The case by case approach to debt problems

The Fund's recent role in debt management

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The role of the Fund in assisting its member countries with their debt problems has changed since mid-1982, in response to a shift in the characteristics of the problems. In the preceding decade, countries with debt difficulties fell into one of two broad categories: (1) those more largely dependent upon officially financed or insured credits, and (2) others that borrowed mainly from private sources. For countries in both categories, debt problems were perceived as individual occurrences, without wider implications.

For the first category, a well-established set of procedures to redress the problems existed through the Paris Club framework for restructuring official debt. These were not formally codified rules, because creditor governments never did treat debt relief operations as anything but exceptional, undertaken at the express request of an individual debtor government, in the face of accumulating payments arrears and an evident inability to maintain debt-service payments. Before agreeing to modify the terms under a Paris Club renegotiation of debt, by stretching out maturities of principal and interest, creditor governments expected the debtor country to have negotiated a stabilization program supported by the Fund through a stand-by arrangement in the upper credit tranches (this has occurred without exception since 1977). Fund staff at Paris Club meetings were relied upon to furnish an objective assessment of recent economic performance, the main elements of a current adjustment program with the Fund, and the debtor's balance of payments prospects and external debt outlook.

The second category of cases consisted mainly of middle-income countries that ran into difficulties because of weak domestic policy or unanticipated exogenous developments, or a combination of both. Here solutions appeared to be achieved in two stages. First, private creditors, mostly commercial banks, were approached by the debtor government, especially when arrears on bank debt-service payments appeared earlier than on official obligations. However, the banks quickly came to realize that in negotiating with a sovereign borrower in this situation, it was not easy to work out conditions that would give them sufficient assurance that policy changes adequate to prevent a recurrence would be implemented. It was therefore natural that in most of the bank debt renegotiations that were conducted between 1975 and 1978, the banks, as a second step, urged the debtor countries to undertake stabilization programs supported by the Fund. As a result, for five of the six countries negotiating with the banks during that period, a stand-by or extended arrangement was in effect when the banks signed the final agreement.

The banks also found that in the highly competitive environment in which they operated, it was difficult to reach common ground on the financial terms and conditions of debt relief. Often with 200 or 300 banks from a number of countries involved, the need for fair treatment required "lead" banks to make massive and often time-consuming efforts to obtain cooperation from all the creditor banks; this was particularly important given the "cross default" clauses in most agreements, which would have created a chain reaction if some banks declared a debtor country in default. Moreover, the anxiety of banks to ensure that their claims would be treated no less favorably than those of others often led to an insistence that the debtor government approach its official creditors through the Paris Club, if it had not already done so. Thus, four of the six countries that renegotiated their bank debt over 1975–78 concluded official debt restructurings, and three of these came into effect before agreement was reached with the banks. When an official restructuring took place, the Fund's role reverted to that described for the first category of countries. However, the Fund staff also participated in some of the negotiations with the banks, including (with the knowledge of the debtor) meetings in which the debtor was not present. On occasion, the Fund assumed a more active role, at the request of the debtor authorities, in facilitating discussions with the banks. The Fund also provided technical assistance to some of the countries in preparing their discussions with the banks and helped with the compilation of statistics.

The Polish debt crisis of 1981 moved the problem into a new phase, in which "contagion effects" became a factor. The commercial banks suddenly developed an intensified perception of risk in lending to the East European countries as a group; this affected Romania and Yugoslavia, both Fund members, and Hungary, which became a member in 1982. The countries concerned were able to provide assurance to the banks, by entering into stand-by arrangements with the Fund, that appropriate policies were being adopted to reduce the risk of default. Once an arrangement with the Fund was in place, the banks were found willing to proceed with new credits as well as with refinancing maturing debt.

Until this stage, the Fund's attitude was generally to try to help the debtor country devise a program that gave assurance that it could resolve its balance of payments

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difficulties in a medium-term framework. In some instances, the Fund staff did seek "indications of the likely magnitudes involved in a bank debt restructuring and also indicated to the banks the level of bank financing that it considered crucial to the success of a reasonable adjustment effort" (see IMF Occasional Paper No. 3, *External Indebtedness of Developing Countries*).

Change in conditions

As the debt problems of Mexico, and then those of Argentina and Brazil, became apparent, a perception developed that their reliance on commercial flows was so great that it entailed a distinct risk of program failure, unless the Fund could ensure that the financial assumptions on which the program was based were secured by explicit prior commitments from the banks to cover their share of the financing requirements of the program supported by the Fund.

It was the need to obtain agreement on the provision of additional bank and official finance *before* the approval of a Fund-supported arrangement that altered the role of the Fund in relation to commercial banks in the management of the debt problem. For, in addition to its certification function, the Fund developed a coordinating role as a mobilizer of funds from other lenders. This departure arose from several considerations. As noted earlier, the Mexican reliance upon bank financing was so large, and the assistance that could be furnished by the Fund so small relative to the need, that it was essential for the commercial banks not only to maintain their exposure but also to be prepared to enlarge it through the provision of additional financing. It was recognized that without such support, the compression of the economy, made unavoidable by lack of adequate external finance, might well make the situation unmanageable and render the Fund's own financial contribution ineffective.

Further, it was important to keep all elements of the banking industry involved. The major commercial banks understood that their stakes were so high that they could not afford to pull out without greatly reducing the quality of their own assets. The problem was to ensure that hundreds of other banks, especially the regional and smaller banks in the United States, would stay in the picture. If they did not, the major banks would be placed in the impossible position of having to explain (to shareholders, if not to depositors) why they were getting deeper into a country from which other banks were hastily extricating themselves. This was the issue of maintaining market discipline, i.e., preventing an uneven reduction in exposure by a large number of different lenders through, for example, withdrawal of short-term trade finance or the rundown of interbank deposits. There were also complex issues of intercreditor equity among banks with very different exposures, operating in different regulatory environments, and with varying accounting conventions, disclosure requirements, and funding constraints. These differences required formulas to be devised, in cooperation with the various national supervisory authorities, for allocating the net increase in exposure among the many banks from a number of national banking systems.

Finally, speed in decision making was imperative, requiring tight but credible deadlines. A series of highly complicated and closely articulated relationships had to be managed among a very large number of players—involving, in the case of Mexico, over 500 banks, their supervisory authorities in more than a dozen countries, governments of creditor countries, the Bank for International Settlements, the World Bank, and, of course, Mexico. The Fund found itself at the center of this web of relationships, as it was later when similar arrangements were established for Brazil, the Philippines, and Argentina, among others.

In each case, an agreement with the Fund became the basis for mobilizing much larger sums by way of restructuring and new financing, than those it provided directly. This was natural since the adjustment effort mounted by the debtor country was the prime factor in assuring its creditors that corrective action was being taken, that it had the support of the international community through the Fund, and that its progress would be carefully monitored. The task had to be tackled country by country, and not only because of the obvious fact that the Fund could operate best through a stand-by or extended arrangement with each of its debtor member states. The fundamental judgment on the balance between adjustment and financing had to be made in each case, based on the initial conditions prevailing at the time of the debtor country's approach to the Fund; the level of its foreign exchange reserves and its accumulation of payments arrears; the types of claims involved; the proportions of debt owed to different creditors; the number, size, and national affiliation of the banks involved; and so forth.

Special problems arose with the interbank market in the case of the two largest debtors. Branches or affiliates of debtor country banks located in the main financial centers, especially New York and London, had borrowed substantial sums at very short maturities and re-lent them at longer maturities to their principals or to other borrowers in the (debtor) home country. These interbank deposits presented the most difficult problem of preventing the withdrawal of funds, let alone assuring a net increase in exposure. These differences in country situations often emerged in the course of managing the crisis and had to be resolved quickly and in a manner that protected the cohesion of the various interests engaged in the rescue effort.

General solutions?

Various generalized solutions were proposed during this period, born of a conviction that the burden of debt servicing confronting a number of countries simply could not be managed in a world marked by deep recession, historically high interest rates, and a sharp curtailment of commercial lending. These schemes did not make much headway, however, for several reasons.

First, they proceeded from a perception about the global aggregates that was never true for the components. The existence or absolute magnitude of countries' borrowings was not in itself a reason for payments difficulties nor was the type of economy concerned. Recent data on debt and debt ratios for all developing countries, and equivalent figures for the different categories among developing countries, show that within each group were countries unaffected by a debt problem.

Among oil exporters that were OPEC members, two (Algeria and Indonesia) owed about 45 percent of the debt of their category, yet had no particular problem of market access. Of the net oil exporters among developing countries that were not OPEC members, Egypt and Malaysia accounted for about one fourth of the group's debt but, again, had no access difficulty. Among the net oil importers, about one half the debt was owed by the major exporters of manufactures, and four countries in this group (namely, Israel, Korea, Portugal, and South Africa), accounting for roughly one third of the total debt of the group, continued to borrow at very competitive terms throughout the period. In the low-income category, the two largest countries—China and India, which accounted for almost 40 percent of the debt—had no need for relief. Finally, in the residual group, at least three major borrowers had confronted their problems earlier and were already on the mend (Hungary, Romania, and Turkey), and two others (Colombia and Thailand) continued to have access on competitive terms. Any attempt to apply a general solution would have meant that countries whose creditworthiness was unimpaired would face interruptions of market access; a generalized ap-

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proach could well create a new problem rather than provide a solution for an existing one.

A second factor militating against generalized solutions was that many of them implied large losses for commercial banks, inflicted in a manner that would prevent a gradual process of building up reserves and allowing write-offs over a period of time. Schemes to transfer bank claims on developing countries to international or national public entities would have involved either substantial public sector commitments or immediate and open losses for the banks. This would have risked breaking the nexus between commercial banks and their customers in the developing countries and destroying relationships built up over many years, if not decades. The debtor countries not only relied upon the international banks for normal trade financing but also expected to reactivate their access to markets for project and sectoral finance. Indeed, the promise of being able to attract new flows as existing credits were repaid was at the heart of the unflagging commitment that most debtors displayed in their approach to the debt problem. Generalized solutions tended to categorize problems mechanically according to quantitative criteria, such as levels of net capital flows or net resource transfers, whereas solutions to individual cases needed to be more sensitive to the organic interrelationships that underlay the financial magnitudes.

A third flaw of most generalized solutions lay in their assumption that support would be forthcoming from the governments of the major creditor countries. The political environment was not conducive to such use of public funds. In many countries, there was a drive to cut back on budget deficits, and any solutions that impeded the attainment of this objective were unlikely to find favor with financial officials and legislators. An even greater problem lay in a widespread public perception that the commercial banks had lent in an imprudent way, and that public funds should not be employed to rescue large private institutions from the consequences of their own errors of judgment. Similarly, while developing countries experienced serious adverse external conditions, their payments difficulties resulted in part from inadequate domestic economic policies. There was also a feeling that many of the countries that were in difficulty were among the most developed among the developing countries and that assisting them with public funds would skew the distribution of aid flows away from countries that were poorer, had little or no recourse to market borrowing from abroad, and stood perhaps in even greater need of external assistance for dealing with their problems.

A final difficulty with some generalized solutions concerned the time that their implementation would require. Many schemes would have required changes in national legislation or in the charters of international institutions whose amendment necessitated high voting majorities and large participation ratios to become effective. Yet in dealing with debt problems as they arose, time was of the essence and the constraints set by the need for urgent action meant that solutions had to be found within the bounds of existing legal and institutional arrangements.

The individual solution

With the passage of time, some evidence of the viability of the cooperative approach to debt management has begun to accumulate. In the 18 months ending in mid-1984, the external adjustment that has taken place in the non-oil developing countries has been characterized as "dramatic," and while it is recognized that sharp cuts in imports were involved, growth has resumed in a number of them.

On the financing side, the Fund (as of the end of 1984) had disbursed some $22 billion since the middle of 1982 to support adjustment in nearly 70 member countries, with another $8 billion of commitments outstanding under 31 current programs. In addition, new financing has been mobilized along with debt rescheduling. In 1983, some 30 developing countries (including 11 of the 25 largest borrowers) completed or were in the process of completing debt rescheduling agreements with official and commercial creditors. These agreements reduced the debt-service payments of non-oil developing countries by $23–24 billion in 1983, and by about the same amount in 1984. As a result, their debt-service ratios declined from a peak of 25 percent in 1982 to 22.3 percent in 1983. This compares with 27.6 percent, which would have applied in the absence of rescheduling. The maturity structure of debt has also been improving, with the ratio of short-term debt declining to 25 percent in 1983 from about 30 percent of exports of goods and services in 1982 and to an even lower ratio in 1984. In 1983, $13 billion of bank lending was also arranged in conjunction with Fund-supported adjustment programs.

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Despite these encouraging developments in the debt situation and the recovery in the industrial world, considerable pessimism has persisted over the manageability of the debt problem. One explanation for this paradox is that lags exist between actions taken by debtor countries and the recognition of their positive results. A second reason is the concern over the prospect of a "hump" in countries' debt amortization in the next few years, resulting from the reschedulings of 1982–83. A third factor is the rise of about 2 percentage points in interest rates in the first half of 1984. This disturbing development has generated another spate of generalized solutions for "capping" interest rates and for reducing the burden of higher interest rates in other ways. There is no question that higher rates pose a risk to the viability of the solutions that have been found. However, before giving credence to the solutions proposed, two sets of factors must be kept in view, the first general and the second more specific.

At the more general level, there are several elements to be considered. First, the trough in imports of non-oil developing countries was reached in the fourth quarter of 1982, with imports from industrial countries falling by about 20 percent in U.S. dollar terms from early 1981 to late 1982. Thereafter, the financing packages put together in association with Fund programs were sufficient to stabilize the level of imports. Second, the exports of non-oil developing countries to the industrial countries began to recover from the fourth quarter of 1982 with the recovery in output in the industrial countries. As a result, the exports of these countries rose from some $190 billion (at an annual rate) in that quarter to some $240 billion in the first quarter of 1984. This expansion of exports helped bring about an improvement of around $70 billion (at an annual rate) in the trade balances of this group of countries. This is expected to result in a resumption in the growth of imports, projected to rise in volume terms by about 6 percent in both 1984 and 1985, despite any increase in the burden of interest charges on non-oil developing countries (net of interest earned).

At a more specific level, the effects of interest rate movements on dollar-denominated debt are sufficiently country-specific to require careful and individual

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analysis. There is, first of all, a wide variation in the reliance of countries on floating rate credit. Most of the poorer countries in Africa and Asia have not been significant users of such credit, some because they chose not to. Second, the proportion of variable rate debt in total debt has varied. Third, the interest rate factor has been offset to a varying extent by improvements in export receipts, following the strong upswing in North America that has accompanied the hardening of interest rates. The offsetting benefits have been greatest for countries such as Mexico, because of their proximity to the U.S. market, but the upswing has also helped countries farther away which have a highly diversified productive base, such as Korea, and possess the flexibility to adapt rapidly to the requirements of a booming North American market. There is a recognition that imaginative solutions may still become necessary were interest rates to rise or commodity prices to weaken further. However, there is an inclination to confine the search for such solutions to the banks negotiating with each debtor country, with support from the supervisory authorities of the banks and also from the Fund and the World Bank.

An application of this approach was the acceptance by the banks of the proposal advanced by the Fund's Managing Director in 1984 to consider a longer time frame for bank rescheduling arrangements for countries that have made or are making substantial progress toward adjustment, as a way of recognizing good performance, avoiding the necessity for repeated annual reschedulings, and restoring the conditions needed for the return to market access, as well as for rebuilding confidence in the system. The Managing Director proposed such an approach for Mexico and expressed the hope that other countries whose performance is improving could also qualify, if their progress is sustained. The periods of consolidation, as well as of grace, would have to be longer for these advantages to be obtained and the terms and conditions would have to improve. The successful completion of multiyear restructuring agreements with Mexico and Venezuela illustrate the banks' readiness to adopt a forward-looking approach to debt restructuring, and represent an important step in preparing the way for countries' return to more normal market access. In the case of both countries there is a provision for the Fund to continue a monitoring role through its regular surveillance procedures, but on an enhanced basis.

The need for a longer-term perspective on debt management is important, and not only on the financial side. In spite of the progress already made, the debt problems are not going to vanish overnight. Their effective resolution will depend, first and foremost, upon continued action on the part of the indebted countries themselves aimed at strengthening their economies over a period of years. These efforts both need and deserve the support of the international community. The industrial countries need to make further progress toward a better and more stable world economic environment and the conditions in which international trade can flourish. Continued cooperation among financiers will also be required to ensure that determined adjustment efforts receive the necessary financial backing. The Fund, for its part, will have a role to play in all these areas in the years ahead.

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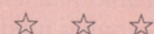

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