

XXIV. Debt Relief

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How are debt rescheduling and debt reduction reflected in fiscal accounts?

In what ways are official debt and bank debt relieved?

Does the distinction between government and central bank liabilities matter?

An inability to service external debt indicates that macroeconomic policies have been unsustainable and that a policy adjustment is unavoidable (see the note on *Public Expenditure and Sustainable Fiscal Policy*). However, adjustment measures may be incapable of restoring sustainability without either temporary or permanent debt relief. The purpose of this note is to outline the fiscal implications of alternative ways of restructuring debt to provide such relief.

The Accounting Framework

The conventionally defined fiscal deficit measures the gap between revenue and expenditure. The cash deficit refers only to transactions for which cash has been disbursed or cash revenues have been received. The commitment deficit measures the government's planned net use of resources resulting from budgetary decisions. The government's inability to meet its expenditure commitments on a timely basis is reflected in an accumulation of payments arrears, producing a difference between the commitment deficit and the cash deficit. While an unsustainable debt burden may manifest itself in a variety of ways—including a need to levy bad taxes or cut essential spending programs—it is often associated with an accumulation of arrears to external creditors. Assuming that the government plans to service its debt in full, its interest obligations would be reflected in the commitment deficit and its actual interest payments in the cash deficit. Where the government has no intention to fully service its debt, it is sometimes useful to distinguish an accruals-based concept of the deficit to reflect the gap between its contractual obligations and its budget commitment. Rather than making this distinction, the term "commitment" tends to be used rather flexibly. The build-up of amortization arrears affects other financing needs. The alternative deficit concepts give rise to different accounting frameworks:

Cash basis

Revenue

- Noninterest expenditure
- **Actual** interest
- = Cash deficit
- = (-) Financing
- = New external borrowing
- **Actual** amortization
- + Net domestic borrowing

Commitment basis

Revenue

- Noninterest expenditure
- **Scheduled** interest
- = Commitment deficit
- = (-) Financing
- = New external borrowing
- **Scheduled** amortization
- + Change in arrears
- + Net domestic borrowing.

Alternatively, the two accounting frameworks can be combined as follows:

$$\begin{aligned} & \text{Revenue} \\ & - \text{Noninterest expenditure} \\ & - \text{Scheduled interest} \\ & = \text{Commitment deficit} \\ & - \text{Change in interest arrears} \\ & = \text{Cash deficit} \\ & = (-) \text{Financing} \\ & = \text{New external borrowing} \\ & - \text{Scheduled amortization} \\ & + \text{Change in amortization arrears} \\ & + \text{Net domestic borrowing} \end{aligned}$$

This framework—which ignores nondebt related payment arrears—will be used below to describe the impact of the main debt restructuring options.

The distinction between the commitment and cash deficit has a significance that extends beyond the implications discussed in the note on *Expenditure Arrears*. In particular, where there are external arrears, it is the commitment deficit that often needs to be reflected in macroeconomic analysis. Since the commitment deficit is defined analogously to the external current account deficit, which is always defined on a commitment basis, a comparison of the two will lead to correct inferences about the implied private sector savings-investment balance. See equation (2) of the note on *Public Expenditure and Sustainable Fiscal Policy*.

Official Debt

Debt rescheduling and debt reduction

Official debt restructuring has focused primarily on the **rescheduling** of debt service payments in respect of medium- and long-term debt to governments and multilateral lending agencies. Terms are normally agreed in the context of Paris Club negotiations between creditors and debtors. These terms vary on a case-by-case basis, with exceptional, more favorable, rescheduling (Toronto terms) granted to the poorest and most heavily indebted countries. There is a menu of rescheduling options which allows for changing the maturity structure of debt, extending grace periods, canceling some portion of debt service, and the use of concessional interest rates. Arrears are usually consolidated under Paris Club agreements. Rescheduling changes the time profile of debt service payments, giving a country breathing room in which it can get an economy back on track so that it can eventually discharge its debt service obligations. It is for this reason that a Paris Club rescheduling is often linked to the strength of adjustment policies in general, and Fund conditionality in particular. With exceptional rescheduling terms the present value of the debt is also reduced. But in some cases, the debt burden is so great that even rescheduling on exceptional terms is not enough, and a significant **reduction** in the stock of debt is required. This would be the case where the debt overhang discourages investors, who see the future need for an unacceptably large diversion of resources to meet debt payments.

Fiscal impact

Debt rescheduling alone has no impact on the fiscal deficit measured on a commitment basis. The accounts would simply record the following:

Revenue
- Noninterest expenditure
- **Originally** scheduled interest
= Commitment deficit
- Rescheduled interest
= Cash deficit
= (-) Financing
= New external borrowing
- **Originally** scheduled amortization
+ Rescheduled amortization
+ Net domestic borrowing

By contrast, the cash deficit will likely fall, depending upon how much of the interest obligation was previously being discharged. Similarly, amortization payments will probably fall, implying an even smaller need for new external borrowing and domestic borrowing than implied by the fall in the deficit alone. With lower domestic borrowing, domestic interest and amortization could also fall by a modest amount in the same year, but by more over the medium term. Only where a country is accumulating large interest and amortization arrears is debt rescheduling likely to place an additional burden on the budget, as debtors are required to share some of the cost of debt relief.

In the case of debt reduction, the government is relieved of the obligation to repay part of its debt. Official debt reduction can take a variety of forms—debt can be canceled, interest and amortization payments can be forgone—which can be compared on a present value basis. Whatever method is adopted, the deficit measured on a commitment basis should fall. The cash and commitment deficits are brought into line (or closer into line if nondebt-related payment arrears persist), as follows:

Revenue
- Noninterest expenditure
- **Newly** scheduled interest
= Commitment deficit
= Cash deficit
= (-) Financing
= New external borrowing
- **Newly** scheduled amortization
+ Net domestic borrowing

The new cash deficit may be higher or lower than the preceding cash deficit, depending upon the cash flow implications of the debt reduction operation. But countries that require debt reduction are probably servicing rather little of their debt, and a requirement that the debtor is expected to bear some of the costs of debt reduction could again lead to increased interest and amortization payments. Debt reduction operations also have some transactions costs. The advantage of accepting this deal is that relations with creditors are regularized,

access to foreign capital is reestablished, and the burden of debt service—relative to capacity to pay—will hopefully be reduced.

It should be clear from the preceding discussion that the distinction between debt rescheduling and debt reduction is blurred, since debt rescheduling on exceptional terms embodies an element of debt reduction. Moreover, debt rescheduling and explicit debt reduction will often go hand-in-hand. There is therefore a need for flexibility in the application of the accounting procedures suggested above to describe the fiscal impact of debt relief.

The debt reduction case nevertheless demonstrates rather clearly the macroeconomic importance of the commitment based definition of the fiscal deficit. Debt reduction is intended to close external financing gaps, and is normally reflected in a reduction in the external current account deficit. With given investment plans, the implied reduction in foreign saving must be offset by higher domestic saving. Since there is no reason to believe that private saving will be immediately affected, this offset must be seen in government saving, if properly defined. This is indeed what happens, as the commitment deficit will reflect exactly the same amount of interest relief (net of transactions costs) as the external current account deficit, while the cash deficit could rise and the cash-based measure of government saving would fall correspondingly.

Bank debt

Bank debt restructuring is more ad hoc than its official debt counterpart, although there is a significant element of commonality to the agreements that have been concluded. In part, this reflects efforts to ensure **burden sharing** between the banks and official creditors in granting debt relief. A feature of bank debt restructuring agreements is that interest payments falling due or in arrears have in virtually all cases been excluded from rescheduling. As part of these arrangements, short-term debt is sometimes rolled over or converted into medium-term loans. Medium-term loans are also refinanced. Like agreements with official creditors, bank debt restructuring is linked closely to the strength of adjustment being undertaken. Stronger policies usually attract longer maturities and grace periods, reduced fees, and have favorable terms for refinancing. The principle of burden sharing has also been extended debt reduction. The fiscal impact of bank debt restructuring is much as described above for official debt restructuring, except that there are usually additional transactions costs involved, which depend upon the nature of the debt reduction operation.

Modalities of bank debt reduction

Debt buybacks

The secondary market price of developing country private debt is often substantially less than its face value—Peruvian debt, for example, has traded at a 95 percent discount. It has been argued that these discounts can be exploited to reduce debt cheaply. With a 95 percent discount it would cost only 5 cents to reduce debt by \$1. However, if debt is reduced by this method, capacity to service remaining debt will likely increase and the price of that debt—and its market value—will rise. The debtor country could find itself worse off as a consequence, since it has incurred the costs of debt reduction but its debt remains largely unaffected. The external creditor is correspondingly better off. In essence, the debtor is repurchasing marginal debt at its average price rather than its lower marginal price. The cash flow repercussions for the debtor can, however, be alleviated if the buyback is paid for externally, which is the essence of the Brady Plan. But if the debtor incurs

new debt in the process, there remains a sizable transfer from the debtor to its creditors which must be paid for out of the budget.

Debt exchanges

It is sometimes argued that exchanging new debt for old debt offers a costless way of reducing debt. With a 95 percent discount a government could buy back \$100 million of old debt with \$5 million of new debt if the new debt sells at par. But unless the perceived riskiness of debt is affected, the discount on the new debt will be the same as on the old, and debt cannot be reduced by this method. This can happen only if it can be established that new debt is senior to old debt. Whether it is then in the creditors' interests to allow debt exchanges depends upon how the creditor translates seniority into an expected flow of debt service payments.

Debt equity swaps

Debt equity swaps are alleged to have the additional advantage that they reverse capital flight and attract capital inflows, as well as reducing external debt. But swapping debt for equity involves no more than an exchange of liabilities. Whether this is beneficial depends upon the efficiency consequences of having **additional** equity owned by foreigners. If this is not the final effect—because foreigners sell equity domestically (and then use it to purchase foreign exchange, for example) or foreign equity owners cannot exercise effective control over their assets—then there is no benefit and possibly some harm resulting from the exercise. Some more innovative debt swap operations are illustrated below by reference to country experiences.

Role of the Central Bank

It has been assumed that all external debt is a liability of the government, and debt service transactions take place directly between the debtor government and its foreign creditors. However, in many cases, foreign financing is channeled through the central bank. It is the Fund's recommended practice that in such circumstances the benefits of debt relief be treated as general balance of payments support, and obligations of the government (and private debtors) to the central bank arising from the onlending of external borrowing continue to be serviced in domestic currency. This preference arises from a desire to ensure that the benefits of debt relief are not lost through a loosening of fiscal policy. If the central bank lends on the same terms it receives, there is macroeconomically no difference between debt relief granted to the government and the central bank. Debt relief to the central bank will have no effect on government finances; it would, however, affect public sector finances if central bank and government financial operations are consolidated. Without consolidation, care is needed in interpreting fiscal data, since the central bank may be bearing costs otherwise borne by the government, such as foreign exchange losses (see the note on *Fiscal Activities of Public Institutions* for further discussion.)

Country Illustrations

Innovations in debt swap operations

In recent years, a number of new modalities have been developed for the purpose of debt reduction. **Debt-for-nature** swaps have tended to take the form of an acquisition of developing country debt, at a discount, by

conservation organizations; the debt is then converted into local currency instruments to fund conservation programs. A program was launched in **Bolivia** in July 1987, which exchanged US\$0.7 million of claims—obtained in the secondary market at an 85 percent discount—for local currency to fund the management of ecological resources and to demarcate an area of tropical forest around the Beni Biosphere Reserve as a protected area. In **Costa Rica**, the Central Bank authorized the conversion of up to US\$5.4 million of debt. Conservation organizations can redeem such debt, obtained at a discount, for local currency bonds. Interest earned on these bonds may be used to finance conservation programs approved by the Ministry of Natural Resources, Energy, and Mines. The use of bond financing of conservation programs as a means of extinguishing external indebtedness reflected, in part, the authorities' concern with limiting the domestic liquidity impact of conversions. A similar program has been in place in **Ecuador** since October 1987. Under this program, up to US\$10 million of debt claims purchased on the secondary market at a discount may be converted into local bonds to be held by the Fundacion Natura. The bond principal will provide an endowment, and the Fundacion Natura will use the interest proceeds from the bonds to finance a variety of conservation programs. In the case of the **Philippines**, the authorities agreed to redeem up to US\$2 million of debt obtained by the **World Wildlife Foundation (WWF)** for local funds to implement a conservation strategy focusing primarily on management of protected natural areas, conservation training, and support of conservation groups.

Other recent innovations include **debt-for-charity** swaps. These arrangements usually involve the outright donation of commercial bank claims by the commercial bank itself (usually reflecting the existence of a tax break for charitable donations), which in turn are exchanged, through an intermediary, for local currency used to support charitable programs. In late 1988, the Midland Bank in the United Kingdom donated US\$0.8 million to UNICEF; in 1989 Deutsche Bank donated another US\$2.9 million worth of claims. Proceeds from the conversion of the claims into local currency at a discount are currently being used to finance health care, water supply, and tree-planting projects in central **Sudan**. Similar operations have also been undertaken in **Bolivia** and **Zambia**.

Bibliography

Dornbush, Rudiger, John H. Makin, and David Zlowe (eds.), *Alternative Solutions to Developing-Country Debt Problems* (Washington: American Enterprise Institute for Public Policy Research, 1989).