropriate, information on overdue obligations to the lender would be

included, together with information on other arrears that would have important implications for the analysis of the external position of the borrowing country, in Article IV consultation reports or other staff reports to the Executive Board on the country.

C. The understandings described above may be modified in light of the evolution of policies and practices of the lender and the Fund. The experience with the parallel lending will be reviewed within two to three years after the initiation of such lending with a view to assessing the appropriateness of the lending and its modalities.