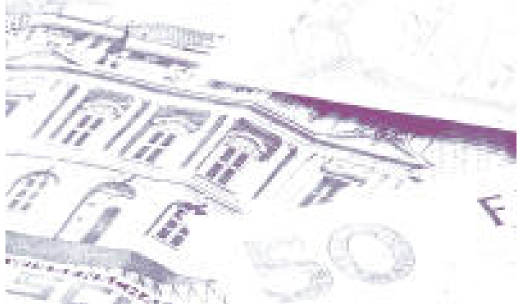

Debt Situation and the Role of the Fund

Reflecting its concern with the heavy debt burden of many developing countries and the difficulty experienced by some highly indebted poor countries in breaking out of the rescheduling cycle, the Board met frequently during 1995/96 to discuss the Fund's role in addressing the debt situation.

Official Flows to Developing Countries

In September 1995 Directors considered the issue of official financial flows to developing countries, the debt situation of these countries, and reschedulings by Paris Club and non–Paris Club creditors, with emphasis on the implications of the Paris Club's Naples terms, which had replaced previous concessional (Toronto or London) terms for rescheduling the debt of low-income countries. Under Naples terms, countries may receive a reduction in debt service on eligible non-ODA (official development assistance) debt of up to 67 percent in net present value terms, with the prospect of a reduction in the stock of debt after establishing a good track record over a three-year period under rescheduling agreements and Fund programs.[11] Directors welcomed the Naples terms as representing an important breakthrough in reducing to sustainable levels the external debt burden of eligible low-income countries.

Most Directors agreed that broad coverage under stock-of-debt operations tailored to individual country circumstances, with at least comparable treatment by other bilateral and commercial creditors, would make it possible for many, though not all, eligible countries with strong track records of adjustment to achieve external sustainability. Directors noted that a number of low-income countries would face a heavy debt burden even after a stock-of-debt operation and that the circumstances of these countries differed widely as regards both their relations to their largest creditors and the state of their adjustment efforts. While many Directors viewed current mechanisms as sufficiently powerful to handle the debt burdens of most heavily indebted poor countries, a number of Directors were of the view that current policies of bilateral aid donors and of the multilateral institutions needed to be reexamined to ensure that the heavily indebted low-income countries found an exit from rescheduling and set off on a secure path to debt sustainability.

Directors noted that, even after stock-of-debt operations, most heavily indebted poor countries would remain dependent on aid flows. Many Directors observed that, for countries adopting strong adjustment programs, appropriate instruments were already available to provide both flow reschedulings and new inflows from sources including the multilateral institutions. It was essential, in these cases, that the new flows be provided in amounts large enough and on terms concessional enough to allow these countries to achieve their growth potential. The continuation of the ESAF was considered critically important in this context.

Problems of Heavily Indebted Poor Countries

At a Board meeting in February 1996, Directors discussed country-specific staff analyses of the sustainability of debt as well as analytical aspects of the debt problems of heavily indebted poor countries. On the scope and nature of the debt problems of these countries, a number of Directors noted that empirical evidence about the effect of high levels of debt on economic performance was inconclusive. While emphasizing that sound economic management and persistence in implementing reforms were overriding factors in determining the capacity of countries to service their debts, it was generally acknowledged that persistently high levels of debt may intensify economic risk, undermine confidence, and crowd out private investment

[11] The background studies by staff were published as *Official Financing for Developing Countries* (December 1995) in the Fund's series of World Economic and Financial Surveys.

and productive public expenditure. There was also broad recognition, as embodied in several debt-reduction initiatives, including Paris Club procedures, that the opportunity for countries to exit from a continuous cycle of reschedulings could reap benefits for debtors and creditors alike.

Most Directors agreed that the methodology proposed by the staff for assessing debt sustainability was generally appropriate and that threshold ranges of 20–25 percent for the ratio of debt service to exports and 200–250 percent for the ratio of the present value of debt to exports were useful indicators of debt sustainability when viewed in conjunction with various measures of risk and vulnerability. Many Directors supported the staff's assessment that, for the majority of the heavily indebted poor countries, sound policies coupled with new concessional financing and debt relief under current mechanisms would be sufficient to achieve debt sustainability in the medium term. Nevertheless, it was recognized that for a number of heavily indebted poor countries the burden of debt was likely to remain above sustainable levels over the medium term, even with strong policies and full use of existing debt-relief mechanisms. Directors considered that additional assistance was needed for these countries to ensure that their adjustment and reform efforts would not be put at risk by continued high debt and debt-service burdens.

The discussion suggested six principles on which future work on debt sustainability could be built:

- The objective should be to achieve overall debt sustainability on a case-by-case basis, focusing on the totality of a country's debt.
- Action should be envisaged only when the debtor has shown, through a track record of reform and sound policies, the ability to put to good use whatever exceptional support is provided to achieve sustainability.
- New measures should build, as much as possible, on existing mechanisms.
- For problem cases, additional action should be coordinated to ensure broad and equitable participation among all creditors.
- Any action on relieving debt to multilateral creditors should preserve the financial integrity and preferred creditor status of these institutions and be consistent with the constraints of their charters.
- New external finance for the heavily indebted countries should be granted on appropriately concessional terms.

Directors met again in March 1996 to discuss a proposed framework, prepared jointly by the staffs of the Fund and the World Bank, to resolve the debt problems of the heavily indebted poor countries. The staff proposals conformed to the six principles established at the conclusion of the February Board meetings. The first stage of the proposed framework would involve building on the existing three-year track record required to qualify for a stock-of-debt operation on Naples terms from Paris Club creditors and at least comparable treatment from bilateral and commercial creditors. Countries able to exit from the debt-rescheduling process with stock-of-debt operations would be expected to do so.

Other countries, for whom such operations would not bring their debt burdens to sustainable levels, would be expected to undertake a second three-year program, during which they could receive enhanced debt relief and other financial support. From the outset of this second program, these countries would have a firm commitment from the international community, including the multilateral creditors, that their debt burden would be brought to a sustainable level on the successful completion of the program. The Fund would be expected to take action to reduce the present value of its claims on a country participating in the initiative at the end of the second phase. Various possibilities involving support under the ESAF—as the centerpiece of the Fund's strategy to help the low-income countries, including in the context of the initiative to assist the most heavily indebted poor countries—might achieve the needed reduction in present value terms. In related discussions, many Directors emphasized that, in designing a mechansim to provide for such an operation, the impact on the level of self-sustained ESAF operations for other countries eligible for assistance under the ESAF should be kept to a minimum.

The Interim and Development Committee meetings in April 1996 welcomed the proposed framework to resolve the debt problems of the heavily indebted countries. The Interim Committee agreed that further action would be needed on a case-by-case basis, in line with the broad principles of the proposed framework, including contributions by the international financial institutions from their own resources, contributions by bilateral donors, and appropriate action by the Paris Club and other creditors. The Interim Committee requested the Fund, in conjunction with the Bank and in close collaboration with all involved creditors and donors, to put forward as soon as possible specific proposals with the aim of reaching decisions by the time of the October 1996 Annual Meetings (see Appendix VI).

Private Market Financing for Developing Countries

In a discussion in September 1995 of private market financing for developing countries, Directors noted that recent progress in resolving the commercial bank debt problems of developing countries demonstrated the strength of policy adjustment in those countries and the structuring of debt relief to fit individual country needs.[12] They were encouraged that several low-income developing countries had recently concluded debt buybacks but acknowledged that other countries faced considerable difficulty in servicing and in paying back their commercial bank debts. To deal with this problem, it might be necessary for these countries to undertake debt- and debt-service-reduction operations. Many Directors agreed that the Fund could support debt operations for these countries under its current guidelines through small stand-by arrangements in conjunction with ESAF arrangements, although a few Directors believed it would be inappropriate for the Fund to extend non-concessional financing to countries with a limited medium-term capacity to service debt.

International Debt Adjustment

Meeting again in February 1996 for an informal discussion of recent proposals for orderly debt workouts in crisis situations, Board members agreed that the progressive integration of capital markets on a global scale had changed the international financial environment. While the new environment eased financing constraints and created opportunities for more productive use of world saving, it carried the risk that loss of market confidence could cause massive reversals in capital movements and destabilizing shifts in asset prices. In a financial crisis, the adoption of a comprehensive package of adjustment measures was essential, but external resources were also vital to support this adjustment and to restore market confidence. Many Directors emphasized that market participants should not assume that official financing could be made available on a scale to ensure that all creditors could be paid on schedule.

Allowing breathing space in such circumstances for adjustment policies to take hold might involve restructuring payment schedules to fit a country's capacity to pay. Many Directors were not confident of patient forbearance on the part of holders of securitized claims and believed that countries might be obliged under certain circumstances to impose a moratorium on debt-service payments while seeking to reschedule their obligations. Most, but not all, Directors cautioned against the use of exchange controls as an instrument for handling crises, arguing that payments suspensions should apply equally to domestic and nonresident holders of debt. They generally agreed that a moratorium on servicing a government's domestic debt would not be helpful and considered that if a suspension of payments on external debt-service obligations was essential to resolving a crisis, it should be supported by the official international community.

Directors were cautious, and most were negative, about proposals to establish a formal international debt adjustment mechanism. They were concerned that if such a mechanism was seen as making it easier for troubled debtors to restructure their debts, international capital markets might raise the cost of capital to a broad range of developing countries. Proposals in this area would have to balance the need for speedy resolution of individual crises with that of protecting the rights of creditors. Large-scale financial assistance to troubled debtors or mechanisms to give relief on debt obligations had the potential to create moral hazards for debtors. The best safeguard against these hazards was tight conditionality. Directors were also concerned about the moral hazard that applied to creditors, and to minimize this hazard, generally wanted to maintain constructive ambiguity as to the amounts and speed with which assistance would be available.

[12]The background studies by staff were published as *Private Market Financing for Developing Countries* (November 1995) in the Fund's series of World Economic and Financial Surveys.