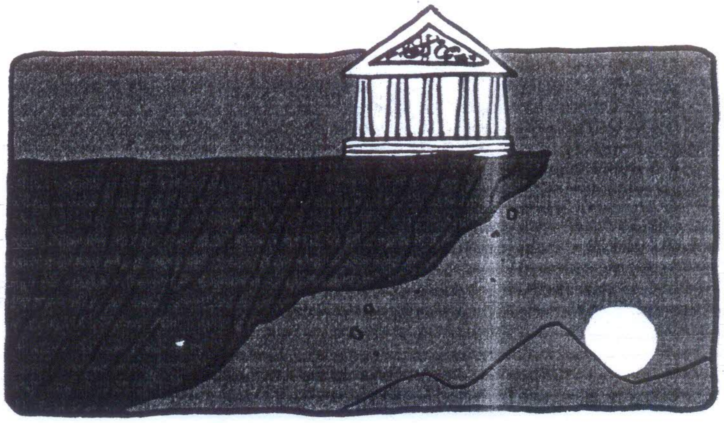

Recent Experience with the Debt Strategy

The volume and nature of resource flows to developing countries over 1936–88 viewed against the evolution of a new approach to debt problems

Ishrat Husain

The debt crisis that emerged in the early 1980s continues to be a dominant economic policy issue for a group of developing countries. Some advances have been made since then toward finding a satisfactory resolution of this problem. The international financial system is more stable today than it was in 1982, and a number of developing countries have embarked on policy reforms to restructure their economies. But the debt overhang has made it difficult for the highly indebted middle-income countries to resume stable economic growth. It is in this context that the recent initiatives to reduce the debt of these countries mark a new phase in the evolving debt strategy (see box on initiatives, page 16).

The earlier phase of this strategy, begun in 1985 and known as the Baker plan, had three main ingredients: (1) the pursuit of adjustment policies in the debtor countries; (2) concerted new lending by commercial banks; and (3) public loans, particularly by the international institutions. The stumbling block in its implementation has been a serious shortfall in commercial bank lending to the highly indebted countries (HICs) and the uneven progress made by these countries in their adjustment efforts. For a growing number, the past few years have brought declining net resource inflows, persistent payments difficulties, and low rates of domestic investment. In 1986, net lending to these countries was negative, and the 1988 net figure, while positive, was only a quarter of that for 1984, even though interest payments to banks were almost as high as those made in 1984.

Commercial banks have responded to the debtors' calls for debt reduction by asking for increased credit or guarantees by official creditors to improve the quality of new loan assets that will result from debt reduction schemes. Some commentators are calling for comprehensive international debt facilities to help write off much of the commercial debt with guaranteed multilateral financing. Both types of proposals involve substantial costs for the governments of industrial countries, and although the use of public funds could well play an important catalytic role in certain cases, the volume of multilateral financing is still limited relative to some $260 billion currently owed by the HICs to commercial banks.

Against this background, and in light of the recent new moves to reduce the debt burden of the HICs, this article reviews experience with the debt strategy following the Baker plan. Various debt reduction techniques are also examined.

Recent resource flows

Developing countries' access to external finance continued to falter in 1988; preliminary estimates show an 8 percent drop in their net flows of all types of long-term external resources over 1987 (see Table 1). For the HICs, the decline was even larger, at more than 18 percent.

Total net lending by all creditors (including multilateral agencies) to developing countries was highly concentrated in a few large creditworthy countries and in the HICs. In 1988, 80 percent of total net lending went to China, India, and Indonesia. The most important source of debt finance to developing countries continued to be multilateral lending, which accounted for roughly half of net lending.

Net flows to developing countries from financial markets (i.e., commercial bank loans and bonds) are estimated to have been $2.3 billion in 1987 and $2.1 billion in 1988. The increase in outstanding interest arrears was estimated by banking industry sources at nearly $5 billion in 1987. In 1988, some $1.5

billion of outstanding arrears was liquidated.

The very low level of new borrowing by developing countries from international capital markets can be traced to two factors. First, most of these countries were (and continue to be) excluded from new voluntary financing because of creditworthiness considerations. Second, some countries have deliberately limited borrowing or have made prepayments on earlier loans.

For highly indebted countries, the importance of nondebt-creating flows (direct investment and debt-equity swaps) rose significantly. Between 1986 and 1988, while net lending to these countries from all sources fell to $4.4 billion, the total value of nondebt-creating flows more than doubled, to almost $10 billion. The bulk of the increase, however, came from a rise in foreign direct investment, accomplished in part through debt-equity swaps (see "New Financing Approaches in the Debt Strategy," by Klaus Regling, *Finance and Development*, March 1988).

Secondary markets for developing country debt expanded dramatically in 1988. The total face value of debt conversions—transactions that actually reduced external bank debt—is estimated by the World Bank at more than $21 billion, compared with some $8.2 billion in 1987. Debt-equity swaps, accounting for the largest portion of debt conversion activity, were almost 42 percent of the total. Informal conversions and exit bonds accounted for nearly equal parts of an additional 45 percent of the face value of retired debt. The rest, roughly 13 percent, comprised official debt buybacks and conversions to domestic debt (see box on debt reduction techniques, page 16).

As the number of participants has grown, secondary markets for developing country debt have become more liquid and more active. But transactions have still been highly concentrated. In 1988, nearly 93 percent of the total value of secondary market transactions involved just four countries—Argentina, Brazil, Chile, and Mexico—and over 72 percent was accounted for by transactions in the debts of Brazil and Mexico alone.

Growth in informal debt conversions, conducted outside the purview of official programs, was another important feature of the market in 1988. Such transactions made up a large share of the debt retired in Brazil, Mexico, and the Philippines.

Cash transactions, including asset swapping among commercial banks, to realign their portfolio of developing country debt, increased significantly in volume. Many banks raised their provisioning levels sufficiently to cover losses stemming from such sales. An increasing number used the secondary market to shed their developing country claims, clean their balance sheets, and avoid participation in rescheduling and new loan ("new money") arrangements.

Table 1
Net resource flows to developing countries, 1986–88[1]

	1986	1987	1988
		All countries	
Aggregate net resource flows[2]	51.5	41.4	44.2
Of which			
Direct investment	6.6	10.3	11.0
Net lending[3]	24.3	10.4	11.6
Total external resource balance[4]	55.8	51.6	51.0

Sources: IMF, and Debt & International Finance Division, World Bank.
[1]Countries reporting to the World Bank's Debtor Reporting System.
[2]Identified net long-term capital flows: foreign direct investment, net official transfers, net lending from private and official sources and the change in arrears calculated as difference between projected interest due and paid. (Net lending is on a cash basis and is not affected by principal arrears.)
[3]Including IMF.
[4]Current account plus change in reserve assets minus official transfers.

Table 2
Commercial bank lending to highly indebted countries
(In billions of US dollars)

	1986	1987	1988	1986-88
Concerted new money[1]				
Commitments	8.3	2.4	5.6	16.4
Disbursements	3.2	5.7	6.0	15.0
Change in exchange rate adjusted claims[2]	3.5	0.6	2.0	6.1
Net disbursements[3]	−0.4	2.3	2.1	4.0

Sources: See footnotes below.
[1]IMF.
[2]BIS. These claims take into account identified debt conversions, arrears, and other balance sheet adjustments.
[3]Debt and International Finance Division, World Bank.

Commercial bank lending

The debt strategy emerging from the Baker plan stressed the importance of increased net lending by commercial banks to the HICs. But the large flows of voluntary finance from commercial banks have not resumed. The amount of net new financing that private creditors provided to highly indebted countries over 1986–88 has been a subject of controversy.

Commercial banks have pointed to the amount of "new money" they provided to HICs, claiming they have contributed between a quarter and a third of the financing provided to these countries during 1986–88. Indeed, according to IMF estimates, total commitments during this period under concerted lending arrangements (involving many lenders acting in unison) amounted to $16.3 billion, of which almost $15 billion was actually disbursed. The commercial banks use these gross disbursement figures to support the contention that they came close to the Bake plan targets. A more meaningful indicato however, is net disbursements or net flow that have contributed to financing curre account deficits.

Data on the stocks of commercial ba claims on HICs support a different conclusio These claims include short-term credits a represent the net effect of new lendin repayments, arrears, write-offs, debt conve sions, and other balance sheet adjustment including exchange rate effects. When co rected for identified debt conversions a arrears, these changes show that betwe January 1986 and September 1988, the n financing provided to highly indebted cou tries by commercial banks was only sligh more than $6 billion.

Meanwhile, debtor country data show th during 1986–88, commercial bank credito provided only $4 billion in net new financi on long-term public and publicly guarante debt to the highly indebted countries (s Table 2). If the private nonguaranteed de is taken into account, there were n

Table 3
Official lending to highly indebted countries, 1986–88[1]
(In billions of US dollars)

	1986	1987	1988
Disbursements	15.0	14.6	15.8
Principal repayments	8.9	10.7	12.3
Net lending	6.1	3.9	3.5
Interest payments	7.0	7.5	9.2
Net lending as percent of interest payments	87	52	38

Source: World Bank.
[1] Includes use of IMF credit.

repayments to commercial banks amounting to $2.4 billion. The general trends outlined above conceal great differences across countries, but in no case did commercial banks provide more net financing than they received in interest payments. The contribution of commercial banks in meeting the external financing requirements of HICs during 1986–88 did not, therefore, live up to the expectations of the proponents of the Baker plan.

One reason for commercial banks' unwillingness to lend has been poor country performance. (This is also reflected in the deep discounts on HIC loans in the secondary market.) But there are other factors, such as banks' concern with building their capital bases; the competitive pressures they face in increasingly deregulated and liberal domestic financial markets; and the effect on their ability to raise new shareholder equity in the markets of their exposure (outstanding loans) in developing countries.

US banks have been the most active in reducing their developing country exposure. Between mid-1987 and the end of the third quarter of 1988, these banks reduced their claims on all developing countries by more than $20 billion. More than half of this represented a reduction in claims on highly indebted countries. These banks remain the largest commercial creditors of the highly indebted countries and their assets are extremely concentrated in those countries. In contrast, Japanese banks have shown a marginal increase in their exposure in developing countries. Even though the total developing country claims of French, German, and British banks are not much smaller than the US banks, the vulnerability of those banking systems appears to be considerably less than some of the large money center US banks or a few Japanese banks. The smaller share of each bank's claims on highly indebted countries in the total loan portfolio, the generally higher levels of provisioning (reserves to guard against bad loans), and tax deductibility of provisions have minimized their risks.

The recent rapid increase in international interest rates also acted as a deterrent to new borrowing by some developing countries that found their debt servicing capacity stretched to intolerable limits. The six-month Eurodollar LIBOR (London Interbank offered rate) reached almost 11 percent in mid-March 1989, compared to around 8 percent in 1988. A jump of this size in interest rates translates into a roughly $18 billion increase in developing countries' annual interest obligations.

The virtual halt in commercial bank lending is particularly threatening to the debtors other than the big four. Their debts do not represent a significant claim on banks' balance sheets, but additional borrowing may be relatively more important for them in maintaining the momentum of growth or helping sustain adjustment.

Official creditors

Official creditors continue to be the most important source of net lending to developing countries. In 1988, total net official lending rose from $17.5 billion in the previous year to $21.8 billion despite a rise in prepayments by some countries and large repayments on earlier loans. In contrast to commercial banks, official creditors' share in net disbursements to highly indebted countries were several times their share in total claims on this group of countries. Official creditors' net lending of $3.5 billion amounted to 38 percent of the interest payments they received from these countries on earlier loans (see Table 3) and was responsible for positive total net flows to HICs of $2.9 billion.

The heavy involvement of official creditors in several countries led to a rise in the share of official creditors in total debt outstanding. During 1986–88, six countries (Argentina, Bolivia, Chile, Ecuador, Mexico, and Nigeria) received more in net disbursements than they needed to refinance their interest payments to official creditors. IBRD net lending was well above interest payments due to the IBRD in eight countries. Two countries—Venezuela and Yugoslavia—made net repayments to the Bank.

Among the bilateral official creditors, the Japanese Government proposed the recycling of up to $30 billion of Japan's external surplus over the three years 1987–89 to developing countries. This was an encouraging development. But other official bilateral creditors (e.g., export credit agencies) also need to do more if financing requirements for the resumption of even minimal per capita growth in the highly indebted countries are to be met.

Voluntary debt reduction

The constraints to mobilizing adequate flows of new money, especially from the commercial banks, are likely to remain strong. If net flows from commercial banks are unlikely to rise significantly, how else could the external financing requirements of this group of countries be met? The debtor countries themselves have to continue to take primary responsibility for their fate through further adjustment. Favorable economic policies and good economic management will attract new project and trade financing, multilateral lending, export credits, and direct foreign investment. But this will still not suffice in all cases, and for several of these countries, reduction in the stock of debt or debt servicing followed by reflows of flight capital would be important in filling the financing gaps.

One reason for the persistence of slow growth is that the debt overhang acts as a severe tax on increases in current and future income (see article by Eduardo Borensztein in this issue). Debt reduction, on the other hand, should encourage investment and increase the incentive to implement better policies which, in turn, would boost exports and debt-servicing capacity.

Though the debt strategy has turned more and more openly to market-based voluntary debt reduction during 1988, these techniques have not yet been fully translated into debt relief for the debtor countries. Only in cases where the debtor country exchanges its external debt for equity or converts external debt into local currency debt has the country been able to capture the discount. But these transactions account for less than one half of the total volume of secondary market transactions. The other problem with voluntary debt reduction is the existence of "free riders," who may hold out in the expectation that the value of their claims would rise if other creditors participate in the reduction of debt, thereby getting a "free ride."

The third issue inhibiting the fuller use of

The World Bank's role in debt reduction

The Executive Directors of the World Bank approved the operational guidelines and procedures for use of IBRD resources to support debt and debt-servicing reduction on May 31, 1989. It was decided that:

- All member countries that had a clear need for debt or debt-service reduction in order to achieve reasonable medium-term economic growth objectives and that had adopted a sound medium-term economic policy framework would be eligible for Bank support. However, Bank support for debt or debt-service reduction would be decided on a case-by-case basis, taking into account the strength of the medium-term economic program for adjustment, the severity of the debt burden, the scope for voluntary market-based operations, the medium-term financing plan, and the potential benefits from Bank support, particularly for investment and growth. All transactions to be supported by the Bank should result in a substantial discount leading to a significant reduction in the present value of future debt-service obligations. Bank resources are to be provided for this purpose over a period of approximately three years.
- Around 25 percent of a country's adjustment lending program over a three-year period, or around 10 percent of its overall lending program where the Bank was concentrating its support on investment lending and where the country had an acceptable medium-term economic policy framework, would be set aside to support operations involving significant reduction of the principal. Where additional resources are justified, an increment of up to 15 percent of the overall three-year lending program could also be made available for interest support. The incremental lending should not be more than $6 billion over the next three years, FY1990–92.
- The Bank would provide support for debt and debt-service reduction primarily through direct lending arrangements on normal IBRD terms, which the borrower would use for approved debt reduction and credit enhancement programs. Guarantees of interest payments should not be used unless there were exceptional circumstances providing strong justification. In cases where the Bank does not have a substantial adjustment lending program, support may be provided through special operations devoted to debt and debt-service reduction with appropriate policy conditionality.

On June 29, 1989, the Executive Directors of the IBRD agreed to recommend to the Board of Governors a transfer of $100 million of IBRD's net income during FY1989 to the International Development Association (the Bank's affiliate that lends to the poorest countries) to be held in a special facility. These resources would be made available to facilitate commercial debt reduction in countries that borrow from IDA alone. To avail themselves of these resources, eligible countries must have:

- an appropriate medium-term adjustment program, and
- a debt management strategy that includes (1) a program for addressing the commercial debt problem in a manner that offers a realistic prospect for reducing debt-service payments to a sustainable level, and (2) provides for substantial debt relief from official bilateral creditors through an agreement with the Paris Club.

voluntary debt reduction techniques is the determination of the appropriate market value of the existing debt. The difficulty in negotiating the price of existing claims suggests that many creditors do not regard the prevailing secondary market discounts as a true reflection of the underlying value of their claims. A number of large creditor banks have converted their debt at much higher prices than the secondary market price and are thus reluctant to recognize the losses inherent in the deep discount of the market. Further, the coverage of loan loss provisions varies across banks and across countries—and thus the lower limit of these provisions and the tax deductibility considerations determine the extent to which the banks can reasonably afford to reduce the value of their claims. While the Swiss and German banks have comfortable levels of provisioning, equal to 70–75 percent of their exposure to problem debtor countries, the Japanese banks have only 15 percent, and the major US banks, about 25 to 30 percent. Meanwhile, the average discounts in the secondary market are 60 to 65 percent, implying a loss greater than that covered by provisioning against bad loans.

In 1988, private corporate restructuring in debtor countries and opportunities for informal conversions to fund local subsidiaries aroused interest in secondary market transactions and stimulated voluntary debt reductions. For example, the amount of Brazilian debt traded in 1988 was nearly five times the amount transacted in the previous year. The introduction of new debt conversion programs was largely responsible for the increase in activity. Similarly, the privatization program in Mexico, the debt conversion program in Chile, and the debt-equity program in Argentina contributed to a rise in secondary market transactions.

The total value of debt reduction, taking into account conversions of one type of external debt (usually loans) into other debt instruments or equity, or through buybacks, amounted to over $43 billion in 1988. The net reduction, however, is estimated to be only some $17 billion, or less than 5 percent of the stock of commercial bank debt to the highly indebted countries. Because of the large amount of debt-to-equity conversions, the impact on these countries' total external liability is less. A rough estimate, taking into account the increase in debt and equity investment liabilities, puts the net reduction of external liabilities in 1988 at $8.5 billion, or 40 percent of the retired debt.

Conclusion

The final verdict on the Baker plan is a mixed one. A number of HICs made progress in adjusting their external sector during 1986–88 and the threat to the international banking system abated. But external financing in support of adjustment programs remained scarce. Net resource flows to developing countries, particularly from commercial banks, continued to fall. Moreover, they were insufficient in meeting the investment needs of these countries and in helping them meet their debt service obligations.

Against this background, indebted countries had to cut back on investment. Their growth did not resume and living standards either stagnated or fell. The heavy debt burden continued to impede the mobilization of domestic resources, discourage repatriation of flight capital and direct foreign investment, and eroded the credibility of adjustment programs. This situation called for a strengthening of the ability of countries to sustain their adjustment efforts through a renewed debt strategy (see article by Michael P. Dooley and C. Maxwell Watson in this issue). ■

Ishrat Husain
from Pakistan, is Chief of the Debt and International Finance Division of the Bank. He holds a PhD from Boston University and was formerly Chief of the Resident Mission in Nigeria.