11

Debt Denouement, 1987–89

For five years after the debt crisis hit in 1982, the IMF's strategy was to help countries adjust policies and obtain enough new financing so that they could stabilize and strengthen their economies and eventually be able to service their debts on normal market terms. Normal terms in that context meant the terms on which the debt had been contracted, regardless of changes in circumstances and without allowance for arrears unless authorized through an agreement with creditors. This "financing assurances" policy came under increasing fire as time passed without a resolution of the crisis.

The policy of requiring financing assurances was formalized by the Executive Board in April 1983. (For the full text of this and of the 1980 policy that it modified, see the Appendix to this chapter.) That policy stated that, as a condition for approving a credit arrangement, "the Executive Board would need sufficient safeguards to ensure that the Fund's resources would be used to support a viable and financeable adjustment program." To that end, stand-by arrangements would include "review clauses . . . linked, if necessary, to the satisfactory outcome of discussions on balance of payments financing from other sources."[1] In other words, if bank creditors refused to reschedule the country's debts, the Fund would normally suspend access to its own money.

Before adoption of that policy, the strategy had been based primarily on plans, rather than results. Until 1980, the Fund had insisted that a country's policies should provide for the elimination of any external payments arrears during the period of a stand-by arrangement. From 1980 to 1983, Fund policy acknowledged that in some cases the avoidance of additional arrears would be a more feasible goal.[2] With that mandate for flexibility, the method of determining whether a proposed adjustment program would be adequately financed varied substantially from

[1]Also see "Fund Policies and External Debt Servicing Problems," SM/83/45 (March 8, 1983), pp. 24–26, and the minutes of EBM/83/58 (April 6, 1983).

[2]The 1980 modification (see the Appendix) stated that, "depending on the member's circumstances and the length of the program, it might not be feasible in the early stages of the program to go beyond an understanding that the member would try to avoid any further increase in outstanding arrears." That understanding implied that the requirement of eliminating arrears would not necessarily apply to one-year programs. In practice, most arrangements approved in the early 1980s called for only a partial reduction of external arrears during the first year.

case to case, reflecting the diversity of circumstances facing countries and of bank practices regarding rescheduling. Several cases in the early 1980s stretched the informal financing assurances policy, though without formally accepting the continuation of an ex ante financing gap. For example, the 1981–84 stand-by arrangement with Romania, discussed in Chapter 8, was resumed in June 1982 while arrears to both official and private creditors persisted, but the Fund allowed only a token purchase until the anticipated agreements with creditors were in place. The 1980 stand-by arrangement with Turkey (see Chapter 6) was approved, and the 1983 stand-by arrangement with Sudan (Chapters 9 and 16) was activated, when official creditors agreed to cover the financing gap, even though no agreement had been reached with commercial banks. Even later, the initial drawing under the 1985 stand-by arrangement with Yugoslavia (Chapter 13) was allowed while negotiations were continuing with bank creditors, on the grounds that those negotiations were proceeding smoothly.

By 1987, many observers were convinced that the debt strategy had to be more forcefully separated from the interests of commercial banks. The most heavily indebted countries might never be able to shed their burden without substantial relief from the contractual obligations that they had undertaken in the carefree days before 1982. Moreover, most banks had already dodged the threat of bankruptcy, the risk of a systemic collapse was long past, and bank creditors no longer had a clear incentive to increase their exposure to developing countries. That view, however, was rejected by some prominent analysts, and it ran into substantial political opposition in some creditor countries. At the IMF, as in the economics profession and the political establishment, both sides of the argument were fiercely debated while the debt-relief proponents gradually gained the upper hand. This process culminated in 1989 when the U.S. government swung its weight from one side of the debate to the other. From that point on, the Fund regularly supported the adjustment programs of countries that were negotiating relief from debt or debt-service obligations, and on several occasions provided direct financial support for debt relief.

Toward Debt Relief: Turning the Titanic

The need for relief from debt-service obligations had, to some extent, been recognized from the beginning. Several of the heavily indebted countries lacked the foreign exchange to repay the principal on loans coming due, and rescheduling postponed that difficulty for months or years at a time. Some lacked the reserves to pay interest as well, and concerted lending enabled them to borrow enough to cover a substantial part of it. The introduction of multiyear rescheduling agreements (MYRAs) in 1984 provided a mechanism for the further smoothing and delaying of amortization schedules. Through all of this stopgap activity, however, the discounted present value of the contractual stream of future payments remained essentially undiminished. Eventually, economies would have to grow by enough to produce the required cash, or governments would have to default. As the years

ticked by, it became increasingly obvious that, for the most heavily indebted, the burden of foreign claims on future export receipts was an insurmountable barrier to new foreign investment and even to the retention of domestic savings. Without true debt relief (reduction of the discounted present value), growth was impossible.

Latin American governments regularly made the case for negotiated debt relief throughout the early 1980s, with little success. From 1984 to 1987, they attempted to take joint action either to persuade creditors to soften their stance or, if necessary, to reduce or suspend payments unilaterally. That process started with the Quito Declaration of January 13, 1984, in which the heads of state or their representatives of 26 Latin American and Caribbean countries rejected suggestions that they declare a moratorium on servicing external debts but stated that debt service should be subordinated to the goal of development. The declaration called for creditors to negotiate formulas aimed at limiting debt service in relation to export earnings.[3] Five months later, when the ministers of finance and of foreign affairs of 11 Latin American countries met at Cartagena, Colombia, the prospects for joint action (or, as the financial press liked to call it, formation of a "debtors' cartel") seemed to be growing.[4] On June 22, 1984, the ministers issued a communique known as the "Cartagena Consensus," which reaffirmed their determination to meet their debt obligations but also concluded that the debt crisis was a political crisis and that solutions to it were the coresponsibility of debtors and creditors.[5]

The Cartagena group continued to meet periodically, but the "consensus" did not run very deep. Some of the key countries, such as Mexico and Chile, preferred to negotiate on their own. Others, such as Peru during the administration of Alan Garcia and Brazil during the administration of José Sarney, decided to take unilateral action on their own—with disastrous consequences.[6] By the middle of 1987, the drive for concerted action had stalled, bogged down by the difficulty of finding a strategy on which a critical mass of indebted countries could agree.[7]

Farther north, several plans were advanced as early as 1983 for official action by creditor countries to relieve countries from the burden of foreign debt. The major

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[3]For the full text, see the *CEPAL Review* (United Nations, Economic Commission for Latin America), No. 22 (April 1984), pp. 39–51. For the list of participants, a summary, and related stories, see the *UN Chronicle*, Vol. 21, No. 3 (March 1984), pp. 13–17.

[4]The term "debtors' cartel" was introduced very early after the crisis hit Latin America, long before the Cartagena conference. For example, the *New York Times* of December 6, 1982 (p. D9), described the "fear among bankers in New York and London . . . that [Latin American] countries might organize a 'debtors' cartel' and unilaterally declare a moratorium on all their debt servicing."

[5]For a summary, see *IMF Survey* (July 2, 1984), pp. 201–2.

[6]The Brazil moratorium is discussed in Chapter 10. The case of Peru, which led to arrears to the Fund as well as to other creditors, is covered in Chapter 16.

[7]The last major effort to establish a unified bargaining position came in the fall of 1987, when Sarney persuaded his counterparts in Mexico and Argentina to ask their finance ministers to develop a plan. The ministers met in September, in the margins of the IMF Annual Meetings, and aimed to produce an agreement at the time of a summit meeting of eight Latin American presidents in Acapulco, Mexico, in November. The idea died, however, when Mexico pulled out. For a review, see Bresser Pereira (1999), esp. pp. 20, 26, and 37. For a political analysis of the failure to establish a cartel, see Kugler (1987).

international banks were receptive to such ideas in principle, but little progress was made toward developing an operational proposal or an equitable approach to burden sharing.[8] By 1986, the momentum for such proposals began to build, albeit still slowly and predominantly in the United States.[9] Bill Bradley, a prominent member of the U.S. Senate, concluded in 1986 that the debt crisis had cost U.S. firms at least a million jobs, and he proposed the establishment of a $42 billion fund to reduce the outstanding stocks of sovereign debts of developing countries. Over the next two years, Peter Kenen of Princeton University, Jeffrey D. Sachs of Harvard University, investment banker Felix Rohatyn, U.S. Representative John LaFalce, James D. Robinson III of American Express, and others advanced schemes to forgive debt through creation of an official fund. A number of the proposals suggested that the IMF be asked to manage such a facility.[10]

Curiously, *official* support for a relief plan then was still concentrated in Europe and Japan. In the United States, Paul A. Volcker, the Chairman of the Federal Reserve System until mid-1987, was strongly opposed, primarily because he believed that countries would be more likely to regain normal market access to foreign credits if they could meet their contractual payments. James A. Baker III, Secretary of the U.S. Treasury until mid-1988, was just as strongly opposed, mainly because of concerns about the political consequences of granting debt relief to foreign countries and not to domestic borrowers. The Japanese government, however, developed a proposal—the Miyazawa Plan—in the spring of 1988, which attempted to sidestep the delicate issue of forgiving principal by restricting debt relief to reductions in interest rates.[11] That proposal was tabled at the summit meeting of the

[8]For an early debt-relief proposal from the banking community, see Zombanakis (1983). The potential role of debt relief was a major agenda item at the annual International Monetary Conference sponsored by the American Bankers Association, held in Brussels in May 1983; for a summary, see Hummer (1983). In an April 1984 meeting of the Executive Board on the World Economic Outlook, Jacques J. Polak (Netherlands) noted that indebted countries were exposed to "cyclical risks" because their debt-service payments were invariant with respect to fluctuations in their export earnings. He argued therefore that it "might be useful to think of a country's debt service as a function of its exports, or perhaps of the external conditions under which it could reasonably hope to achieve the best possible export performance." That suggestion, which was not very far from the call of the Cartagena group for export-based limits on debt service, was supported by Jacques de Groote (Belgium) but apparently had no further impact on thinking in the Fund. Minutes of EBM/84/50 (April 2, 1984), pp. 12–13.

[9]In addition, and with more success, support was growing for debt relief for low-income countries with heavy debts that were primarily to official creditors on concessional terms. See Chapter 14.

[10]See Corden (1989) and Williamson (1988). The Fund also was prominently featured in the 1983 Zombanakis proposal. The 1989 plan of Lawrence Klein and Angelos Angelopoulos proposed reorganizing the World Bank to manage debt relief.

[11]Kiichi Miyazawa was the minister of finance; the principal author of the plan was Makoto Utsumi, Director-General of the International Finance Bureau in the Ministry of Finance. Specifically, the plan called for securing a portion of a country's debt by setting up a reserve fund financed partly from the country's own reserves and partly from money set aside from a medium-term Fund loan. Participating countries could buy back all or part of the unsecured portion of the debt. Bank creditors would be asked to forgive interest due on the unsecured portion for a fixed period and to reschedule principal.

Group of Seven (G-7) countries at Toronto in June 1988, and again in September at the Interim Committee meeting in Berlin. The Miyazawa Plan was not endorsed, but it did contribute to the growing consensus for some form of debt relief.[12]

At the IMF, an intense intellectual debate began in 1987, after Jacob A. Frenkel became Director of Research and L. Alan Whittome became Director of the Exchange and Trade Relations Department (ETR). Staff views were divided between those who believed that debt relief would primarily benefit creditors and would delay the restoration of normal creditor-debtor relations (a view associated with but not universally held in ETR), and those who concluded that the existence of a large stock of debt with a heavily discounted market value was an insuperable barrier to normalcy. Even among the latter, few believed that the Fund could move much beyond its standard practices until a more general political consensus developed in creditor countries.[13] Nonetheless, when Jacques de Larosière—the architect and the godfather of concerted lending—retired as Managing Director in January 1987, he forecast the demise of the prevailing strategy in his farewell address to the Executive Board:

> But we may be entering a phase in which the banks may have to make more options available. Perhaps because they are strengthening their positions, the commercial banks have adopted a somewhat more diversified attitude toward new money packages. This reality of the marketplace may well have to be taken into account by the banks to ensure the success of future financing packages and the maintenance of solidarity among the financial community.[14]

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[12]To the debtor, reduction of the stock of principal outstanding (forgiveness, or as Lissakers (1991, p. 234) put it, the "dread f-word") and reduction of the interest rate are essentially equivalent operations: either approach reduces the discounted present value of the outstanding obligations. To the creditor, however, these options might have quite different costs, owing to regulatory or tax policies. By limiting relief to interest payments, the Miyazawa Plan was attractive to Japanese banks but was too limited in scope to generate broad support in other countries. The other major official debt-relief plan tabled in 1988—the Mitterrand plan, which led to the adoption of "Toronto terms" for official debt forgiveness—was restricted to low-income countries and to official rather than commercial credits; see Chapter 14.

[13]The earliest staff paper arguing that debt overhang was a major problem was Dooley (1986). The reluctance of the staff to take a general position on debt relief in the early days of the debate is reflected in the following rather tortuous passage from the April 1986 *World Economic Outlook*: "Some arguments have been put forward for financial arrangements that would ease both current and future burdens for debtor countries. Whatever the benefits and drawbacks of such an approach, a strong case can be made for the appropriateness of private creditors responding to the financing needs of adjustment programs that, if successful, would result in more adequate debt-servicing capacity in the future" (p. 101). Also see footnote 36, p. 490. Throughout 1986, the staff for the most part avoided the issue of debt reduction while concentrating on analyzing the factors that would be needed to enable countries to grow out of their debt problem via the Baker strategy. Even in 1988, much of the staff analysis on debt relief was leading to ambiguous conclusions. See, for example, Corden (1988), which examines conditions under which debt relief would not promote investment; and Dooley (1988), which examines conditions under which buyback and debt-equity swap schemes would not benefit debtors.

[14]Minutes of EBM/87/9 (January 14, 1987), p. 34.

From then on, the Fund began to distance itself from the concerted-lending approach by endorsing the development of a "menu" that would give bank creditors the option of exiting from the relationship by swapping loans for equities or negotiable bonds. The Deputy Managing Director, Richard D. Erb, suggested in February 1987 that exit bonds "could . . . be viewed as a more general means of dealing with the debt overhang" (Corbo, Goldstein, and Khan, 1987, p. 498). In April, the Interim Committee "welcomed the exploration of a wider range of procedures and financing techniques by commercial bank creditors as appropriate, such as debt-equity swaps, exit bonds, and greater securitization with a view to expediting the mobilization of financial support for indebted countries."[15] Meanwhile, as more and more banks strengthened their capital base and were able to set aside large provisions to cover possible losses on sovereign loans, they became increasingly resistant to calls to participate in exposure-raising concerted-lending agreements and increasingly willing to participate in the exit strategies of the menu approach.

The menu approach led naturally to the inclusion of options for debt relief. Gradually in the course of 1987 and 1988, as the Fund implicitly or explicitly accepted and supported debt reduction operations in dealing with Bolivia, Costa Rica, and Mexico (as discussed below), those options became increasingly viable. The new Managing Director, Michel Camdessus, quietly but increasingly encouraged the relief option during that period. In a speech to the Institute of International Finance in May 1987, he called for "a wider range of financing options . . . carefully designed so as to guard against an unintended reduction of resources available to the debtor country." To the Interim Committee that fall, he suggested that "such options as securitization and interest capitalization might prove helpful."[16] The following May, in a speech at a Caracas seminar organized by the Aspen Institute, he endorsed the "additions to the menu of options that in effect work to reduce the existing stock of debt, while countries simultaneously pursue a return to more normal debtor-creditor relations." As examples, he cited the innovations that had recently been launched in Bolivia, Chile, and Mexico.[17] Those cautious feelers were, however, firmly rooted in an adherence to the basic strategy.[18]

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[15] Communiqué, para. 5 (April 10, 1987).

[16] Summary Record, Interim Committee, Informal Plenary Session (September 27, 1987), p. 1.

[17] "Managing the Debt Problem—Next Steps," remarks by Michel Camdessus before the Institute of International Finance, Washington (May 22, 1987), p. 5; and his remarks to the seminar on "Latin America in the World Economy," organized by the Aspen Institute Italia and SELA, Caracas (May 2, 1988), p. 8. Bolivia is discussed in the next section. Chile was an innovator in the exchange of debt obligations for equity shares ("debt-equity swaps"). Mexico's debt-conversion agreement with Morgan Guaranty Bank was also innovative (see below, p. 490–91).

[18] At a speech to the Second Committee of the United Nations General Assembly in October 1987, Camdessus noted that governors at the Annual Meetings had "expressed dissatisfaction with the implementation of the debt strategy," but "there remained a broad and strong consensus that the basic principles underlying the strategy continue to be valid." *IMF Survey* (November 2, 1987), p. 321. In November, the staff circulated a paper for Executive Board discussion, warning that commercial bank recalcitrance "had the potential to jeopardize the implementation of a country's adjustment program" and suggesting that the Fund could decide to lend into commercial

In February 1988, Camdessus circulated a confidential note to a few senior staff, suggesting that the Fund should try to assist the securitization of discount bonds, perhaps by providing guarantees. Simultaneously, he led a concerted but ultimately unsuccessful effort to interest senior U.S. officials in the plan. Although this specific proposal was not pursued further, a staff paper was issued later that month calling for the Fund "in certain cases, as in Bolivia," to "play a role in facilitating the 'sharing of the discount' on outstanding debt through buybacks or analogous transactions." That idea, however, failed to win consensus support when it was taken up by the Executive Board at the end of March.[19]

To generate some momentum for new ideas on debt relief, an informal, interdepartmental committee was established within the Fund in June 1988, known simply as the "Debt Group." Its primary task was to review the various proposals and ideas being generated inside and outside the Fund and to exchange information on countries where innovative approaches were being tried, with an eye toward developing a new institutional view on debt relief. (After the Brady Plan was announced, a higher-level group was constituted under the chairmanship of the Managing Director; the new group became the "Senior Debt Group," and the original—chaired by C. Maxwell Watson, Advisor in the Exchange and Trade Relations Department—became the "Junior Debt Group.") This work was considered to be so sensitive that few other staff members even knew of the group's existence at that time. As early as July 1988, the group developed the argument that the Bolivian buyback scheme could serve as a useful model for a number of other countries, so long as the Fund had a proper appreciation of the risks.[20]

Finally, in September 1988, when the Interim Committee met in Berlin, ministers were ready to endorse the general idea of expanding the menu approach in a way that could encompass debt relief (see below, p. 491–92). Although five more months would elapse before the cornerstone was set in place in the form of the Brady plan, the momentum was already unstoppable.

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arrears in "exceptional cases." In February 1988, the Board reaffirmed the existing strategy and concluded that any relaxation should be applied "only in very limited circumstances." See "Financing Assurances in Fund-Supported Programs," EBS/87/266 (December 14, 1987), pp. 1 and 14; and minutes of EBM/88/17 (February 5, 1988), pp. 9–10. The staff also considered but did not formally pursue the idea of using the Fund's powers under Article VIII to approve exchange restrictions for countries attempting to negotiate settlements with recalcitrant banks, which might have provided a measure of protection against lawsuits.

[19]"Management of the Debt Situation—Developments, Issues, and the Role of the Fund," EBS/88/55 (March 9, 1988), p. 8; and minutes of EBM/88/5 (March 31, 1988).

[20]Memorandum to the Deputy Managing Director from the Debt Group, July 19, 1988; in IMF/RD Deputy Managing Director file "Debt Schemes, 1988–May 1989" (Attachment III to Debt Group's Review of Activities of January 31, 1989; Accession 91/455, Box 4, Section 489). The 1988 Debt Group was an outgrowth of an interdepartmental working party on debt restructurings that was established in 1984. See memorandum and report from C. David Finch (Director of ETR) to the Managing Director (April 27, 1984); in IMF/RD Managing Director file "Debt Negotiations (Documents)," (Accession 86/34, Box 5, Section 208).

Pre-Brady Debt Relief: Two Case Studies

In a few cases in 1987 and 1988, the Fund supported the efforts of debtors and creditors to put an end to years of painful and costly negotiations by arranging for partial relief from existing debt-service obligations. Two cases stood out: Bolivia in 1986–87 and Mexico in 1987–88.

Bolivia

Bolivia, like so many other countries in Latin America, faced a debt crisis in 1982. This case, however, differed in important respects from the others and did not involve the Fund until some three years later.

Hyperinflation and Collapse: 1981–85

Bolivia's economy weathered much of the 1970s reasonably well. The government of General Hugo Banzer, which took over through a coup in 1971, enjoyed favorable terms of trade, allowed foreign direct investment to flourish, and had ready access to external financing from commercial creditors.[21] After Banzer was ousted in 1978, political chaos ensued at the same time as external economic conditions were deteriorating. A stabilization program was launched in 1980, supported by a stand-by arrangement with the Fund. That program went off track, and the Fund arrangement was canceled without the final drawing having been made. Bolivia nonetheless reached an agreement with its commercial bank creditors in April 1981 on the understanding that a new Fund arrangement was imminent. The Fund staff, however, concluded that none in a parade of Bolivian governments had the ability to implement an adjustment program, and no agreement was reached.[22] The military finally relinquished power to a democratically elected government in October 1982, but the new regime, led by President Hernán Siles Suazo, still lacked the political base to implement an effective program. The Siles government soon went into arrears on the debt that had been rescheduled the year before, after which it had essentially no access to external financing. Throughout Siles's tenure, which lasted until August 1985, the government attempted to maintain public sector spending well beyond its limited and fading ability to generate internal revenue. The inevitable result was a sharp rise in inflation, from just under 300 percent a year in 1982 to more than 2,000 percent in 1984 and to a hyperinflationary 23,500 percent for the last 12 months before a successor government—led by President Victor Paz Estenssoro—could introduce a

[21]For a history of Bolivia's political and economic fortunes in the 1970s and 1980s, see Morales and Sachs (1990).

[22]Bolivia did continue to use Fund resources: SDR 0.14 million as a final borrowing from the Trust Fund in March 1981 (bringing Bolivia's total borrowings from the Trust Fund to SDR 36.2 million, or $45 million); SDR 24.5 million ($27 million) through the Buffer Stock Financing Facility in June 1982, to finance stocks accumulated under the International Tin Agreement; and SDR 17.9 million ($20 million) under the Compensatory Financing Facility in January 1983, to compensate for a temporary shortfall in export receipts.

new policy regime on August 29, 1985. By that point, the economy was in a total shambles. In just three years, GDP per capita had fallen from $570 to $470; merchandise exports had fallen by 20 percent in dollar terms; and even with no new foreign borrowing, external debt of the public sector had risen from 39 percent of GDP to 133 percent. For more than a year, Bolivia had made no interest payments on its debts to commercial banks. The new government would have its hands full in trying to restore stability and credibility, not to mention growth.

Financing Stabilization with Arrears: 1985–86

The Paz government turned immediately to the IMF for assistance. On September 26, 1985, a mission headed by Hans Flickenschild (Deputy Division Chief of the Pacific Division, Western Hemisphere Department) arrived in La Paz to make an initial assessment of the New Economic Policy announced on August 29. Without question, the turnaround in policy was extremely ambitious and—if the government could deliver on its promises and resist domestic political opposition—appropriately designed to deal with the immense distortions and weaknesses in the economy.[23] The exchange rate had been allowed to float and become unified with the black-market rate. The huge subsidies implicit in most public sector prices (such as very low petroleum prices) had been largely eliminated. Reforms aimed at broadening the tax base were being implemented. Although the Fund mission believed that additional fiscal measures would have to be taken if the program was to succeed in stabilizing the economy, it concluded that there was a sufficient basis to open negotiations for the use of Fund resources.[24]

In late November, Flickenschild's team returned to La Paz to negotiate a program. Their instructions were unusual: the Managing Director was prepared to treat Bolivia as a special case, especially with regard to the handling of its external debt. Of Bolivia's nearly $4 billion in medium- and long-term external public sector debt, some $700 million was principal on loans from commercial banks. Much of that was in arrears, and overdue interest on bank loans added more than $200 million to the total amount due.[25] From the Fund's perspective, it would be important for Bolivia to reach an agreement with commercial banks on these debts to help the country regain credibility and restore normal trading relationships. The usual strategy for doing so, however, in which the banks would be expected to participate in a new concerted lending package and reschedule existing debts, did not make sense in this case. Bolivia—the poorest country in South America—could afford neither to take on new external debt on commercial terms nor to make more than a goodwill gesture in paying interest on its already outstanding commercial

[23]Morales and Sachs (1990), Chapter 7, provides a detailed review of the various measures taken.

[24]Bolivia stayed current on its obligations to the Fund throughout the crisis period and reduced its total indebtedness from a peak of SDR 94 million (139 percent of quota; $103 million) in January 1983 to SDR 74 million (56 percent of its increased quota; $76 million) in September 1985.

[25]"Bolivia—Recent Economic Developments," SM/86/290 (December 2, 1986), Tables 51 and 52. The authorities did not at that time have comprehensive data on short-term debts outstanding.

obligations. Whatever arrangement Bolivia reached with the Fund, the commercial banks would have no choice but to grant very generous debt relief in some form. Accordingly, de Larosière asked the staff to develop alternative scenarios based on the assumption that such debt relief would be forthcoming.[26]

In view of the comprehensiveness and strength of the August 29 policy package, negotiation of the performance criteria for the proposed stand-by arrangement was relatively straightforward. The mission's main concern was to ensure that political pressures did not undermine implementation of the government program. Confidence was bolstered during the mission when the authorities reacted to a series of shocks—including a sharp drop in world tin prices, one of the country's principal exports—by allowing the exchange rate to depreciate by about one-third. Opposition political parties called a general strike in protest, but the government held its ground and declared a temporary "state of siege" to maintain control of the economy.

Assessing Bolivia's financing requirements was more difficult. To have any hope of restoring economic growth, Bolivia had to raise the level of its imports before it could expect to raise exports. To do so, it would need additional financing well beyond what could be provided by the Fund. The scenario developed by Flickenschild in December 1985 assumed a rise of about $50 million in imports in 1986 (8 percent over the previous year); no change in exports; and full capitalization of more than $1 billion in arrears to banks and bilateral official creditors, offset marginally by payment of about $100 million in current interest to those creditors, of which some $60 million would go to commercial banks.

That last number became the principal point of contention. It was small in relation to the total arrears to the banks, but it was large in relation to Bolivia's pent-up demand for imports. Moreover, while the staff saw its proposal as a reasonable manifestation of the Managing Director's call for flexibility and bank creditors saw it as an unreasonable concession to the debtor, Bolivia and many outside observers saw it as an unrealistic demand on a desperately impoverished country. At this time, Harvard Professor Jeffrey D. Sachs was serving as an economic advisor to the Paz government, and he advised the authorities against accepting the Fund's recommendation to resume paying interest to the banks. The Bolivian negotiating team, led by Minister of Planning and Coordination Guillermo Bedregal,[27] pro-

[26]The clearest statement of de Larosière's initial position on debt relief for Bolivia is in the form of his handwritten response to the briefing paper for the mission, made on November 17, 1985. There he asked the mission to estimate how the economy would be affected "if debt relief were to be *very* generous and cover a *bold* stretch out of interest payments, and if new money were to be granted by the [World Bank, the International Development Agency], and the banks in an active way"; and he concluded that, "given the *extreme* characteristics of the case (virtual collapse of the export sector, breakdown of the administrative apparatus, existence of massive arrears—all factors that the commercial banks have taken account of in writing off or provisioning their claims on the country) we need *more* than the classical remedies." (The emphasis is in the original.) The scenarios developed by the staff did not include concerted lending from the banks, on the grounds that such an assumption was unrealistic.

[27]President Paz Estenssoro also met twice with the IMF staff team during this mission.

posed cutting the figure by close to half, and the issue was not resolved by the end of the mission.[28]

The staff returned to La Paz in late February 1986 to try to conclude negotiations, by which time economic conditions had seriously deteriorated. Export prices were badly depressed, agricultural harvests were being wrecked by heavy rainfalls, and the government—under increasing political pressure to abandon its commitment to stable wages—had begun intervening and introducing controls to prop up the peso in the foreign exchange market. Flickenschild cautioned the government against losing momentum in liberalizing the economy, and he again advised them to resume paying interest to commercial creditors as a means to get a favorable rescheduling agreement. With Sachs now playing a more active role in the negotiations, the authorities—led by a new planning minister, Gonzalo Sanchez de Lozado—strongly resisted that suggestion, and the issue was once again left unresolved. The mission did, however, succeed by mid-March in negotiating all but a few loose ends for an adjustment program to be supported by a 12-month stand-by arrangement with the Fund. That preliminary agreement also would open the door for Bolivia to seek debt relief from official creditors through the Paris Club.[29]

After two visits by Bolivian officials to the Fund to clarify the remaining technical issues, the Letter of Intent for the Fund arrangement was signed at the end of May 1986. In the meantime, the Bolivian authorities continued to meet with U.S. officials and with commercial bank creditors, without getting much official encouragement or making much progress toward an agreement. The Fund had now reached a crossroads. The proposed program had to be financed in some form by the commercial banks: either through a rescheduling agreement or through the accumulation of arrears. To this point, as described in the introduction to this chapter, Fund policy had been not to accept the accumulation of arrears to external creditors as a means of financing a program. If it adhered to that stance in this case, there would be no program at least until Bolivia caved in to the demand that it resume paying interest to the banks.

In spite of the potential for setting a troublesome precedent, the decision not to wait for an accord with bank creditors was never seriously questioned within the Fund.[30] Bolivia was a low-income country struggling to emerge from economic and

[28]The figure of $60 million assumed payment of current interest on the outstanding principal at a fixed rate of 7 percent. Bolivia's proposal was to pay interest at 4 percent. The LIBOR rate on three-month U.S. dollar deposits in December 1985 was 8.1 percent.

[29]In addition to the treatment of external arrears, exchange rate policy was a key policy issue. Sachs advised the government to peg the exchange rate to the U.S. dollar as an anchor for price expectations, while the Fund staff argued that a fixed-rate regime would be impractical since Bolivia lacked the reserves to back it up. Eventually, Bolivia officially floated the peso but stepped up the level of intervention in order to stabilize the rate. Under the terms of the stand-by arrangement, credit policy was tight enough to stabilize the exchange rate, and the strategy succeeded.

[30]It must be stressed that the lack of objection arose entirely because of the extreme circumstances facing the Bolivian authorities, which made the issue of precedence essentially moot. An interesting comparison may be made with Chile, where delays in negotiations with the banks had delayed the Fund's work as well (see Chapter 9).

financial chaos, and it had formulated a strong adjustment program. It was the first program to come before the Board for a country that was included under the umbrella of the October 1985 Baker initiative, and it was understood that Bolivia would soon be coming back to the Fund for support under the just-implemented Structural Adjustment Facility (SAF). To decline such a program was simply not a viable option. In the end, the staff merely *assumed* that some cash payments would resume in the second half of 1986 and that Bolivia would on that basis reach an agreement with its bank creditors. That strategy was communicated to the banks, who raised no objections to it.[31]

The stand-by arrangement was approved by the Executive Board on June 19, 1986. Remarkably, for a case in which the Board was departing from normal practice, no one on the Board questioned the proposal to approve a program that was being financed in large measure through the accumulation of arrears to banks. Directors all agreed that Bolivia had no alternative, and the issue of precedent never arose.[32]

Through the second half of 1986, Bolivia implemented the adjustment program, met all of the performance criteria for the stand-by arrangement except for the ceiling on external arrears, and drew the funds that were available. In December, the Fund made additional resources available through the SAF and the Compensatory Financing Facility (CFF), and for the year as a whole became the largest single source of external financing for the country.[33]

Buying Back the Debt: 1987–88

Toward the end of 1986, Bolivia made a bold move to reach a negotiated settlement with its bank creditors, by proposing to buy back a portion of its debt at a heavily discounted price. The Advisory Committee, chaired by Ulrich Merten of the Bank of America, responded favorably on the condition that the buyback be financed entirely by contributions from donor governments, not by Bolivia's own resources. The Fund staff and management also responded positively and urged the authorities to determine the buyback price through an auction rather than through a predetermined fixed price. Neither the authorities nor Sachs (their principal outside advisor on the economics of the deal) were receptive to the auction proposal, and that idea was soon dropped. The Advisory Committee approved the buyback

[31]See "Bolivia—Request for Stand-By Arrangement," EBS/86/120 (June 2, 1986), p. 29. The Advisory Committee met on June 9, and then cabled the authorities that it was prepared to cooperate with them in resuming negotiations after the anticipated Fund approval of the program.

[32]Minutes of EBM/86/98 (June 19, 1986). Bolivia's contractual debt-service obligations for 1986 exceeded the country's total expected earnings from exports of goods and services.

[33]Bolivia made three drawings under the stand-by arrangement, totaling SDR 32.7 million; drew SDR 64.1 million through the CFF to compensate for a shortfall in export receipts following declines in the world prices of the two major export commodities, natural gas and tin; and borrowed SDR 18.1 million from the SAF. Total disbursements to Bolivia in 1986 thus amounted to SDR 114.9 million (127 percent of quota and approximately $156 million). Other major multilateral support came from the World Bank and its soft-loan affiliate, the International Development Association (IDA); the Inter-American Development Bank (IDB); and regional funds.

proposal in March 1987, along with a general plan for the conversion of debts into equities. For the next few months the committee set out to line up the required unanimous consent of the 120 or so other creditor banks, while Bolivian officials concentrated on securing official contributions.

The Fund became more deeply involved in the buyback scheme at the request of the Advisory Committee, when some of the noncommittee creditors insisted that the Fund be brought in as a condition for their approval. The problem was that some of the donor countries were insisting on anonymity, while the banks were insisting on proof that all of the funds used for the buybacks were external donations. The Fund therefore agreed to serve as an intermediary: to receive the donations in a trustee account, administer the account, and make payments to the Advisory Committee at Bolivia's request.[34]

Meanwhile, economic conditions were beginning to deteriorate again. Fiscal and monetary policies were loosened in a vain effort to counter a deepening recession. Export receipts were severely threatened by a dispute with Argentina over the price of Bolivia's natural gas (which then accounted for more than half of Bolivia's exports). And when Bolivia attempted to reorganize the central bank to make it more efficient and accountable, the effort went awry and left the government unable to provide the data that the Fund needed to determine whether the country was still in compliance with the terms of the stand-by arrangement. The arrangement expired in July with the last two scheduled drawings unmade.

Notwithstanding these difficulties, the staff believed that Bolivia's economic prospects were reasonably bright. The general thrust of policies was reasonable, and inflation—which had been the highest in the world just two years earlier—was well under 1 percent a month. In July 1987 Flickenschild negotiated a medium-term program to be supported by a three-year Extended Fund Facility (EFF) arrangement, but that tentative agreement turned out to be premature. By the fall, it appeared that Bolivia's prospects were too cloudy, and in any event Bolivia could ill-afford additional debts on nonconcessional terms. On that basis, the staff decided to shelve the EFF plan and instead to wait until a program could be jointly negotiated with the World Bank for a program to be supported by the newly established Enhanced Structual Adjustment Facility (ESAF).

The buyback scheme was approved in final form by the banks in November 1987, shortly after the Fund completed the paperwork establishing the "voluntary contributions account" for Bolivia. Earlier in the year, Bolivian debt had been selling in a very thin secondary market for about 6 percent of its face value, but as it became clearer that the scheme would be implemented, the price began to rise. When Bolivia formally offered in January 1988 to buy back a portion of the debt,

[34]The Deputy Managing Director, Richard Erb, approved the proposal in principle in late June, 1987. A general description of the proposed account was circulated to Executive Directors in mid-August, and the establishment of the account was approved by the Executive Board (with only France dissenting) on October 21. See "Bolivia—Debt Buyback Arrangement," EBS/87/181 (August 19, 1987), "Bolivia—Establishment and Administration of Voluntary Contribution Account," EBD/87/251 (October 5), and minutes of EBM/87/147 (October 21).

it offered 11 cents on the dollar. That price held, and when the books were closed in March, Bolivia was able to purchase some $240 million of its outstanding $650 million in bank loans, using just over $26 million in cash that had been donated by European and Latin American countries.

Whether the buyback benefited Bolivia was much debated. Bulow and Rogoff (1988) observed that the scheme did not reduce the market value of Bolivia's outstanding debt (6 percent of the original face amount was approximately the same as 11 percent of the reduced amount), and they concluded that the full benefit of the donated cash had gone to the banks rather than to Bolivia. Critics of that view questioned whether the change in the market value of the debt was a good measure of the benefit to the country. Taking a broader view of the relevant costs and benefits of buyback schemes, Fund staff conducted several studies and generally derived more positive conclusions than those of Bulow and Rogoff.[35]

Mexico

In the halcyon days just after Christmas of 1987, the Mexican authorities completed negotiations for a path-breaking deal to relieve their debt to foreign banks. As discussed in the preceding chapter, the stand-by arrangement with the Fund was in difficulty because of policy slippages aggravated by the almost total collapse of the Mexican stock market. Negotiations were under way with the Fund staff for a renewed adjustment effort that could serve as the basis for a waiver of the end-year program criteria. That effort produced a major new policy regime in mid-December (the *Pacto*; see Chapter 10, above). Separately, Mexico was negotiating with the U.S. authorities and with Morgan Guaranty Bank to exchange part of its bank loans for bonds that would be partially guaranteed by the U.S. Treasury. When the deal was announced on December 29, it made headlines as a breakthrough from a general impasse between creditors and debtors on the handling of debt obligations.

The Mexico-Morgan deal worked as follows. The Mexican government extended an offer to the banks to exchange up to $20 billion in outstanding loans for negotiable bonds. The bonds would be sold to the banks at a discounted price to be determined by auction, but the principal would be guaranteed by the U.S. Treasury. To implement that guarantee, the treasury issued zero-coupon bonds with 20-year maturities, to be held in custody by the Federal Reserve Bank of New York.[36] Although the principal was only a small fraction of the total discounted present value of the bonds, the hope was that Mexico's impeccable record of paying interest on time throughout the debt crisis would make the bonds an attractive exit from the seemingly endless cycle of new-money packages.

The banks were given less than two months to respond to the offer, at the end of which fewer than 100 banks (out of some 500) exchanged $3.67 billion in loans

[35]See Cline (1995), pp. 187–93, for an introduction to the controversy, and Dooley (1989) for a staff analysis.

[36]See "Mexico—Recent Economic Developments," SM/88/47 (February 25, 1988), pp. 64–65.

for $2.56 billion in bonds. Both the amount and the discount (30 percent, compared with an expected 50 percent) were disappointingly small. Part of the problem was that some of the Advisory Committee banks (including the largest creditor, Citibank) resented the negotiation of the deal outside the established committee structure. Part of the problem was the absence of a guarantee on interest payments. Part of the problem was the reluctance by some banks to realize a loss on their loans, especially in countries where regulators were making relatively unfavorable rulings on how those losses should be reported.

Nonetheless, the Mexico-Morgan deal was a watershed for the debt strategy. It showed that there was a market for discount bonds, if they could be packaged and marketed attractively. It showed that creditors could cope with the wide range of circumstances facing individual banks if the menu was flexible enough. And it showed that creditor governments could generate substantial leverage by using guarantees to support debt-relief operations. On a very small scale and with tentative force, it contained many of the elements of the Brady Plan that was still more than a year away. As Alan Whittome noted a few weeks later, the "Mexico exchange open[ed the] door wider to encouraging some degree of forgiveness."[37]

The first opportunity that the Fund had to assess the plan was in March 1988, when the Executive Board completed the Article IV consultations with Mexico and reviewed performance under the stand-by arrangement. The staff view was that the debt conversion scheme would make a positive contribution toward resolving Mexico's debt problem by reinforcing cooperation with creditors and by bringing market signals into the process. At the Board meeting, several Directors expressed disappointment that the amounts of debt exchanged were small, but they nonetheless gave Mexico high marks for having made a positive innovation in the debt strategy.[38]

The Brady Plan

In August 1988, Baker resigned as Secretary of the U.S. Treasury in order to manage the campaign of George Bush for the presidency. He was replaced the following month by investment banker Nicholas F. Brady. Almost immediately after taking office, Brady found himself at the IMF Annual Meetings in Berlin, where reviving the debt strategy was a key item on the agenda of the Interim Committee. Camdessus opened the meeting by clearly stating the need for debt relief:

> ". . . we have to recognize that the burden of current and prospective debt service obligations places significant economic and political constraints on policy formulation. . . . techniques must be found, not just to provide additional finance, but also to

[37]Memorandum to the Managing Director (January 5, 1988); IMF/RD (Historian's files).

[38]"Mexico—Staff Report for the 1987 Article IV Consultation and Second Review Under Stand-By Arrangement," EBS/88/23 (February 4, 1988), p. 31; and minutes of EBM/88/36 (March 10, 1988).

> lighten, in a mutually agreeable, market-based way, the relative burden of existing indebtedness."[39]

Pierre Beregevoy, the French minister of finance, noted that the G-7 finance ministers (who had met the day before) had been able to agree on implementing the "Toronto terms" for relieving the debt burdens of low-income countries but had not been able to deal with the problems facing middle-income developing countries. He and others alluded to the Mexico-Morgan deal as a model, but none of the assembled ministers was able to offer a concrete proposal for strengthening the debt strategy. At the conclusion of the meeting, the committee issued a communiqué stating (para. 4) that "the menu approach should be broadened further, including through voluntary market-based techniques which increase financial flows and which reduce the stock of debt without transferring risk from private lenders to official creditors." No one yet had any idea how that goal was to be achieved.

Cooking Up a Plan: November 1988–March 1989

Although Brady expressed skepticism at the Berlin meetings about officially funded debt-relief schemes, he soon gave his deputy, David C. Mulford, instructions to devise a new strategy to be introduced after the new administration took office in January 1989. Whether it was to be a debt-relief plan or a more aggressive promotion of the growth-oriented strategy introduced by Baker three years earlier was still to be worked out, but Mulford's goal was to convince the government and the Federal Reserve that the crisis could not be resolved without a radical new approach.

The basic plan was worked out within the circle of U.S. officials during the period between the November election (won by Bush) and the January inauguration, after which Mulford presented it to his G-7 counterparts. To hone the plan and make it acceptable to all involved parties, Mulford discussed it with Camdessus on several occasions and sought the advice of Fund staff. By February, all of the necessary support was in place, and Brady prepared to announce the plan a few weeks before the next Interim Committee meeting (scheduled for April 3) so that the committee could formally endorse it at that time. He had already agreed to address a Washington symposium on debt, sponsored by the Bretton Woods Committee and the Brookings Institution, on March 10. Camdessus—with whom the U.S. authorities had consulted on the role that the Fund would play in this new strategy—was also speaking on that occasion. It would provide the ideal setting.

As the date of Brady's speech approached, the need for a new debt strategy became critically and painfully urgent. The Venezuelan government, trying to effect adjustment policies so as to qualify for financial support from the IMF and other creditors, was confronted with violent protests that left hundreds of people dead (see the section on Venezuela, pp. 516–20). One of Latin America's wealthiest

[39]Record of discussion, ICMS Meeting 31 (September 25, 1988), p. 3.

economies and a country with a democratic tradition, Venezuela now was poised on the edge of a knife and could well collapse without decisive support from the United States and the IMF. As word of Brady's impending speech began to leak, the plan appeared to be a response to the riots in Caracas and was widely billed as a rescue for Venezuela.[40]

As Brady outlined the proposal over lunch at the U.S. State Department on March 10, the plan contained five new elements.[41] First, he suggested that commercial banks agree to a "general waiver of the sharing and negative pledge clauses for each performing debtor," to enable individual banks to "negotiate debt or debt service reduction operations." Without this element, which was inserted after some prodding from Fund staff, any small creditor bank could continue to block agreement, and negotiating flexible and innovative exit strategies would remain cumbersome and time-consuming. Second, the IMF and the World Bank should dedicate a portion of loans to qualified countries "to finance specific debt reduction plans." For the Fund, this proposal was to become known as the provision of "set-asides," primarily to help countries buy back their bank debts at a discount. Third, the Bretton Woods institutions should "offer new, additional financial support to collateralize a portion of interest payments for debt or debt service reduction transactions," a suggestion that would become known as "augmentation." Fourth, Brady signaled a shift in the U.S. position toward favoring an increase in Fund quotas, to support the provision of resources for the new debt strategy (see Chapter 17). Fifth, he called upon the IMF to reconsider the policy of requiring firm financing assurances to be in place. The banks and the country should negotiate the type of financing needed, and if arrears accumulated while those negotiations proceeded, the Fund should not let that problem prevent it from approving a financial arrangement.

That afternoon, at one of the conference's panel discussions, Camdessus welcomed Brady's initiative and noted that it deserved a "positive response from the international community." How positive that response would be was not yet clear, especially since some of the leading commercial bank creditors remained adamantly opposed to debt relief.[42]

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[40]For example, a front-page story in the *New York Times* on March 9 began, "Prompted in part by the debt-related violence in Venezuela last week, the Bush Administration has decided to encourage bank creditors of third-world nations to reduce the value of the debt and therefore the countries' cost of making payments on it, officials say."

[41]For a report on the speech in the context of the conference, see the *IMF Survey* (March 20, 1989), pp. 90–92. For more detailed descriptions of the Brady Plan and its implementation, see Collyns and others (1992), Clark (1993), and Cline (1995).

[42]At the same meeting of the Bretton Woods Committee where Brady introduced his plan, Yusuke Kashiwagi (Chairman of the Bank of Tokyo) gave a speech arguing that the "resolution of the debt issue depends more than anything else on the strong will and efforts of the debtor countries themselves to come to grips with the structural adjustments and revitalization of their economies. . . . More debt reduction or debt relief will not solve the debt issue because the underlying issues . . . remain unaddressed" (manuscript).

Implementing the Plan: March–May 1989

The Executive Board was already scheduled to discuss the debt strategy the week following Brady's speech, so Directors had an early opportunity to react. Although there was broad support in principle for the U.S. initiative, there was a great deal of initial skepticism about the suggested innovations in the Fund's role. If the Fund were to set aside a portion of a loan to finance buyback operations, that money would not be available to the member to finance its adjustment program. If the Fund were to augment the loan, the risk to the Fund would be that much greater, and fewer resources would be available for other members. If the Fund were to abandon its traditional policy on requiring financing assurances (i.e., if it were to lend while the country accumulated arrears to other creditors), both the Fund and the member could face a backlash that would threaten and delay the restoration of normal market access.[43] This discussion was preliminary, but it suggested that revamping the strategy might not be easy.

The major difficulties were resolved two weeks later, at the regularly scheduled meeting of the ministers of finance and central bank governors of the G-7 countries (held in Washington, the day before the Interim Committee meeting). Both Germany (represented by Gerhard Stoltenberg) and the United Kingdom (Nigel Lawson) were opposed to some elements of the proposal, especially the burden and the risks that could be imposed on the use of IMF resources. To allay those concerns, the United States reportedly agreed to limit the proposal for additional use of Fund resources to the support of interest reduction. That is, any funds to be set aside for buybacks or other debt reduction operations were to be found within the normal access limits. With that amendment, the G-7 endorsed the plan, making its acceptance the next day by the Interim Committee all but inevitable.[44]

On April 3, the Interim Committee formally endorsed the Brady Plan. Ministers flatly rejected the arguments that had been made earlier against the Fund financing debt reduction operations through set-asides or other means, and the committee "requested the Executive Board to consider as a matter of urgency" the proposals that had been put forward (communiqué, para. 3). Stoltenberg cautioned that "the use of the Fund's resources—including the use of these resources in support of debt reduction operations—must be in conformity with its task as a monetary institution," and that the Fund's resources "must supplement, not substitute for, other sources of finance."[45] He concluded, however, that the Brady initiative (as modified) was consistent with those principles. In that context, the committee welcomed Japan's offer to provide parallel financing and noted the importance of

[43]Chairman's summing up; minutes of EBM/89/36 (March 17, 1989), pp. 31–33.

[44]For two insider accounts of the G-7 involvement, see Toyoo Gyohten's discussion in Volcker and Gyohten (1992), pp. 223–24; and Lawson (1992), pp. 860–63. (Lawson erroneously places the G-7 meeting on February 2, not April 2, but he correctly describes it as on the "eve" of the Interim Committee meeting.) Lawson credits the Japanese support for the Brady Plan to a quid pro quo in which the United States agreed to support Japan's bid for an ad hoc IMF quota increase.

[45]Record of discussion, ICMS Meeting 32 (April 3, 1989), pp. 48–49.

"close collaboration" between the Fund and the World Bank in implementing the strengthened debt strategy.

When the Executive Board returned to the issue on Friday, May 19, 1989,[46] the only real questions concerned the specifics of the Fund's involvement in four contentious areas: magnitude and treatment of additional access to Fund resources, the handling of set-asides, eligibility of countries for the plan, and modifications to the policy on financing assurances. But this would turn out to be one of the most complex, lengthy, and fractious meetings of the Executive Board during the whole period covered by this History, and the meeting was not concluded until Tuesday morning, May 23.[47] Essentially, Germany and the United Kingdom, backed to varying degrees by some other European countries, sought to limit the degree to which the Fund would modify its procedures and intensify its involvement in the debt strategy; the United States, backed to varying degrees by other industrial and most developing countries and by the Managing Director, sought to retain as much of the proposals for change as possible.

First, the most contentious area, the magnitude and treatment of additional access to Fund resources. The staff proposed that a Fund arrangement might be augmented by "up to 40 percent" of the member's quota to support the member in securing agreements for debt or debt-service reductions.[48] The United States preferred that the 40 percent figure be only an indicative norm and to retain the option of approving larger amounts in some cases. The United Kingdom had a strong preference for limiting the use of these additional resources for interest rather than principal reduction, as had been agreed in general terms by the G-7 and the Interim Committee. That is, the Fund would supply additional resources that would be set aside in an escrow account to serve as a guarantee to the banks in exchange for a reduction in the rate of interest on outstanding loans. Charles Enoch (Alternate—United Kingdom) argued that the ceiling on augmentation should be 25 percent rather than 40 and that in any case the augmented arrangement should not exceed the Fund's normal access limits. Bernd Goos (Alternate—Germany) supported that amendment and added that to qualify for augmentation, a country should be required to match the additional funds with its own resources.[49] Sup-

[46]To prepare for the complexity of the discussion, Executive Directors had a preliminary exchange of views in informal sessions on May 5 and 10.

[47]The Board met all day Friday for a *tour de table* in which Directors stated their positions and debated the key issues. At the end of the day, there were at least simple majorities on all of the disputed issues, but minority positions were still strongly held. The meeting resumed on Monday afternoon to reconsider the points where substantive differences remained and to try to establish a consensus. After some discussion, the Managing Director read out a draft summing up. That draft was discussed in detail and in some respects hotly disputed, and the meeting was adjourned in the evening, to be continued on Tuesday morning. After several amendments, the summing up was finally approved just before lunchtime on Tuesday, though still without a consensus on all points.

[48]"Fund Involvement in the Debt Strategy—Further Considerations," EBS/89/96 (May 12, 1989), p. 5.

[49]Enoch's statement is at EBM/89/58 (May 19, 1989), pp. 8–9; Goos's is at EBM/89/59 (same date), p. 12.

ported by a few other Directors, they argued long and hard for the limits and restrictions. Although they were in the minority, Camdessus felt that achieving a consensus on this point was extremely important.

A related issue on augmentation that arose during the meeting concerned the possible establishment of escrow accounts. The staff proposal was that once the member had reached or was about to reach an agreement with the banks, the Fund could consider making extra resources available to catalyze that agreement. Enoch suggested that any such funds be segregated and placed in an escrow account outside the control of the Fund (possibly at the Bank for International Settlements, the BIS). The funds would remain in the escrow account for the life of the Fund arrangement unless they were needed to meet the interest payments. Goos, supported by others including Jorgen Ovi (Denmark) and Renato Filosa (Italy), went further and proposed that the Fund should wait to disburse the funds until they were needed, and then release them only if the country was in compliance with the performance criteria for the Fund arrangement. That amendment worried the staff, which was convinced that the funds would be of no use to the member if not made available up front and that it was essential for the Fund to stay at arm's length from the negotiations between the member and the banks.

Several Directors concurred that if the use of escrow accounts were endorsed, the accounts should not be held at the Fund. They objected both to the possibility that the Fund, rather than the member country, would be guaranteeing the country's interest payments; and to the possibility that the Fund would be thereby drawn into the negotiations with the banks. In response, Camdessus argued very strongly that the Fund was the most well-suited institution to hold the escrow accounts, and he insisted that this option not be precluded.

On Tuesday, after several hours of debate, a compromise was reached on augmentation. First, 40 percent of quota was to be a ceiling, not a norm; to qualify, the member would have to show that the extra resources would be "decisive" in enabling agreements with creditors. Second, if the funds were not used "within an appropriate period," the member would be "expected" (though not required) to make early repayment.[50] Third, an arrangement, including augmentation, could exceed the normal access limits only if the Board agreed at the time of approval to invoke the "exceptional circumstances" clause. Fourth, the nature of any escrow accounts was to be determined later and was omitted altogether from the summing up of this meeting. For the text of the summing up, see the Appendix to this chapter.

The second contentious area for discussion was the handling of set-asides. The staff proposed that a portion, perhaps 25 percent, of qualifying Fund commitments be set aside to finance either debt reduction operations (i.e., principal-reducing operations such as buybacks of discounted debt) or reduction of debt service (e.g., negotiated reductions in interest rates). Brady's original proposal suggested limiting

[50]The distinction, which was introduced as an expedient, was explained in a statement by the General Counsel, François P. Gianviti; minutes of EBM/89/61 (May 23, 1989), pp. 9–10. To introduce a policy requiring the member to make an early repayment would have taken a higher and possibly unattainable majority of the voting power on the Board.

the use of set-asides to principal rather than interest reduction, but the distinction lacked a clear economic rationale. Several Directors, led by Hélène Ploix (France) and supported by the Managing Director, noted that since money was fungible once it had been disbursed, it was senseless to insist on this differentiation. Furthermore, the staff paper noted that it would be counterproductive to hinder the banks from developing financial instruments that combined debt and interest reduction.[51] The U.S. Executive Director, Charles H. Dallara, countered that the basis for the distinction was political rather than economic: to make the plan work would require a quota increase for the Fund, and the Bush administration believed that the only way it could persuade congress to go along was to demonstrate that the Brady Plan was capable of reducing the stock of bank loans to developing countries.[52] Separating the two elements was also important to those who wanted to restrict the use of additional resources to interest rate support (which would in most cases mean that the funds would not be used). The final wording of the agreement acknowledged those differing vantage points and yet restricted the set-asides to principal-reducing operations.

The third contentious topic was eligibility. The staff proposed that the Brady Plan apply primarily to countries whose foreign debts were selling at "a sufficiently deep discount" in the secondary market.[53] The logic behind this proposal was that setting aside Fund resources for buybacks or other debt reduction operations made sense only if the country could conduct the operation at a substantial discount; otherwise, there would be no leverage. Furthermore, the Fund's own liquidity position was tight, and any additional use of resources had to be limited to the most difficult cases.[54] Several Directors from developing countries (led by Alexandre Kafka of Brazil) objected, on two grounds: a moral hazard problem could arise if countries were told that they could gain access to the plan only if they could first show that their debts were being discounted by the market, and the proposal could unfairly punish countries that had already made progress or had made the sacrifices necessary to keep their debt selling at par.[55] The Managing Director maintained that the moral hazard problem was of no practical significance; any advantage to a country from devaluing its debt in the market to get access to set-asides would be overwhelmed by the disadvantages to its reputation and to the soundness of its finances. In the end, the proposal was formally dropped, but the wording of the fi-

[51]"Fund Involvement in the Debt Strategy—Further Considerations," EBS/89/96 (May 12, 1989), p. 4.

[52]Also see footnote 12, p. 481.

[53]"Fund Involvement in the Debt Strategy—Further Considerations," EBS/89/96 (May 12, 1989), p. 3.

[54]See "The Fund's Liquidity and Financing Needs—Update," EBS/89/100 (May 17, 1989), p. 7.

[55]Kafka's position was stated at EBM/89/58, p. 16. Some speakers also questioned whether the proposal might violate the "equal treatment" of members required by the Fund's Articles. The staff argued in response that the "deep discount" requirement was an example of a type of "balance of payments need." As long as any member facing that particular problem was eligible, then equal treatment was satisfied. See the statement by William E. Holder (Deputy General Counsel), at EBM/89/60, p. 3.

nal agreement implied that only countries with deeply discounted debt would be likely to qualify.

The fourth area of contention concerned modifications to the policy on financing assurances. The basic policy then in effect specified that the Fund would approve arrangements only when it had received firm assurances that the member's adjustment program would be fully financed. Accumulation of arrears did not count as financing, although—as discussed above—the Fund had allowed a few exceptions to that policy over the preceding three years. The staff now concluded that other creditors should no longer be allowed to determine whether an arrangement would be approved. They proposed that the policy be broadened to include toleration of arrears in some cases, while retaining critical-mass requirements and "approval in principle" as options.[56] Directors had no objection to the idea of accepting arrears to bank creditors (i.e., approving the program while negotiations were ongoing), but several of them (Enoch, Goos, Ovi, and others) did object to changing the policy vis-à-vis official creditors.[57] That view was accepted, and the final agreement was that "an accumulation of arrears to banks may have to be tolerated where negotiations continue and the country's financing situation does not allow them to be avoided. . . . The Fund's policy of nontoleration of arrears to official creditors remains unchanged."

It had, after all, not been easy, but the Brady Plan was adopted essentially intact, and the debt strategy was substantially expanded.

Debt Reduction Programs in the Fund

The Fund began implementing the new strategy immediately. Visibly, the institutional role was to negotiate and finance adjustment programs with qualified countries and to provide for augmentation of the arrangements in support of negotiated settlements with bank creditors. Less visibly but just as crucially for the success of the strategy, the staff responded to requests from debtors for technical assistance in preparing for negotiations with creditors. A key element of the Brady Plan was a menu of options for creditors to choose from, each of which was designed to have approximately the same discounted present value as the current price of the country's bank debt in the secondary market. Basing the menu on market prices was designed to reduce the scope for dragging out negotiations as each side sought to gain advantages, but it introduced new and technically complex elements into the process that were not immediately accepted by all parties. The

[56]"Fund Involvement in the Debt Strategy—Further Considerations," EBS/89/96 (May 12, 1989), p. 7–8.

[57]The staff recommendation, in part, was that the Fund "should be prepared to approve outright an arrangement with a member before agreement on a suitable financing package has been agreed with creditors in cases where negotiations with creditors proved to be prolonged, and where it was judged that such prompt Fund support was essential to the economic program. . . ." "The Fund's Policy on Financing Assurances," EBS/89/79 (April 20, 1989), p. 13.

Fund staff—especially Michael P. Dooley (Assistant Director of the Research Department), who had first developed the analytical structure for the menu approach, and Maxwell Watson, who chaired the Junior Debt Group—met frequently (often secretly and over the objections of the U.S. authorities) with officials of indebted countries to advise them on how to evaluate creditors' proposals for menu options. During 1989 alone, such assistance was given to Argentina, Brazil, Costa Rica, Mexico, the Philippines, and Venezuela.[58] Separately, the staff also met with bankers to help explain the authorities' position in the negotiations.

By mid-May, the staff reports for three possible financing cases—Costa Rica, the Philippines, and Mexico—had already been circulated and were waiting only for the approval of the guidelines. A fourth—Venezuela—was in the final drafting stages. Having finished its marathon debate on the morning of May 23, 1989, the Executive Board caught its collective breath over lunch and then went to work on the first two cases that same afternoon.

Costa Rica

The path that brought Costa Rica to the front of the queue for the Brady Plan was essentially the same path trod by so many other developing countries in the 1980s. What made this case stand out was the magnitude and the persistence of the deadlock between the indebted country and her commercial bank creditors.

The Crisis Develops: 1980–83

The journey began in a familiar place. Costa Rica developed severe macroeconomic imbalances in the early 1980s as the result of excess government spending, fueled by external borrowing contracted at interest rates that were initially negative in real terms and that became unbearably costly by 1980, and aggravated by a substantial deterioration in the terms of trade (by 20 percent from 1980 to 1982).[59] Costa Rica's initial response to the external shocks incorporated too little policy adjustment. The authorities negotiated a stand-by arrangement and then an EFF arrangement with the Fund in 1980 and 1981, respectively, but the programs were not well implemented and—notwithstanding the onset of a severe recession—failed to resolve the imbalances.[60]

[58]For a report on the seminal visit, see "Technical Assistance Visit to Mexico," memorandum from Guillermo Calvo (Senior Advisor in the Research Department), Dooley, and Watson to the Managing Director (June 6, 1989); IMF/RD Managing Director file "Mexico, January–October 1989" (Accession 91/455, Box 2, Section 446).

[59]For detailed discussions of the development and treatment of the Costa Rican crisis, see Castillo (1988) and Nelson (1990).

[60]Prior to the 1980 stand-by arrangement, Costa Rica's obligations to the Fund totaled SDR 35.4 million (86 percent of quota, or about $45 million), owing to loans under the oil facility and the CFF. The government made only one drawing under each program, plus one more CFF drawing in June 1981. When the EFF arrangement was canceled in December 1982, obligations totaled SDR 84.2 million (137 percent of quota, or $93 million).

The economic crisis became a debt crisis in July 1981, when the government suspended paying interest or principal on bank debts. That put the EFF arrangement on hold (though payments to the Fund and other multilateral institutions continued on schedule). A new government was elected in February 1982; soon after they took office in May, they sought a new stand-by arrangement with the Fund. Negotiations for that arrangement were prolonged, partly because the more general debt crisis exploded around Latin America at the same time, but principally because bank creditors were reluctant to approve a rescheduling for Costa Rica. Although the Fund's policy of requiring financing assurances was working effectively in situations where the banks' solvency would have been threatened by a failure to reach agreement, it was less effective where the banks' exposure was relatively small. In dealing with Costa Rica, whose external debt was less than 5 percent of Brazil's (though far larger in relation to GDP), the bank creditors decided to bargain hard.

In December 1982, shortly after the banks agreed to reschedule outstanding loans and settle arrears (on terms that were substantially more severe than those granted to the larger indebted countries), the EFF arrangement was canceled and replaced by an ordinary stand-by-arrangement. This time the program was fully implemented, the arrangement was fully utilized, and by the end of 1983 Costa Rica had made remarkable progress toward stabilization.[61] The difficulty—little appreciated at the time—was that the settlement had left the country with a debt-service burden that would absorb more than 50 percent of Costa Rica's total export revenues over the next several years and that would block the restoration of stable growth.

Standoff with Bank Creditors: 1985–87

Two years later, Costa Rica went again to the Fund for assistance in coping with its debts. A stand-by arrangement was negotiated in early 1985, but it went off track: first temporarily, because of delays in obtaining external financing from commercial banks and the World Bank, and then more seriously because of slippages in controlling monetary growth. The arrangement expired with two of the five scheduled purchases undrawn.[62]

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[61]At the conclusion of the 1983 stand-by arrangement, Costa Rica's obligations totaled SDR 183.3 million (the all-time peak): 218 percent of the just-increased quota, or approximately $191 million.

[62]The arrangement, approved on March 13, 1985, was for SDR 54 million (64 percent of quota, or $52 million), to be drawn in five installments over 13 months. The text is in "Costa Rica—Stand-By Arrangement," EBS/85/31, Sup. 2 (March 14, 1985). Costa Rica drew SDR 14 million on approval and another SDR 10 million in April. In October 1985, the Executive Board granted a waiver for the failure to meet the test on reducing external arrears (Decision No. 8109-(85/155), adopted October 23, 1985). Costa Rica then drew down another SDR 10 million. No further drawings were made, and the arrangement expired on April 30, 1986, with an undrawn balance of SDR 20 million. Repayments of earlier obligations exceeded the drawings under this arrangement, and at end-April, Costa Rica's obligations to the Fund totaled SDR 165.7 million (197 percent of quota, or $195 million).

A new government, headed by the future recipient of the Nobel Peace Prize, Oscar Arias Sanchez, was elected in 1986 and immediately sought to negotiate a new stand-by arrangement with the Fund. That effort failed over differences in view regarding the appropriate pace of adjustment in fiscal policy, and in July Costa Rica again went into arrears to its commercial bank creditors. Although the Fund staff believed that the first priority was to strengthen the adjustment effort, they also concluded that the debt burden had become an independent problem that had to be resolved. As the staff report for the 1986 Article IV consultation put it, "even under the most optimistic scenario, there will be a continuous need for substantial debt relief in the years ahead."[63] Without debt relief, the economy could not achieve its growth potential; without growth, the country could not generate enough foreign exchange to service the foreign debt.

In September and October 1986, President Arias's finance minister, Fernando Naranjo Villalobos, met in New York with the banks' Advisory Committee (chaired, like that of Bolivia, by Merten) to propose a long-term solution to Costa Rica's vicious-circle debt problem. The proposal—radical for its day but judged by the Fund staff to be realistically based on the government's capacity to pay—called on the banks to reschedule debts over 25 years, with interest rates rising from 2½ percent initially to no more than 6 percent after seven years and with interest payments capped at no more than 1½ percent of GDP. As evidence of good faith, in October the government unilaterally began making partial interest payments to limit the accumulation of arrears.[64] The Advisory Committee, unwilling to set a precedent that could affect its ongoing negotiations with the larger countries in Latin America, rejected the proposal.

Simultaneously with the bank negotiations, Naranjo met several times with the Fund staff and management to try to get support for the government's economic program. On December 3, 1986, Arias joined the battle, coming to the Fund for a meeting with de Larosière.[65] The Managing Director continued to insist that stricter control of the budget deficit was needed before the Fund could agree to a stand-by arrangement.

After two more missions by the staff to Costa Rica, agreement was reached in April 1987 on the terms of an economic program that the Fund was prepared to support with a stand-by arrangement. Before the proposal could be presented to the Executive Board, however, the authorities would have to make substantive

[63]"Costa Rica—Staff Report for the 1986 Article IV Consultation," SM/86/241 (September 15, 1986), p. 14.

[64]At the time, Costa Rica's arrears to bank creditors amounted to about $33 million. The government began paying interest at the rate of $5 million a month, which was somewhat less than the amount coming due.

[65]This visit was part of a wider effort by Arias to get additional financial support to cover the spillover costs to Costa Rica from the civil war in neighboring Nicaragua. In late 1986, an estimated 250,000 Nicaraguan refugees were in Costa Rica, equivalent to 10 percent of the local population. The United States, which had been providing covert support to the insurgency in Nicaragua, was also providing official assistance to Costa Rica that amounted to nearly 5 percent of Costa Rica's GDP.

progress in their negotiations with the banks. Those negotiations had been going badly for months, and in the wake of the Brazilian moratorium on debt servicing (Chapter 10), they were going nowhere at all. Although no one could have predicted it at the time, the difficulties that were already evident were leading to a stalemate in the negotiations between Costa Rica and its bank creditors that would persist until 1989.

The banks' Advisory Committee had three main concerns. First, it wanted to avoid any deal that included innovative options or an unusual degree of concessionality, which could complicate its negotiations with Brazil and other heavily indebted countries. Second, the banks represented on the committee had different needs and perspectives, and they were having great difficulty agreeing among themselves on the best approach to take with regard to Costa Rica. Although an innovative approach seemed to be called for to cater to these differences, there was a danger that any new proposal could further complicate the process.[66]

The banks' third concern was that they were being asked to fill the lion's share of Costa Rica's financing gap. The Fund was proposing to accept a stand-by arrangement totaling SDR 50 million (59.5 percent of quota, or roughly $68 million), to be made available in six installments over 18 months. Even assuming full utilization of the arrangement, scheduled repayments to the Fund from earlier loans would exceed drawings during this period, so the Fund's exposure in Costa Rica was anticipated to decline by SDR 15 million before the arrangement expired. Small changes were projected for Paris Club creditors and the World Bank, while the banks were being asked to raise their exposure by $200 million (approximately a 10 percent increase) through the end of 1988. Throughout 1987 and into 1988, the Advisory Committee banks tried without success to convince the Fund to accept a larger arrangement that would at least result in a net cash flow to Costa Rica.[67] The Fund's position was that its role should be primarily to assist the government in obtaining longer-term financial assistance from other creditors by promoting adequate macroeconomic and structural policies, and that the requested bank financing was moderate and reasonable.

After the Managing Director (Camdessus) approved the Letter of Intent for the stand-by arrangement in April 1987, the government tried to resolve the impasse

[66]In May 1987, Citibank's decision to set aside $3 billion in reserves as a provision against losses on loans to developing countries gave it a greater ability to resist pressures to accept costly solutions for individual countries. Bank of America had a larger ratio of nonperforming loans and was less able to extricate itself through loan-loss provisioning. Both banks were members of the Advisory Committee.

[67]Costa Rica could have requested an additional SDR 55 million ($70 million) through the CFF to compensate for the depressed level of world prices for coffee (Costa Rica's principal export commodity). The Fund discouraged the authorities from making that request. While it would have facilitated an agreement with the Advisory Committee, the staff were concerned that the primary effect would have been to correspondingly reduce the amount that the country could have expected to obtain from the banks.

with the banks by proposing a menu of long-term financing options, including exit bonds and debt-equity swaps, as a means of coping with the diversity of needs and strategies among creditor banks. Arias came to the Fund for a second time, in June, but there was little that Camdessus could do other than to try to encourage the banks to be more forthcoming. In late July, the Advisory Committee informed Naranjo that it had decided to wait until October to resume discussions, apparently so as first to achieve some progress with Brazil. The minister then went to Washington to tell Sterie T. Beza, the Director of the Western Hemisphere Department, that as long as the Fund put off approving the stand-by arrangement, Costa Rica had no real hope of getting help from other official creditors. Beza did not believe that approving the arrangement "in principle" would make much difference. That procedure worked reasonably well in situations where negotiations with banks were nearly finalized, which was not the situation here. Naranjo asked if the Fund could approve the arrangement without waiting for the banks, by accepting the accumulation of external arrears. Beza responded that this would be a "major departure from present practices," but he agreed to take up the request with management.[68]

Camdessus took the view that the Fund could consider approving the program under these circumstances, but only with the concurrence of the Advisory Committee banks and other creditors. Throughout August 1987, both Beza and the Deputy Managing Director, Richard Erb, sounded out various private and official creditors, all of whom agreed on the desirability of showing flexibility in this particular case. A detailed strategy was then developed in September and finalized during the Annual Meetings at the end of that month. First, the government agreed with the Fund to tighten credit policies by enough to ensure that the program would stay on track. Second, the government agreed with the banks on an interim schedule of partial interest payments. Third, the banks—while refraining from formally accepting the accumulation of arrears—agreed to provide a general statement of support for the strategy. On that basis, the Managing Director approved presenting the proposed stand-by arrangement to the Executive Board and asking the Board to approve temporarily the continued accumulation of arrears:

> In the particular circumstances of this case, the staff recommends that the Executive Board approve the stand-by arrangement and the exchange restrictions evidenced by existing external payments arrears and by the external arrears that will remain pending rescheduling agreements until April 30, 1988, or the completion of the second

[68]The quotation is from a memorandum from Beza to the Managing Director (July 28, 1987), reporting on his meeting with Naranjo; in IMF/RD Managing Director file "Costa Rica, November 1986–December 1987" (Accession 88/14, Box 1, Section 550). As discussed in Chapter 10, the Fund had approved a stand-by arrangement with Bolivia in 1986, while Bolivia had outstanding arrears to bank creditors. The Costa Rica case was more complicated in that the government was using an exchange restriction, which was subject to IMF jurisdiction, to prevent the transfer of foreign exchange for the purpose of servicing bank debts. Moreover, Bolivia was regarded as an exceptional case because of its very low per capita income.

> program review, whichever is earlier. This action would provide Costa Rica and the commercial banks with the time needed to make satisfactory progress toward the conclusion of a financing package. This package will be the subject of the second review of the program.[69]

The Executive Board meeting to consider the proposal was to be held on October 28, 1987. Shortly before the meeting, some Executive Directors objected informally to the proposal to approve the exchange restriction that was the basis for the accumulation of arrears to banks. The staff then decided to finesse the issue by withdrawing that element of the proposed decision. That amendment meant that the Fund would approve the loan but not the restriction. Costa Rica would be out of compliance with its obligations under Article VIII, section 2(a), but in the opinion of the Fund's legal counsel, approval of a stand-by arrangement neither required the member to be in compliance with that provision nor implied the Fund's approval of a restriction that conflicted with the Articles.[70] The Board accepted that interpretation, albeit reluctantly, and the stand-by arrangement was approved.[71]

Debt Relief: 1988–89

Unfortunately, Costa Rica was able neither to implement the 1988 economic program underlying the stand-by arrangement nor to negotiate an agreement with the banks. To keep monetary policy on track required either a tightening of the budget or a rise in domestic interest rates, and the government was unwilling to do either. The authorities decided not to request any drawings under the arrangement until they could establish a record of keeping the program on track. Although policies improved in the course of 1988 and departures from the program criteria were relatively minor, no drawings were ever made.[72]

The Advisory Committee met regularly throughout 1988 but was unable to resolve its internal differences. In May, the Bank of America proposed a complex scheme involving the issuance of zero-coupon bonds financed in part by a new-money loan, "rolling" interest-rate guarantees (i.e., establishment of a fund to

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[69]"Costa Rica—Request for Stand-By Arrangement—Letter of Intent," EBS/87/91, Sup. 1 (October 16, 1987), p. 22.

[70]Minutes of EBM/87/150 (October 28, 1987), pp. 4–5.

[71]Several Executive Directors (notably Bernd Goos—Alternate, Germany; Filippo Di Mauro—Temporary Alternate, Italy; and Masahiro Sugita—Alternate, Japan) expressed misgivings about the procedure and noted that their preference would have been to approve the arrangement in principle, pending completion of the financing arrangements. None abstained from approving the proposed decision.

[72]The Fund's initial approval of the arrangement entitled Costa Rica to make the first scheduled drawing, but the authorities elected not to avail themselves of it. The next scheduled drawing was dependent on completion of a review. When a staff mission in January 1988 determined that the credit ceilings were not met, the authorities elected not to request a waiver. For a summary of the problems with the stand-by arrangement, see "Costa Rica—Staff Report for the 1989 Article IV Consultation and Request for Stand-By Arrangement," EBS/89/87 (May 3, 1989), pp. 3–5.

guarantee interest payments for four quarters ahead), concessional interest rates linked to economic performance, and with official support to be coordinated by the World Bank through a consultative group. That proposal was eventually shot down by other banks on the committee, and the World Bank declined to participate in it.[73] Meanwhile, the Fund staff (Dooley and Watson) began providing technical assistance to the authorities on how to arrange to buy back their bank loans at market-based discounts.

A partial breakthrough was finally achieved at the end of November, 1988, when the government and the Advisory Committee agreed on the outline for a two-stage approach to reducing Costa Rica's debt burden and settling arrears. In the first stage, Costa Rica would buy back a substantial portion of its bank loans from a subset of creditor banks that were willing to participate, at heavily discounted prices reflecting the prevailing prices in the secondary market. In the second stage, the full set of creditor banks would be asked to choose from among a menu of options to replace the existing loans with bonds or other financial instruments. That specific proposal failed to gain enough support from noncommittee banks, but it did generate the momentum that would carry negotiations to a successful conclusion within a few months.[74]

In February 1989, the government opened negotiations with the Fund on a program to be supported by a new stand-by arrangement. The staff mission to the Costa Rican capital, San José, failed to get an agreement, principally because of differences over the size of the fiscal deficit: the authorities wanted to set a target for the 1989 deficit that was approximately unchanged from the 1988 outturn (3½ percent of GDP), while the staff (led by Armando Linde, Chief of the Central American Division in the Western Hemisphere Department) argued that the deficit had to be reduced by at least ¾ of a percentage point. Naranjo went to Washington to make the case to the Managing Director, and after a telephone conference between Camdessus and Arias, a compromise was reached under which small additional fiscal cuts were accepted.[75]

The ink was barely dry on the Letter of Intent when Secretary Brady announced his support for an institutionalized debt-relief plan on March 10. Costa Rica and the Advisory Committee continued to negotiate over the next two months, but now both sides felt able to telescope the process into a single operation in which the debt buyback would be part of the general menu of exit options offered to par-

[73]See "Summary of negotiations with commercial banks" (undated), in IMF/RD Managing Director file "Costa Rica, January–May 1989" (Accession 91/454, Box 4, Section 446).

[74]The buyback scheme required each nonparticipating bank to waive its right to receive a proportional share of any payments, and a number of banks were unwilling to do so on the terms that were offered.

[75]The agreement met the Fund's request that the fiscal deficit be reduced by ¾ of 1 percent of GDP; but it did so by cutting budgeted spending by just ¼ of 1 percent of GDP and deriving the rest by reestimating projected losses by the central bank. The revisions are summarized in memorandums from Beza to the Managing Director, dated February 28 and March 13, 1989; in IMF/RD Managing Director file "Costa Rica, January–May 1989" (Accession 91/454, Box 4, Section 446).

ticipating banks. Agreement on terms was finalized in mid-May, setting the stage for the Fund to consider its own role in the process.

The proposed stand-by arrangement had much to recommend it when the Executive Board met to consider it in the afternoon of May 23, 1989. Not only had the government already demonstrated an ability to implement reasonable policy restraint under extraordinarily difficult circumstances; the country also clearly needed support from the Fund. Costa Rica's external debt to bilateral creditors was large, growing, and heavily in arrears, while obligations to the Fund were at their lowest level since 1981.[76] There were problems, however. One difficulty was that this first case brought forward under the Brady Plan fell short of the guidelines that the Fund had just promulgated that very morning. Because presidential elections would be held in less than a year, the staff had thought it prudent to limit the arrangement to a 12-month stand-by arrangement; the guidelines called for a medium-term program to be in place and supported by an EFF arrangement. The guidelines also called for the program to promote investment, in particular through the support of the Multilateral Investment Guarantee Agency (MIGA, part of the World Bank Group). Costa Rica was not yet a signatory to MIGA and it was still too early in the reform process to project a rise in investment. Nonetheless, as Dara McCormack (Alternate—Ireland) observed, it made no sense to penalize Costa Rica simply because it was a test case for the Brady Plan.[77]

A second problem was the same one that had plagued Costa Rica for five years: the persistence of arrears to the banks. The Brady Plan elements of the stand-by arrangement might help to eliminate those arrears: 25 percent of each scheduled drawing was to be set aside for debt reduction through buybacks or similar schemes, and—once a financing agreement was reached with the banks—Costa Rica had the right to request an augmentation of the arrangement by up to 40 percent of its quota (i.e., by SDR 33.64 million, or approximately $43 million), to support debt-relief operations. But those amounts were small relative to the level of arrears, and it was clear that Costa Rica did not have the means to eliminate arrears completely until it had negotiated concessional terms from the banks, obtained additional assistance from official creditors, and successfully implemented the adjustment program.[78] The staff argued that because the government had adopted a program to eliminate arrears gradually, the Fund should "tolerate" (but not "condone") the temporary continuation of arrears. The Managing Director recommended (for the second time in less than two years) that the Fund approve the exchange restriction under which Costa Rica was accumulating arrears, but (as before) several Executive Directors objected. The proposed decision was ap-

[76]At the end of April 1989, Costa Rica owed the Fund SDR 46.84 million (31 percent of quota, approximately $61 million).

[77]Minutes of EBM/89/62 (May 23, 1989), pp. 22–23.

[78]Costa Rica's arrears to the banks amounted to about $300 million. The stand-by arrangement totaled SDR 42 million ($53 million), so the maximum amount available under set-asides and augmentation was on the order of $56 million.

proved only after acceptance of an amendment eliminating the approval of the restriction.[79]

Of more general concern was the proposal to provide for augmentation of the arrangement at a future date. This proposal was without precedent, and several Directors suggested that the Board should avoid prejudging the issue until after the authorities had concluded their negotiations with the banks. In the course of the meeting, both Camdessus and Erb offered amendments that addressed those concerns, and a slightly watered-down version was passed.[80]

Three days after the Fund approved the arrangement, the Paris Club agreed to reschedule Costa Rica's bilateral official debts. Unfortunately, this official support did little to help accelerate an agreement with the banks, who continued to show little interest in compromising. Not only were the banks still fearful about setting a precedent for larger countries, but now many of them were worried about making a longer-term commitment while the Fund's commitment was limited to 12 months.

Naranjo met frequently with Merten and the Advisory Committee throughout the summer, while Linde's staff team worked with the authorities to try to keep the adjustment program—especially fiscal policy—on track. Neither effort had much success, and both became increasingly more difficult as the 1990 election neared. Only after political intervention at the highest level did the Advisory Committee agree to the outlines of an agreement—announced jointly in San José by Arias and U.S. President George Bush—at the end of October, 1989.[81] Meanwhile, owing to an excessive money-financed fiscal deficit (arguably an inevitable result of the delays in obtaining external financing from bank creditors), Costa Rica never did draw on the stand-by arrangement, which expired unused in May 1990.

Although the Fund was unable to provide any money to Costa Rica, the institution did help keep the negotiations on the details of the bank agreement from collapsing, first by having the staff advise both the authorities and the banks on the valuation and the consistency of various options and later by providing what

[79]The quotations are from "Costa Rica—Staff Report for the 1989 Article IV Consultation and Request for Stand-By Arrangement," EBS/89/87, Sup. 1 (May 19, 1989), pp. 2–3. The Executive Board Decision was No. 9154-(89/62), adopted May 23, 1989. For the context, see p. 500, above.

[80]After noting the authorities' intention to request the augmentation by 40 percent of quota, the amended decision read: "The Fund will be prepared to consider [such] *an* augmentation in the event that the arrangements for the financing of Costa Rica's program provide for appropriate debt service reduction and upon determination by the Fund that such arrangements are consistent with the [objectives of the program] *guidelines on Fund involvement in the debt strategy, approved at EBM/89/61 (5/23/89)*." The first amendment (deletions in square brackets; additions in italics) was suggested by Erb, to avoid prejudging the amount that might be considered. The second was offered by Camdessus to ensure that the Board would retain the right to consider whether the request was consistent with the Fund's general policy guidelines. Executive Board Decision No. 9155-(89/62); minutes of EBM/89/62 (May 23, 1989), pp. 46–49.

[81]The occasion was a two-day summit meeting of 16 elected heads of government from the Americas, called by Arias to celebrate a century of democracy in Costa Rica.

Erb characterized as a "highly qualified" letter of support to the banks.[82] Finally, on May 5, 1990, just three days before Arias's four years as president were also to expire, Costa Rica and the banks completed the agreement that would go a long way toward ending Costa Rica's decade of crisis. The banks agreed to make at least 60 percent of the $1.8 billion of outstanding medium-term debt (including $325 million in past-due interest) available for Costa Rica to repurchase at 16 cents on the dollar (approximately equal to the price in the secondary market). The remaining debt was to be converted into bearer bonds, a portion of which was to be included in a debt-equity conversion program; and terms on the bearer bonds were to be enhanced if Costa Rica's GDP reached a level 20 percent above the 1989 level. The bulk of the $225 million cost of the package was to be covered by official bilateral sources, most of which had been arranged by U.S. officials.[83] Thus the first case under the Brady Plan ultimately succeeded, with the Fund playing a purely catalytic role.

The Philippines

In many ways, the request by the Philippines for an extended arrangement under the guidelines of the Brady Plan was relatively straightforward. After more than a quarter century of prolonged use of Fund resources, the government that had been elected in 1986—headed by President Corazon Aquino—had finally established a track record of adjustment and adherence to programs. (For the history of the earlier period, see Chapter 13.) Most recently, economic performance had been satisfactory throughout the period of the stand-by arrangement of 1986–88, and that arrangement had been fully utilized. In March 1989, the authorities had signed a Letter of Intent requesting a three-year arrangement under the EFF and had indicated their intention to request that the special features of the Brady Plan be applied to it. The staff assessment was that the authorities' economic program

[82]The letter, sent on December 18, 1989, over Camdessus's signature, read in part: "Performance under the stand-by arrangement has been positive in many respects. . . . However, fiscal performance has fallen short of projections. . . . The finalization of the agreement [between the government and the banks], in the context of the implementation of sound economic policies, will be a necessary step toward attaining payments viability for Costa Rica. On the basis of policies that would assure performance in line with the medium-term economic path that had been established, the Fund would be in a position to contribute resources. . . ." In IMF/RD Managing Director file "Costa Rica, May 1989–December 1990" (Accession 91/454, Box 6, Section 446).

[83]Costa Rica put up $42 million from its own foreign exchange reserves. The remainder came from external grants from the United States, Canada, and the Netherlands ($43 million); a medium-term loan from Taiwan Province of China ($40 million); and short-term loans from Mexico, Venezuela, and an offshore affiliate of Costa Rica's National Bank ($100 million). The package is described in detail in "Costa Rica—Debt and Debt-Service Reduction and Refinancing Operations Contemplated Under the 1989 Financing Package," EBS/89/243 (December 27, 1989). The official financing arrangements are described in "Costa Rica—Staff Report for the 1990 Article IV Consultation, Request for a Stand-By Arrangement and External Contingency Financing, and Request for a Purchase Under the CCFF," EBS/91/40 (March 14, 1991), pp. 52–53.

fully qualified for the requested support.[84] When the Executive Board met to consider the request, immediately following the meeting on Costa Rica on May 23, the only question was whether the situation met the just-approved guidelines for the new debt strategy.

The difficulty was that the authorities had made little headway in negotiations with creditors during the two months since the Letter of Intent had been approved, partly because of long-standing differences over how much debt service the country could afford to pay, but also because creditors were reluctant to negotiate until the scope for Fund and World Bank assistance under the Brady Plan was clarified. Consequently, there was a very large ($1.7 billion) financing gap for 1989–90, which would have to be filled through the accumulation of arrears to the banks until an agreement could be reached. Moreover, there was as yet no rescheduling agreement with the Paris Club, and the guidelines emphasized that the Fund would not normally tolerate arrears to official creditors.

Charles Enoch, on behalf of the United Kingdom, objected to the proposal to approve the Philippines' request outright. He preferred instead to approve it in principle, pending further progress in negotiations with official and commercial creditors. He noted that the Philippines had sufficient foreign exchange reserves to fund the program over the next several months, and he concluded that there was no solid basis for going beyond the new guidelines. That view was supported by Directors from Germany, Italy, the Netherlands, and Finland. The majority of the Board, however, concluded that it was important to signal the Fund's support immediately and forcefully both to the Paris Club (which was meeting the following week to consider the Philippines' request for a rescheduling) and to the banks. With five Directors abstaining, the requested arrangement was approved in short order.[85]

The arrangement began well, as the authorities managed to adhere to most of the program targets throughout 1989 while continuing to negotiate with the banks. An agreement was reached in January 1990, under which the Philippines was able to buy back some $1.34 billion in bank loans at a 50 percent discount. The buyback was financed in part using SDR 94 million ($125 million) that had

[84]The staff report, "Philippines—Staff Report on Request for an Extended Arrangement and Possible Access to Contingency Financing Under the CCFF," EBS/89/59, Sup. 1, was circulated on May 1, 1989. On May 23, a supplement was circulated requesting the use of set-asides and noting the possibility that a request for augmentation might be forthcoming at a later date.

[85]Minutes of EBM/89/62 (May 23, 1989). The abstaining Directors held approximately 26 percent of the voting power on the Board. The three-year arrangement totaled SDR 661 million ($830 million, or 150 percent of quota). The Board also approved the provision of external contingency financing under the Compensatory and Contingency Financing Facility (CCFF), up to a ceiling of SDR 286 million, and it agreed to consider a request to augment the arrangement by up to 40 percent of quota (SDR 176 million) once an appropriate agreement had been reached with bank creditors. Of that SDR 1.1 billion in potential access, the Philippines borrowed just SDR 236 million, all before the end of 1989. The extended arrangement was canceled in February 1991.

been set aside from Fund drawings made in 1989.[86] Another $150 million was provided by the World Bank through its program under the Brady Plan. Although the economic program of the Philippines later went off track, in this case the Brady Plan had already led directly to a small but significant reduction in the country's debt burden.

Mexico

The third Brady deal came right on the heels of the first two, before the week was over. Three days after approving the Costa Rica and Philippines arrangements, the Executive Board met on Friday, May 26, 1989, to consider a much larger request: a three-year EFF arrangement and related financing for Mexico with a potential value of more than SDR 3.7 billion ($4.6 billion). In contrast to Costa Rica, Mexico had been a prolonged user of Fund resources since 1982 and now owed the Fund SDR 3.36 billion (288 percent of quota, or $4.2 billion). If Mexico were to make maximum use of the proposed arrangement, including the 40 percent augmentation for debt reduction provided by the new guidelines and assuming timely repayment of the existing loans, those obligations would rise to nearly SDR 4.7 billion (400 percent of quota, or $5.8 billion) by mid-1992. The Fund was about to make one of the largest loan commitments in its history.[87]

Coupling Reform with Relief: July 1988–April 1989

Mexico had established a reasonably good record of economic stability by 1989 but was still being buffeted by internal imbalances and external shocks. The 1986–88 stand-by arrangement, discussed in Chapter 10, had been fully utilized, after which the authorities' intention had been not to seek further financial assistance from the Fund but rather to arrange for enhanced surveillance as a means of encouraging support from other creditors. However, 1988 was a presidential election year: Carlos Salinas de Gortari was elected in July with just a hair over 50 percent of the vote, and the once-invincible *Partido Revolucionario Institucional* (PRI) would continue to rule but with a diminished and shaky political foundation. By the time Hurricane Gilbert hit the Yucatan

[86]The amount that was to have been set aside from the first drawing (in May 1989) was not disbursed, owing to the lack of progress in negotiations with banks. To support the January 1990 buyback operation, the Executive Board agreed in December 1989 to make that amount available, along with the amount scheduled for that month, and to front-load the set-asides that were to become available in June and December 1990. That decision enabled the authorities to use SDR 94.4 million of the SDR 165.2 million December drawing for this purpose. See "Philippines—Staff Report for the 1989 Article IV Consultation and Review, Waiver, and Modification of the Extended Arrangement," EBS/89/229 (December 1, 1989), pp. 1–3; and minutes of EBM/89/167 (December 20, 1989).

[87]The total potential lending commitment including the possible augmentation and the CCFF drawing had been exceeded in absolute size only by the extended arrangements with India in 1981 and Brazil in 1983.

peninsula in late September, inflation was accelerating, Mexican exporters were losing international competitiveness, and the central bank was rapidly losing the reserves without which it would soon be unable to keep paying interest on the external debt. In short, the government had lost whatever opportunity might have once existed to finance the external deficit without help from the Fund.

Discussions on the possibility of financial assistance began quietly just after the July 1988 elections, when the head of the central bank, Miguel Mancera, went to Washington to meet with the Managing Director. Mancera then arranged a quiet meeting between Camdessus and Salinas in Monterey, Mexico, so that the Managing Director could impress upon the incoming president the importance of strengthening economic policies. (As planning minister, Salinas had advocated much higher spending than the Fund had thought prudent.) Discussions continued at the Annual Meetings in Berlin, and shortly afterward Mexico requested a loan under the CCFF to compensate for a shortfall in petroleum exports and a rise in the cost of cereals imports (maize, sorghum, and wheat) in response to the effect of poor weather on domestic production.

In February 1989, after Salinas had been in office for two months and had implemented a new adjustment program (a modification of the *Pacto*, described in Chapter 10), he decided to seek an extended arrangement from the Fund. Salinas insisted, however, that any arrangement be part of a broader financial package that included substantial debt relief from bank creditors. When the staff team—led by Claudio Loser, Senior Advisor in the Western Hemisphere Department—arrived in Mexico City in mid-February, it was not at all clear how much support the Fund could offer with regard to debt relief, but the mission was cleared to discuss that option along with the terms of a three-year EFF arrangement. That mission did not conclude the negotiations, principally because the authorities had made little progress in securing external financing commitments.[88] The delay was just as well, because the mission ended just one week before Secretary Brady's March 10 speech changed all the assumptions and ground rules on debt relief.

The effect of all of this activity was that when the Brady Plan was launched, discussions were well advanced between Mexico and the Fund on exactly the type of program that the plan was aimed to support. At the end of March, when Mancera went to the Fund to conclude the negotiations, he found a whole new landscape. For the first time, the staff was prepared to acknowledge openly that the magnitude of the external debt was a major independent barrier to the resumption of economic growth: Mexico could no longer expect to get enough "new money" from the banks to reduce its debt-service obligations to a sustainable level, and unless it

[88]Memorandum from Loser to management (March 7, 1989); in IMF/RD Managing Director file "Mexico, January–October 30, 1989" (Accession 91/454, Box 2, Section 446). Negotiations over performance criteria were not difficult in this instance. As Jacques Polak observed, the staff "accepted the program essentially as presented" (Polak, 1991, p. 50).

could get to that level, the government could not expect to attract and retain the capital that was essential for growth.[89]

Up to this point, the IMF had only rarely considered exceptions to the practice of requiring that programs be fully financed prior to the release of the Fund's own resources. Those exceptions had been limited to the cases discussed above—Bolivia and Costa Rica—in which the country had substantial arrears to external creditors that could be cleared only gradually. Now that the Brady Plan was in place, it arguably was no longer necessary or even appropriate to wait for other creditors to agree to terms: banks were no longer being asked to increase their exposure, but rather were expected to reduce their claims according to a generally agreed plan that was to be financed in part by the arrangement with the Fund.[90]

The staff was reluctant to abandon the old strategy until it was clear that the banks would support the new one, but the Managing Director accepted that to do so was essential in this case. The critical meeting came on April 3, when Camdessus acceded to the arguments of Mancera and his deputy, Ariel Buira, that Mexico did not have the means to service its debts unless it received financial assistance before financial arrangements were fully in place. With that understanding, the authorities signed a Letter of Intent on April 11, and Camdessus agreed to schedule a meeting of the Executive Board for an early date after the approval of Brady Plan guidelines.

Mexico's Brady Deal: May–July 1989

When the Board met on May 26, 1989, negotiations between Mexico and the banks still had a long way to go. The finance minister, Pedro Aspe Armella, had started the ball rolling by meeting with bank creditors in New York in early April, and the Mexican negotiating team had subsequently presented the Advisory Committee with a menu of alternative debt reduction schemes that were estimated to be equivalent in risk-adjusted net present value but that were tailored to fit the regulatory and other diverse circumstances of individual banks. The committee had, however, expressed skepticism about the menu. Months would be required before enough proposals and counterproposals could be tabled and examined to bring the two sides together.

Directors were mostly satisfied with the program and the proposed financial arrangement. The Fund's resources were expected to be part of a broadly based

[89]The use of concerted lending from commercial banks, which less than seven years earlier had been introduced by Managing Director Jacques de Larosière as an emergency measure in the heat of the initial debt crisis, was now dismissed in the staff report as the "traditional new money approach." "Under the assumption that the external financing being sought would be obtained entirely through the traditional new money approach," the report noted, Mexico would see little if any improvement in its external balance or its growth rate. "Debt reduction operations would help avoid these adverse effects. . . ." "Mexico—Staff Report for the 1989 Article IV Consultation and Request for Extended Fund Arrangement," EBS/89/91 (May 9, 1989), pp. 15–17 and 32.

[90]In the Mexican case, the bank deal was also dependent on financing from a structural adjustment loan from the World Bank, loans from the IDB, and a rescheduling agreement with the Paris Club of official bilateral creditors.

package of official support, including substantial "parallel" financing from the Japanese government as a supplement to the usual resources from the Paris Club and multilateral development banks.[91] Several speakers were plainly worried, however, that negotiating an innovative and expensive deal with commercial banks could be a protracted process. Leonor Filardo (Venezuela), speaking on behalf of Mexico, suggested that perhaps the Fund staff should inject their presence more fully into the negotiations, but the Managing Director noted that this was not their proper function.[92] The staff was providing information to the banks regarding the Mexican economic program and was advising the authorities on the financial implications of various debt-reduction options, but it was not participating in the negotiations.

The only point of serious contention at the Board meeting was the handling of the new Brady elements: the proposal to set aside 30 percent of each drawing for debt reduction and to permit augmentation of the arrangement by 40 percent of quota (SDR 466 million, or $580 million) to help finance the pending bank agreement. The guidelines that had been approved three days earlier called for a 25 percent set-aside, not 30 percent. Although a few Directors groused a bit, the general feeling was that Mexico needed the money for this purpose and could be treated as a special case. The proposed augmentation produced more general consternation. The staff proposal was to note that Mexico intended to request augmentation by "up to" 40 percent of its quota, and that the Fund was "prepared to consider an augmentation" when the negotiations with bank creditors were completed. The Mexican authorities countered that proposal with a request that the Board immediately approve a 40 percent augmentation, to become effective upon completion of the bank package.[93] Approval of that request would not only have preceded the completion of an agreement with bank creditors; it also would have taken Mexico over the normal limit on access to Fund resources for the first year of the program.[94]

Mexico's goal in asking for approval at this stage was to impress upon the banks that sufficient money would be available for debt reduction once the banks agreed on terms, and the authorities justified the request on the basis of the strength of their adjustment program.[95] A number of Directors were reluctant, however (as they had been three days earlier when discussing Costa Rica), to commit the Fund ahead of the banks. It was the same problem that had plagued the debt strategy from the beginning: how to turn a vicious circle of reluctance into a virtuous cir-

[91]Mexico was not yet a signatory to MIGA, but it had formulated a medium-term investment program that would be supported in part by loans from the World Bank and the IDB.

[92]Minutes of EBM/89/64 (May 26, 1989), p. 47.

[93]Statement by Filardo at EBM/89/64 (May 26, 1989), pp. 15–16.

[94]The access limit in place at the time was 110 percent of quota a year, exclusive of any CCFF drawings. The basic EFF arrangement allowed for 80 percent access, so the augmentation would have raised it to 120 percent. To approve that level, the Executive Board would have to invoke the exceptional circumstances clause of the Fund's access policy. (See Chapter 17.)

[95]Mexico was not asking that the SDR 466 million be made available for immediate disbursement; only that the amount of the augmentation be approved up front. Statements by Filardo at EBM/89/64 (May 26, 1989), pp. 15–16 and 28.

cle of commitments. The Mexican request (approval of which required only a simple majority of votes cast) was supported by a substantial majority, but it lacked a clear consensus. Guenter Grosche (Germany) opposed it, as did most other European Directors with the exception of France; Frank Cassell (United Kingdom) stressed that his opposition was based on the principle of not precommitting before full information on the package was available, not because he had any doubts about the viability of the Mexican program.[96] Altogether, those who preferred to stick with the staff proposal represented about 37 percent of the total votes on the Board.

Not wanting to force a decision on the minority, the Managing Director proposed a typically cautious compromise. He noted that even those Directors who favored waiting agreed that the exceptional level of access would be justified if the debt reduction package was strong enough. On that basis, he suggested that the Board approve the staff's original proposal without the Mexican amendment and that the Board agree by consensus that the access limits would not impede the later approval of 40 percent augmentation. Filardo agreed to go along with that compromise, and it was approved without dissent.[97] The effect was that full augmentation could not take place until the Board had the opportunity to conduct a full review of the implementation and financing of the program.

Other official credits fell quickly into place once approval of the Fund arrangement was secured, and attention turned to the banks.[98] Just a few days after the Executive Board meeting, a high-level team of staff experts on financing options went to Mexico City to provide technical assistance to the authorities on developing a viable menu of debt reduction options (see above, p. 499–500). The following week, E. Gerald Corrigan (President of the Federal Reserve Bank of New York) hosted a meeting in Madrid at which Camdessus, Barber B. Conable (President of the World Bank), and Enrique V. Iglesias (President of the IDB) gave a pep talk to the banks on the Mexican adjustment program and the importance of bank support for the debt reduction strategy.[99] Negotiations continued at an intense level through June and much of July, with the Fund staff providing information and with senior U.S. Treasury and Federal Reserve officials intimately involved, goading the banks along and reminding them of the public policy implications of the agreement.

Finally, on July 23, 1989, the Mexican authorities and the Advisory Committee reached agreement: the first Brady deal to be completed. The term sheet covered

[96]Minutes of EBM/89/64–65 (May 26, 1989). Cassell's position is stated in meeting 89/65, pp. 11–13.

[97]Executive Board Decision No. 9162-(89/65), adopted May 26, 1989.

[98]The Paris Club agreed on May 30 to grant Mexico $2.5 billion in debt relief over a three-year period: $1.9 billion by reducing the principal outstanding and $0.6 billion by reducing the present value of scheduled interest payments. On June 13, the IBRD approved three Structural Adjustment Loans totaling $1.5 billion. Additional financing was provided during the year by the IDB and the Export-Import Bank of Japan.

[99]Citibank press release (June 7, 1989); in IMF/RD Managing Director file "Citibank" (Accession 92/194, Box 3, Section 333).

a menu of debt reduction options, each of which was designed to represent approximately a 55 percent discount from the face value of the covered debts (equivalent to the prevailing price of Mexican obligations in the secondary market). In addition to the option of rescheduling existing loans through a new-money facility, the menu permitted banks to replace their loans with 30-year bonds with fully collateralized principal, which could be issued either at par with the loans but with a lower interest rate or at a discount and with a market-oriented interest rate.[100]

From Crisis to Reform: 1989–93

The EFF arrangement and the Brady deal with the banks marked the beginning of the end of Mexico's debt crisis of the 1980s. When Camdessus and Salinas sat down to dinner together in Washington in early October of 1989, the adjustment program was on track, Mexico had made the first two drawings under the arrangement with no difficulty, and the mood of the evening was decidedly upbeat. Though there were a few slips in implementing policies in 1990 (requiring a waiver of some performance criteria),[101] the Mexican economy underwent a rapid transformation and stabilization throughout the period of the EFF arrangement. Inflation fell to single-digit levels, the public sector shifted into a sustained surplus position, net external debt fell by nearly half in relation to domestic output, and private capital began flowing eagerly into the country.[102] Mexico made all of the scheduled drawings under the arrangement, including the augmentation by 40 percent of quota, which was approved by the Executive Board in January 1990.[103]

A much more serious slip would come at the end of 1994, when a new financial crisis would once again place Mexico at the center of the world's attention and create a new and dramatic set of challenges for the IMF. But that is a story for another History.

Venezuela

From Creditor to Debtor: 1988–89

As 1988 drew to a close, the Fund had been conducting enhanced surveillance with Venezuela for 3½ years, in support of a MYRA between Venezuela and its commercial bank creditors. In the last few months, however, deteriorating eco-

[100]For a discussion of the agreement, see Wijnbergen (1991). The interest rate on both the new-money facility and the discount bonds was set at 13/16 of a point above LIBOR, the same odd spread that had been agreed upon after so much agony in September 1986 (see Chapter 10). For further details, see "Mexico's Financing Package," EBS/89/171 (August 23, 1989).

[101]See "Mexico—Waiver and Modification Under the Extended Arrangement," EBS/90/58 (March 26, 1990) and "Mexico—Extended Arrangement—Request for Waiver and Modification," Sup. 1 (April 5, 1990), and Executive Board Decision No. 9409-(90/60), April 18, 1990.

[102]See Loser and Kalter (1992) and the paper by Pedro Aspe Armella in Boughton and Lateef (1994), pp. 126–38.

[103]The arrangement was extended in May 1992 and augmented by an additional 40 percent of quota (SDR 466.2 million), but the authorities at that time expressed their intention not to make any additional drawings unless circumstances worsened materially; the arrangement expired in May 1993 with that amount undrawn.

nomic conditions and the cumulative effect of delayed adjustment (aggravated by the campaign for presidential elections that were scheduled for December) had brought a precipitous drop in foreign exchange reserves. Although the crisis was still incipient,[104] the trend—coupled with the country's massive financing needs for 1989 to cope with maturing commercial debts—would soon make it impossible for the government to continue avoiding drawing on Fund resources.[105] Throughout the 1988 electoral campaign, the leading candidate for the presidency, Carlos Andres Pérez, played a delicate verbal game of abusing the Fund as a vicious foreign power while suggesting that he nonetheless intended to use its resources to get the debt problem and the economy under control.[106]

Following Pérez's election on December 4, Venezuela drew the balance of its reserve tranche in the Fund (SDR 254 million, or $340 million) and requested to draw the first credit tranche (SDR 460 million, or $460 million) as well. A team of officials representing both the outgoing and incoming governments went to Washington in mid-January 1989 for discussions aimed at determining the basis for the requested drawing. Through these meetings, the staff learned that the new economic team was planning both a strong adjustment program and a major liberalization of the economy. The discussions therefore quickly moved beyond the requirements for the drawing of the first credit tranche, onto the financing requirements for Venezuela's longer-term program. A general plan was agreed, under which a stand-by arrangement would be negotiated soon after the first-tranche request was considered, to be followed by an extended arrangement once a track record had been established for policy stabilization and toward normalization of relations with bank creditors.[107]

At the end of January, on the weekend before Pérez's inauguration, Camdessus went to Davos, Switzerland, to participate in the annual World Economic Forum, but especially to meet with Pérez. In an hour-long meeting, Camdessus encouraged the president-elect to pursue the proposed program and assured him of his support. Two weeks later, Pérez announced a dramatic shift in economic policy in a televised speech on February 16: interest rate ceilings would be ended, the exchange rate would be unified and determined by market conditions, fuel prices would be doubled (from extremely low and highly subsidized levels), food subsidies would be reduced, and the tax base would be broadened as part of a general package of tax reforms.[108]

[104]Net reserves at end-1988 were the equivalent of about 5 months of imports, though much of that amount was illiquid or committed.

[105]Venezuela had never drawn on Fund resources other than to make purchases within its reserve tranche. There had been one stand-by arrangement, in 1960, but it had not been drawn upon; see Horsefield (1969), Vol. 2, pp. 413–14.

[106]Pérez, of the Accion Democratica party, had been president from 1974 to 1979, during the boom years of sharply rising oil revenues.

[107]The authorities also indicated a preference for requesting a drawing through the CFF to compensate for the decline in the world price of oil, but that idea was rejected by the Managing Director when it became clear that the Executive Board was unlikely to accept it without a battle. That issue is discussed in Chapter 15.

[108]For a historical perspective on Pérez's break with the traditional policy orientation in Venezuela, see Naím (1993).

No one expected that such a major turnaround could be achieved easily, but the violence of the public reaction to the announcement stunned the world and quickly led to tragedy. On February 27, the announcement of a rise in bus fares triggered massive riots and looting that left more than 300 people dead. Press reports, taking a view that the government did not discourage, widely blamed the IMF for "imposing" or "dictating" the measures that led to the violence. The Fund, signaling a shift in policy against being used as a scapegoat in such situations, responded with public denials. Notably, in a March 2 speech in Washington to the Institute of Foreign Affairs, the Managing Director stated that the Fund had "not dictated—nor can it ever dictate—measures to a sovereign country." In response to those remarks, Pérez wrote a letter to Camdessus, copies of which he sent to leaders of the major creditor countries, arguing that the "formulas" of the IMF "take no account at all of the . . . economic realities in the countries where they are implemented." The letter, which was to receive wide attention in the world press, concluded: "It is impossible to carry out the necessary and urgent measures to adjust our economy" as long as the major creditor countries "refuse to alter the framework within which we are obligated to pay the external debt."[109] Though Pérez could not have known it, the change that he was seeking in that "framework" was to be announced by Secretary Brady just six days later.

Rhetoric aside, negotiations between Venezuela and the Fund proceeded smoothly through this period of turmoil. Pérez's economic team was aiming to sharply reduce government controls, strengthen private sector activity, and promote the use of market signals. A key element, from the vantage of the Fund, was the replacement of a complex system of multiple exchange rates with a unified and market-determined rate. The government hoped thereby to rebuild reserves by inducing a substantial repatriation of private capital held abroad. Though there were many points of detail to negotiate, there were no fundamental disagreements. Agreement was reached on a Letter of Intent for the first-tranche purchase on February 28, well before Pérez's letter was sent.

When the Executive Board met on March 29, 1989, to consider Venezuela's request to use its first credit tranche, the main issue was the lack of financing assurances from other creditors. In particular, although the authorities had begun negotiations with the banks' Advisory Committee on rescheduling and concerted-lending agreements, those talks had a long way to go. The staff had begun exploring various options for a flexible approach as early as January and had determined (well before the Brady Plan was introduced) that the Fund should not let the banks hold the adjustment program hostage as a means of strengthening their bargaining position vis-à-vis the government. As with Bolivia and Costa Rica, the staff was prepared to recommend to the Board that the Fund tolerate arrears to commercial

[109]Pérez's March 4 letter and Camdessus's March 6 reply—which noted that the Fund was supporting the "indispensable" measures that had been decided upon by the Venezuelan government—were published in the *IMF Survey* (March 20, 1989), pp. 81f. For more on this episode and on the more general "scapegoat" issue, see Chapter 14.

creditors as long as the program was on track.[110] Several Directors from industrial countries (including the United States, Japan, and Germany) objected to that recommendation, regarding it as "premature" until the Board could examine the pending request for an extended arrangement. Filardo, speaking for Venezuela, rejoined that to deny approval would seriously weaken the authorities' negotiating position in the coming weeks. In the end, a compromise was reached under which the Fund agreed to tolerate arrears only until the expected date of approval of an upper-tranche arrangement.[111]

Adjustment and Relief: 1989–90

With the hurdle on the treatment of arrears behind them, the staff set out quickly to negotiate a more detailed Letter of Intent for a medium-term program that could be supported by a three-year arrangement under the EFF, with set-asides and augmentation for debt relief under the Brady Plan. A mission (led by R. Anthony Elson, Assistant Director of the Western Hemisphere Department) went to Caracas in mid-April to begin the process, and the Letter was finalized at follow-up meetings in Washington around the middle of May.

Again, the strength of the economic program was not a major issue; agreement was quickly reached. The question now was whether Venezuela was a viable candidate for debt relief under the Brady Plan. The commercial banks were balking, on the grounds that Venezuela was a relatively prosperous and resource-rich country. Whereas the first three Brady cases to come before the Board had per capita incomes in 1988 ranging from $630 (the Philippines) to $1,760 (Mexico), Venezuela's income level was far higher ($3,250). The staff argued, however, that the country's large debt burden meant that per capita income could no longer grow until the debt burden was reduced, and the burden could be reduced only through negotiated relief.[112]

At the Executive Board meeting to consider the EFF request on June 23, 1989, Cassell took up the case against debt relief for Venezuela. Venezuela's debt problem, he argued, was short term, and the country would gain more in the long run by seeking "new money" (concerted lending) and rescheduling rather than relief

[110]The draft decision, prepared in early March and circulated to Executive Directors on March 14, read in part, "Venezuela continues to retain exchange restrictions on payments and transfers for current international transactions as evidenced by arrears on certain debt service payments pending the negotiation of restructuring agreements with foreign commercial creditors. . . . The Fund notes the intention of the authorities to eliminate these restrictions . . . and grants approval for their retention until September 30, 1989." "Venezuela—Staff Report for the 1989 Article IV Consultation and Use of Fund Resources—First Credit Tranche Purchase," EBS/89/34, Sup. 1 (March 14, 1989), pp. 24–25.

[111]The draft decision quoted in the preceding footnote was amended by substituting July 5 for September 30 and adding the sentence, "The Fund will review this decision upon approval by the Fund of an upper credit tranche arrangement for Venezuela or on July 5, 1989, whichever is earlier." Decision No. 9112-(89/40), adopted March 29, 1989.

[112]"Venezuela—Staff Report on the Request for an Extended Arrangement," EBS/89/107, Sup. 1 (June 7, 1989), pp. 31–32 and 46–47. Long-term external debt service in 1988 was equivalent to 40 percent of GDP. The comparable figures for Mexico, the Philippines, and Costa Rica were 44, 28, and 20 percent, respectively.

through a Brady deal.[113] That view was supported by a few other speakers from industrial countries (notably Grosche, and E.A. Evans—Australia), but they noted that Venezuela had already embarked on a debt-relief course, so the point was largely moot.

The specific Brady Plan elements of the Venezuelan request were controversial but did not block approval by the Board. The staff proposal to invoke the exceptional circumstances clause and augment the arrangement by 40 percent of Venezuela's quota to support debt reduction was supported by a narrow majority, but Filardo nonetheless withdrew the request at the end of the meeting so as not to threaten the consensus. Directors agreed instead—as they had for Costa Rica and Mexico—that they would be prepared to consider a request for augmentation once negotiations were concluded with bank creditors. The Board then approved the arrangement—including 25 percent set-asides for debt-relief operations—making it the fourth and final Brady deal to be approved by the Fund in 1989. Venezuela was eligible to draw SDR 247 million (just over $300 million) immediately, and the full potential over the next three years (including the possible augmentation) was more than SDR 4.25 billion ($5.3 billion).[114]

The Board's confidence in Venezuela's policies and its concerns about the prospects for an early settlement with the banks were both well placed. To a remarkable degree, Pérez's government succeeded in implementing its economic program, at least for the first two years. For 1989, the overall public sector deficit was held to just 1¼ percent of GDP (compared with 9¼ percent in 1988 and a program target of 2¾ percent), and a surplus of 5½ percent of GDP was recorded for the current account (compared with a 1988 deficit of 10¼ percent and a program target deficit of 3¼ percent). But in July the banks rejected Venezuela's request for debt relief, on the grounds that Venezuela had the capacity to pay its debts in full.[115] An interim financing agreement was finally signed in September 1989, but the Brady deal was not completed until June 26, 1990, a full year into the extended arrangement. In the meantime, the Fund granted waivers for the authorities' inability to maintain the required level of international reserves, and Venezuela basically stayed on track with the arrangement through the middle of 1991.[116]

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[113]Minutes of EBM/89/80 (June 23, 1989), p. 35.

[114]Enhanced surveillance was effectively suspended for Venezuela in March 1989, in that the authorities agreed not to send the staff report for the first-tranche purchase to the banks. (Fund policies prohibited circulation of reports that also evaluated a request to use Fund resources.) The authorities formally requested suspension of enhanced surveillance along with their request for the extended arrangement; that request was approved by the Board on June 23.

[115]According to Willard C. Butcher, the Chairman of Chase Manhattan Bank (the lead bank on the Advisory Committee), "The banks rejected the proposal because [Venezuela]'s request for debt reduction was excessive and not based on needs. . . . We think Venezuela has the resources to service its debts. . . ." July 25, 1989, letter to the *New York Times*, published on July 29, p. A24.

[116]Following the completion of the bank financing package, the Fund augmented the EFF arrangement in December 1990. At end-1990, Venezuela had drawn close to SDR 1.8 billion ($3 billion) under the arrangement and had an undrawn balance of SDR 2.1 billion ($2.6 billion). The program then went off track, and no further drawings were made.

Adjustment Without Relief: Argentina and Brazil

Not all of the Fund's efforts to help countries reduce their debt burdens in 1989 arose out of the Brady Plan. For two of the three largest debtors in Latin America, the only realistic goal for the Fund at that time was to maintain a dialogue and to try to promote a restoration of stable economic policies.

Argentina

Argentina had some early success in normalizing relations with commercial bank creditors. In particular, the August 1987 agreement between Argentina and its foreign bank creditors introduced several innovative options that prefigured the more formal menus that were adopted after the Brady Plan and that helped Argentina. These options included issuing relatively small claims under the new-money package in the form of bearer securities; substituting low-interest exit bonds (i.e., bonds not subject to future calls to participate in new-money agreements) for new-money claims; and the use of early-participation fees to encourage banks to commit at an early stage.[117] By 1989, however, when a more systematic and substantial effort might have been possible, the economy and government policy were mired down, and the authorities were unable to take advantage of the improved environment.

Plan Primavera: May–August 1988

Argentina's debt situation was becoming desperate in the early months of 1988. The 1987–88 stand-by arrangement with the Fund had been kept barely alive through waivers and amendments, and the United States was still providing short-term financing bilaterally,[118] but the banks had been less willing to compromise. When negotiations bogged down through the first quarter of 1988, Argentina quietly went into arrears to the banks and then for a time paid just enough interest to keep arrears from accumulating to 90 days (a trigger point, after which some creditor banks would have had to declare the loans to be nonperforming). The authorities were convinced that the first priority was to obtain relief from the debt burden, after which they could implement a stronger adjustment program; the Fund, however, saw stronger adjustment as a precondition for progress in debt negotiations. This difference in perspective had been papered over in the compromise that had temporarily reactivated the stand-by arrangement in March 1988 (see Chapter 10), but it had not been resolved.

In May 1988, President Raúl Alfonsín got personally involved in the public effort to obtain debt relief from the banks. In a major May 1 speech to congress, he

[117]For the background on the development of the 1987 agreement, see Chapter 10; for a summary of the agreement, see Watson and others (1988), p. 11.

[118]As described in Chapter 10, two multilateral bridge loans had been provided in 1987 by a group of creditor countries led by the United States; when additional financing was required in March 1988, the United States provided the full amount on its own.

rejected suggestions for unilateral action but called for creditors to negotiate relief through operations such as interest rate reductions, debt-equity conversions, and direct cancellation or reduction of the stock of outstanding debt. Then at the end of the month, he met with the Managing Director in Washington to see what help the Fund might provide. Camdessus, however, could offer only limited encouragement. Whatever debt relief might be obtainable was an issue to be settled between Argentina and the banks. As he had in the February meeting described in Chapter 10, Camdessus promised to support Argentina in that effort, but only after the government presented a credible and effective economic program. The president then went to New York, where he met with the heads of a number of the major creditor banks. A few days later, Camdessus met with several of those same bankers and painted a mixed but generally upbeat picture. Argentina and its creditors, he noted, faced two problems: the need for better economic policies and the need for additional external financing while those policies were being implemented. The first problem was a matter for the Fund, while the second required help from the banks, and he asked for cooperation from the banks as negotiations continued.[119]

Alfonsín was publicly taking a hard line on debt, but the basis for Camdessus's expression of support was that the government was also secretly developing a new policy program. The authorities knew they had to stabilize the economy through the next year: the year of the first presidential election since the one that ended military rule and brought Alfonsín to power in 1983. To make sure the program would generate international support, they consulted with the Fund throughout July, as the plan was being developed. Beza and Desmond Lachman (Chief of the River Plate Division) met with senior officials in Buenos Aires in mid-July, and a team of officials then visited the Fund for further talks. Although the staff repeatedly objected that the plan was lacking in specific proposals to rein in the fiscal deficit, the talks led to an agreement that once the new policies were announced, formal negotiations could begin on a new stand-by arrangement with the Fund.[120]

The Plan Primavera was unveiled on August 3, 1988, in anticipation of the coming spring in the southern hemisphere. Like the Austral Plan and its variants, the Plan Primavera was a heterodox package that aimed to break the momentum of inflationary expectations, but which included too little fiscal adjustment to produce lasting stability.[121] The exchange rate was devalued by 11.5 percent and was to be fixed against the dollar for two months; after that, both the rate of deprecia-

[119]Based on speaking notes prepared for the meeting; in IMF/RD Managing Director file "Argentina, 1988–1987" (Accession 89/118, Box 1, Section 511).

[120]The Fund staff had made a brief effort earlier in the year to persuade the authorities to develop a medium-term stabilization plan that could be supported by an extended arrangement with the IMF, but the government was unwilling to do so without the (unobtainable) support of the opposition Peronist party.

[121]The details of the Plan were circulated to Executive Directors on August 17; see "Argentina—Economic Policy Package of August 3, 1988," EBS/88/170. For a list of references and a brief discussion of how this plan fit into the evolution of economic policy in Argentina, see Kamin and Ericsson (1993), pp. 2–5. For a detailed "insider" account, see Machinea (1990), pp. 73–88.

tion and the rate of increase in controlled prices were to be fixed at 4 percent a month in a bid to prevent the plan from unraveling and to preserve the gain in international competitiveness from the devaluation.[122]

Sibling Rivalry: September 1988

The Plan Primavera produced a brief outpouring of optimism, but the Fund insisted on seeing firm policy implementation before it would resume lending. In August, Camdessus refused to yield to a direct appeal from Secretary Baker and other U.S. officials. Nonetheless, in early September, Lachman took a mission to Buenos Aires to try to negotiate a one-year stand-by arrangement. Although arrears to banks had reached $800 million by the end of August, negotiations with the Advisory Committee were progressing, and achievement of a preliminary agreement and a critical mass of commitments before Christmas seemed like a realistic goal. Arriving in Buenos Aires, however, the staff learned (as it had several times before) that fiscal policies were not being implemented as planned and that the deficit therefore could not be held under the anticipated ceiling without major new policy actions. For 1989, the government intended to set a target of about 3¾ percent of GDP for the deficit, a level that to Lachman appeared unsustainable.

The staff team returned to Washington on September 15, just a week before the center of Fund activity was to shift temporarily to Berlin, where the Annual Meetings were to be held at the end of the month. The goal of the staff and the Managing Director was now quite simple: to persuade the Argentine authorities that a renewed tightening of fiscal policy was a precondition for making any progress with the Fund or other creditors. That view, however, was not universally held, and a major rift was about to erupt that would significantly dilute the Fund's message.

Throughout 1988, a dispute had been brewing between those in the Fund and the World Bank who were independently negotiating with the Argentine authorities on the terms of pending loans.[123] The Fund's focus on fiscal control was sharply questioned by the Bank staff, who sided with the Argentine authorities in viewing the most urgent problem as being structural reform. In the Bank staff's view, being tough on the stance of fiscal policy made it too difficult for the authorities to implement the very reforms that the Bank was proposing to finance.

[122]The Austral Plan, as discussed in Chapter 10, had failed in large measure because the fixed exchange rate could not be sustained once domestic inflation rose above world levels.

[123]The differences in view were deep-seated and predated the open policy dispute by more than two years. In January 1986, while the Fund and the Bank were attempting to develop a coordinated response to the Baker plan, de Larosière expressed concerns to the Bank president, then Tom Clausen, that the Bank's draft country strategy paper on Argentina was taking a position on macroeconomic policies that was at variance with the views of the Fund. The Managing Director was reassured by the response, but later efforts by the staff to persuade the Bank to modify the tone of the paper were unsuccessful. See memorandum for files prepared by the Managing Director (January 23, 1986); in IMF/RD Research Department file "World Bank Collaboration, September 1983–February 1989" (Accession 89/129, Box 3, Section 276).

The Bank staff also argued that sufficient external financing was available to cover a somewhat larger fiscal deficit than the level on which the Fund was insisting. In the Fund staff's view, Argentina could not expect to control inflation or achieve a sustainable balance between domestic saving and investment without a more ambitious program to control expenditure and broaden the tax base. Intense political pressure from the U.S. authorities for the Fund and the Bank to lend—and lend quickly—did not help to resolve the matter.

Both staff positions were reasonable, but the resolution of the debate was further complicated by a conviction on both sides that they had to protect their turf in dealing with member countries. The two Bretton Woods institutions had periodically confirmed the general understanding that the IMF had primary responsibility for "policies related to balance of payments adjustment" and that it was essential to avoid giving conflicting advice to member countries; nonetheless, it was also understood that the "financial implications of economic development programs" were a matter of concern to both institutions.[124] Those understandings did not preclude the Bank from reaching agreements with a member country regarding the appropriate stance of macroeconomic policy to underpin a Bank loan, but it did imply that the Bank should fully take the Fund's views on such policies into account. In dealing with Argentina in 1988, the Fund staff believed that their counterparts across 19th Street were acting improperly in reaching an understanding with the government on policies that were at the very heart of the Fund's own negotiations. The Bank staff believed that such an agreement was essential to safeguard the Bank's own interests and the Bank's own relations with the member country. Camdessus and Barber Conable (President of the Bank) often discussed the need for coordination and cooperation on Argentina as the dispute developed, but with little effect.

By September 1988, the Bank staff had negotiated a "Letter of Development Policy," on the basis of which the Bank was to make a package of four loans totaling $1.25 billion.[125] Although that Letter included a statement of the authorities' intentions with respect to fiscal policy that was more expansionary than the policy on which the Fund staff was insisting as a condition for the stand-by arrangement, it was approved by Conable for submission to the Bank's Executive Board. After informing Camdessus, Conable then announced on September 25, in a press conference in Berlin, that he was proposing that the Bank go ahead with the loans. The announcement gave rise to a general impression that Argentina was prepared to bypass the Fund in developing its adjustment strategy, and it suggested that the Bank was prepared (on this occasion) to concede more to pressure from the United States than was the Fund. It also gave rise to concerns in some creditor countries and among bankers that indebted countries might try to play the two institutions

[124]The first quotation is from the Managing Director's summing up of a 1980 review of Fund-Bank relations; the second is from the original 1966 understanding on the subject. For a fuller discussion, see Chapter 20.

[125]One loan was related to trade policy; the other three were sectoral loans related to housing, banking, and electric power.

against each other in an effort to reduce conditionality on multilateral credits.[126] Whatever view one takes regarding the wisdom or appropriateness of Conable's decision,[127] it unquestionably complicated the Fund's effort to persuade Argentina to tighten fiscal policy and thereby delayed the negotiation of a stand-by agreement.

Hyperinflation: October 1988–July 1989

Following the meetings in Berlin, discussions with the Argentine authorities drifted for a few months without making much progress. A late-October staff visit concluded that the fiscal deficit was still worsening and was unlikely to be held below 4 percent of GDP for 1989. In November, the banks' Advisory Committee proposed terms for a package deal that would have covered the authorities' request for $3.5 billion in financing in 1989 through $2 billion in concerted lending, of which $500 million was to be guaranteed by the World Bank, plus $1.5 billion in exit bonds. Much remained to be negotiated, however, and the prospect of a guarantee from the World Bank was by no means certain. While those negotiations continued, Argentina still was not paying current interest on its existing bank loans.

The Plan Primavera collapsed in February 1989, just six months after its introduction. As the authorities had been unwilling to let interest rates rise sharply in this preelection period and had therefore been unable to hold price inflation to the specified rate of 4 percent a month, the fixed rate of depreciation had been insufficient to maintain international competitiveness or stabilize the level of official reserves. Now the government introduced a system of multiple exchange rates and allowed the rate for capital account transactions to float; that slowed down the reserve losses, but it also led to a reacceleration of inflation and a resumption of capital flight.

In the last three months before the May 1989 presidential election and the two months between the election and the inauguration of Alfonsín's successor, the Argentine economy slid rapidly toward total collapse.[128] Despite various efforts by the

[126]For typical press reports, see *The Wall Street Journal* (September 26, 1988), p. 3 ("a furious behind-the-scenes quarrel between the U.S. and . . . Camdessus"); and London's *The Independent* (September 26, 1988), p. 18 ("an unprecedented break with past practice"). The facts were that the U.S. authorities were lobbying hard behind the scenes for both institutions to approve the loans to Argentina and that the Fund's management specifically rejected that advice. The extent to which the Bank's approval resulted from U.S. pressure rather than from the Bank staff's undoubted conviction that the loans were appropriate is a difficult judgment.

[127]On October 27, the Executive Board of the World Bank approved the loans with three abstentions and one vote against. The opposition focused primarily on the potentially adverse effects on Fund-Bank relations. The process was supported by a $500 million bridge loan arranged through the BIS with backing or financing from ten central banks, the U.S. Treasury, and the Kreditanstalt für Wiederaufbrau of the Federal Republic of Germany. (See the BIS *Annual Report*, 1988–89, pp. 198–99.) After the initial disbursement, Argentina's failure to meet the Bank's conditions prevented the completion of the loans. For other accounts of this episode, see Polak (1994), which is largely complementary to the one given here; and Kapur, Lewis, and Webb (1997), pp. 527–31, which presents a contrasting view from the Bank's perspective.

[128]The constitution provided that the new government would take office in December, seven months after the election. In June, a deal was struck under which Alfonsín agreed to resign in early July so that his successor could take early action to deal with the economic crisis.

authorities to regain control over the exchange rate, the austral depreciated from 20 per dollar in mid-April to 655 on July 10. By then, official intervention had stopped, owing to a lack of reserves; arrears to foreign banks had surpassed $5¼ billion; payments to the Fund had also gone back into short-term arrears;[129] and inflation had hit the astronomical level of nearly 200 percent a month. All that anyone could do in such circumstances was to wait for the new government to turn policies around.

First Steps Toward Renewal: July–November 1989

The May 1989 election would eventually bring historic change to economic policy in Argentina and confound the conventional wisdom. The main opposition candidate and the man who would win the election was Carlos Saúl Menem,[130] who, partly because he was the leader of the traditionally populist Peronist party, partly because of occasional campaign rhetoric advocating a hard line on external debt service, was not expected to become a leader of the "silent revolution" in Latin America. On taking office on July 8, Menem demonstrated that necessity is the mother of revolution as well as invention.[131]

Menem's first move was to announce a new shock program, not unlike the Austral or Primavera plans in its heterodoxy, but unlike them in also being orthodox and recognizing the need for fiscal discipline. The exchange rate was sharply devalued on July 9, and Menem announced a broad range of fiscal measures that included tax reforms, curtailing of subsidies, and extensive privatization of public sector enterprises. To promote credibility, Menem also proposed to give the central bank independence from having to finance the government.[132]

[129]Argentina had briefly fallen behind in its payments to the Fund in January and February 1988 (see Chapter 10), but then had stayed current for a year. The government next missed a payment to the Fund at the end of March 1989. A number of partial payments were made over the next several months, and the level of arrears generally fluctuated between 30 and 60 days overdue (less than the threshhold for triggering action by the Fund) before being cleared in the second half of the year.

[130]Under the Argentine constitution, Alfonsín was limited to one term in office. The Radical party was represented in the election by Eduardo Angeloz, who garnered 37 percent of the vote, compared with 47 percent for Menem. The constitution was later amended, and Menem successfully ran for reelection in May 1995.

[131]Fears of a confrontational approach were also fueled by Menem's decision during the transition to take on Harvard economist Jeffrey D. Sachs as an advisor. As noted in Chapter 10 (Bolivia) and below (Brazil), Sachs had previously advised Argentina's neighbors to insist on debt relief from commercial and official creditors. Sachs, however, had a deeper message: lowering debt-service outflows was a means of ensuring that the country would retain the benefits of fiscal adjustment. Since Argentina had already delayed paying interest on bank debts, Sachs's advice to Menem apparently focused primarily on the design of the adjustment program.

[132]"Argentina—Staff Report for the 1989 Article IV Consultation and Request for Stand-By Arrangement," EBS/89/199 (October 17, 1989), pp. 7–19. Just before the devaluation, the official exchange rate was 300 australes per dollar, and the rate in the parallel market was about 560. The devaluation set the official rate at 650; the parallel rate quickly moved to that level, and the spread between the two rates remained quite small for the next few months.

Menem invited the Fund to send a mission right away to conduct the annual Article IV consultations. When the staff team (led by Lachman) arrived in late July, they were informed that the government wanted to negotiate a new stand-by arrangement as soon as possible. This time, negotiations moved swiftly and smoothly. A follow-up mission in September, headed by Joaquín Ferrán (Deputy Director of the Western Hemisphere Department), produced a general agreement on terms, including a fiscal target of 1¼ percent of GDP for 1990 (compared with an expected outturn of 16 percent in 1989).[133] The authorities signed a Letter of Intent specifying their program goals in mid-October, submitted the supporting legislation to Congress the following week, resumed negotiations with the banks' Advisory Committee, and submitted a request to the Paris Club to reschedule official credits.

The Executive Board approved the request for Argentina's thirteenth stand-by arrangement (the fourth since 1982) on November 10, 1989. The staff report on the proposal stressed that while Argentina was making substantial strides, it had a long way yet to go.[134] There was as yet no possibility of considering debt relief under the Brady Plan. The authorities still had to normalize relations with the creditors to whom they had outstanding arrears, including the World Bank and other official creditors as well as the banks. If that effort proceeded as expected, then the Fund could expect to consider granting an extended arrangement with set-asides or augmentation for debt relief sometime in 1990. Despite the reservations expressed by several Executive Directors—lingering doubts engendered by six years of repeated program failures—there was no dissent from the approval of the new arrangement.[135]

That Board meeting concludes the history of relations between Argentina and the IMF in the 1980s. It ends, much like Richard Wagner's *Götterdämmerung*, with the promise that a new order will soon emerge from the destruction of the old. The new order, however, was not yet fully defined at the end of 1989. Like its predecessors, the 1989–91 stand-by arrangement quickly ran into a conflict between the need for even stronger adjustment and reform and the political realities at home. Not for another two years would Argentina finally find the will and the means to achieve financial stability.

Brazil

Seeking Debt Relief: July–December 1987

Brazil's effort to gain relief from its debt burden began in earnest in the middle of 1987. Shortly after implementing a temporary wage-price freeze in mid-June,

[133]"Argentina—Letter of Intent," EBS/89/194 (October 12, 1989), p. 2.

[134]"Argentina—Staff Report for the 1989 Article IV Consultation and Request for Stand-By Arrangement," EBS/89/199 (October 17, 1989). The arrangement totaled SDR 1,113 million (100 percent of quota and equivalent to $1.4 billion), to be disbursed in six installments through March 31, 1991.

[135]Minutes of EBM/89/145 (November 10, 1989).

the finance minister, Luiz Carlos Bresser Pereira, made his first official trip to Washington, with the goal of winning support for a proposal to capitalize up to 60 percent of the interest due on outstanding bank loans.[136] He met with Senator Bill Bradley, who told him that the banks were unlikely to accept the plan. He then had dinner with Camdessus, who told him that officials in creditor countries were not ready to support such a plan. But the next day, he met and spent several hours with Jeffrey Sachs, who told him that he could never get both economic growth and price stability without first obtaining substantial debt relief. Bresser Pereira went home more discouraged but also more determined.

Back in Brazil, Bresser Pereira—still determined to avoid seeking assistance from the Fund—decided to modify his proposal for debt relief by asking for a 50 percent discount on 20 percent of the debt rather than a capitalization of interest. U.S. Treasury Secretary James Baker then invited him to meet with him in Washington in early September to discuss the idea. At that meeting, Bresser Pereira thought that he had won Baker's support for a voluntary debt reduction scheme along the proposed lines and for delinking negotiations with the banks from those with the Fund. Baker, however, publicly denied that a deal had been struck, and the effort succeeded only in sowing ill will.[137]

The Brazilian authorities pushed ahead with their bid to obtain debt relief. In late September, just before the Annual Meetings, the negotiating team presented a detailed proposal to the Advisory Committee in New York. The proposal called for "securitization of a portion of the debt" owed to commercial banks and expressed interest in "a menu of alternatives," including the conversion of debt into equities. It proposed that interest payments be capped, with the ceiling no higher than LIBOR and linked to the country's "true payment capacity." It suggested issuing "debt conversion bonds" (essentially, exit bonds) that would not be subject to rescheduling or new-money requests because their terms would be linked to capacity to pay.[138] The negotiators asked that these proposals be deliberated independently of the status of Brazil's discussions with the Fund.

The banks rejected this last request, insisting that Brazil would have to show progress in negotiating a Fund program before any medium-term agreement could be completed. Nonetheless, the prospect of granting relief was kept alive enough that Bresser Pereira finally agreed to seek an arrangement with the Fund. That opening generated enough progress to get to an "interim agreement" in December 1987, under which Brazil would pay one-third of the current interest due for the fourth quarter and the rest would be financed by a group of creditor banks. Unfor-

[136]The following account is based partly on Bresser Pereira (1999) and partly on background interviews.

[137]Bresser Pereira (1999) blames David Mulford, Baker's deputy, for scuttling the agreement. In any event, it seems likely that the dispute arose from a misunderstanding and that Baker conveyed more sympathy than he really intended. For a contemporary report, see *New York Times* (September 9, 1987), p. D1.

[138]"Proposal with Respect to Certain Brazilian External Debt Held by Commercial Banks," (September 25, 1987), pp. 3–6; in IMF/RD Managing Director's files (Accession 89/14, Box 1, Section 550).

CORREIO BRAZILIENSE

ORGÃO DOS "DIARIOS ASSOCIADOS" LONDRES, 1808, HIPOLITO JOSÉ DA COSTA -BRASILIA, 1960, ASSIS CHATEAUBRIAND

Número [illegible] — Brasília, segunda-feira, 23 de novembro de 1987

FMI chega para preparar o acordo

Bresser, com o apoio do PMDB, diz que o pacote não incluirá congelamento

Oliveros, Rossi, Reichmann e Clifton: a missão do FMI espera uma pizza, exercitando a paciência que deverá ter para descobrir o déficit

A missão do Fundo Monetário Internacional, que chegou ontem a Brasília, reúne-se hoje com o Banco Central para começar a levantar a situação da economia brasileira e preparar as bases para um futuro acordo com o País. "Já que vamos fazer um acordo no futuro, solicitei a vinda de uma missão precursora" — explicou o ministro da Fazenda, Luiz Carlos Bresser Pereira, ao desembarcar no aeroporto em companhia do presidente do PMDB, da Câmara e da Constituinte, Ulysses Guimarães. O chefe da missão do Fundo, Thomas Reichmann, confirmou que uma das suas preocupações é avaliar o tamanho do déficit público, que começará a ser cortado com o próximo pacote de medidas econômicas destinado a conter a inflação. Antes do acordo com o Fundo, o Brasil pretende concluir o acerto da dívida externa com os bancos credores. "Somente depois disso é que formalizaremos as bases das negociações com o Fundo" — disse Bresser, que desfez os rumores sobre sua saída do Governo ao procurar, e obter em São Paulo, o apoio de Ulysses. O ministro garantiu que o "plano de emergência" para segurar a inflação, a ser divulgado antes do fim do ano, não inclui um novo congelamento de preços. O pacote tem como principal objetivo aumentar a arrecadação fiscal, principalmente através de cortes nos gastos públicos, sem taxar o assalariado. Página 7.

Headline news: IMF mission members Eric Clifton, Doris Ross, Thomas Reichman, and Gumersindo Oliveros featured on Brasilia newspaper's front page as "waiting for a pizza, exercising the same patience that they will need to discover the size of the deficit."

tunately—as recounted in Chapter 10—it was not enough to generate political support for fiscal reform in Brazil, and Bresser Pereira felt compelled to resign when he realized that he could not deliver an effective adjustment program.

Negotiating New Agreements: January–September 1988

The new year brought new momentum. Brazil's negotiators met with the Advisory Committee on the terms of a medium-term agreement throughout the first two months of 1988 and reached agreement—conditional on reaching understandings with other creditors, including the Fund—at the end of February. Then, after a series of technical discussions, the Fund sent a staff team out in May—led by Thomas Reichmann (Assistant Director for the Atlantic Division of the Western Hemisphere Department)—to negotiate a stand-by arrangement. The mission had a limited objective, aiming simply to maintain the momentum until more effective and sustainable adjustment could be implemented later. This strategy was governed by what Reichmann saw as a sequencing problem: inflation was running at such a high level (about 600 percent a year) that it could be stopped only by a shock program, but the operational fiscal deficit was so high (about 7 percent of GDP) that it had to be brought under control before a shock program could work. The goal of both the Fund staff and the new authorities in Brazil (led by Bresser Pereira's successor as finance minister, Mailson Ferreira da Nóbrega) was therefore to get a conventional adjustment program in place quickly, to buy time until a shock program could be implemented in 1989.

The strategy succeeded. In quick succession in June 1988, the authorities signed a Letter of Intent for a Fund-supported program, finalized the agreement with the banks' Advisory Committee for a medium-term package that included several of the innovative menu options that Brazil had requested a year earlier, and persuaded the Paris Club to consider rescheduling official credits. The Executive Board then approved the stand-by arrangement in principle on July 26, pending completion of the other financing arrangements. The Board meeting was a collective sigh of relief, as Directors welcomed the return of "the prodigal son," which they regarded as both "an important day in the history of the Fund" and "a cause for particular rejoicing."[139]

The rejoicing was not confined to Washington. Two days after the Fund approved the stand-by arrangement in principle, Paris Club creditors agreed to reschedule Brazil's obligations to them. Moreover, commercial bank creditors responded with unaccustomed alacrity, and the Advisory Committee rounded up the critical mass of commitments (covering 95 percent of the $5.2 billion loan) by August 18, 1988:

[139]Minutes of EBM/88/115/R-1 (July 26, 1988), pp. 36 (G.P.J. Hogeweg, Alternate—Netherlands), 41 (Jacques de Groote, Belgium), and 14 (Frank Cassell, United Kingdom), respectively. The arrangement was for SDR 1,096 million (75 percent of quota), or approximately $1.4 billion. It was to run through February 28, 1990, with six scheduled disbursements. The cutoff date for the arrangement to come into effect, conditional on a finding by the Fund "that satisfactory arrangements have been made for Brazil's foreign commercial bank financing," was September 9, 1988. Executive Board Decision No. 8927-(88/115), adopted July 26, 1988.

three weeks ahead of schedule. The stand-by arrangement then went into effect on August 23, enabling Brazil to immediately draw one-third of the total amount of the arrangement (SDR 365.3 million, or approximately $470 million).[140]

The Program Fails: October 1988–November 1989

By mid-November, Brazil applied part of the proceeds of the Fund, Paris Club, and commercial bank packages to clear all of its arrears to foreign creditors. Domestically, the government signed a social pact with labor and business groups, as the first stage of a plan to stabilize prices by de-indexing the economy. There was much to celebrate, but true stabilization was still years away. As it had been from the beginning, the debt crisis was, at its heart, a fiscal crisis. Without fiscal discipline, Brazil could do no more than delay the day when it once again would be unable to pay. On October 5, 1988, a new constitution was adopted, under which the obligation of the federal government to transfer revenues to the states was sharply increased. When Reichmann's team went to Brazil later that month to begin what would become a long effort to conduct the annual Article IV consultations and review progress under the stand-by arrangement, the devastating effects of the constitutional change were not yet clear. By the time the consultations were completed nearly a year later, the government's accounts were out of control.

The authorities tried to regain control over the economy in January 1989, through what became known (in an echo of Argentina's Plan Primavera) as the Summer Plan. The key elements of the program were the introduction of a new currency (the new cruzado, replacing the old one at an exchange of 1:1,000), a 14 percent devaluation against the U.S. dollar, a freeze on prices, and an end to automatic wage indexation. It also included some fiscal measures, but they were small in relation to what was required.[141] The Summer Plan failed to brake inflation, which nearly doubled from 934 percent in 1988 to 1,765 percent in 1989, and it failed to control the operational budget deficit, which rose from 4.8 percent of GDP in 1988 to 6.9 percent in 1989.[142]

Discussions between the Fund and the authorities continued throughout 1989, both in Brazil and in Washington. Although there was no shortage of goodwill on either side, all efforts to keep the program on track were doomed by the constraints on fiscal policy. The August 1988 drawing was the only one that Brazil would make on the stand-by arrangement—Brazil's only drawing, in fact, since the extended arrangement had collapsed nearly four years earlier.

[140]Executive Directors of the Fund were officially notified on August 19 that the critical mass of bank commitments had been obtained. They then approved the stand-by arrangement on a lapse-of-time basis, without further discussion. The bank package became effective on September 22. See "Brazil—Stand-By Arrangement—Effective Date," EBS/88/130, Sup. 3 (August 19, 1988), and Decision No. 8956-(88/126), adopted August 23, 1988.

[141]"Brazil—Staff Report for the 1988 Article IV Consultation," EBS/89/189 (September 27, 1989), p. 16.

[142]The inflation figures are for the consumer price index. Other general indexes showed similar rates of increase. See "Brazil—Recent Economic Developments," SM/91/201 (September 30, 1991), pp. 11 (inflation) and 20 (fiscal deficit).

At the end of October 1989, the Executive Board finally concluded the 1988 Article IV consultations, in a meeting that was dominated by what Cassell (who just 15 months earlier had spoken of Brazil as a source of "rejoicing") called "a sense of sadness." Everyone who spoke expressed concern about the failure to control the fiscal accounts or to stabilize prices. Some representatives of developing countries laid a good part of the blame on the difficult external environment, but most stressed that Brazil needed to come to grips with its internal political constraints. Brazil's Executive Director, Alexandre Kafka, noted that part of the explanation for the fiscal overruns originated in the effect of the impending presidential election on the budget; and part of it originated in the constraints imposed by the new constitution. Johann Prader (Alternate—Austria) observed that these constraints led to a "minimalist approach to adjustment . . . in which excessive damage to the economy was avoided rather than . . . one in which conditions were created for a durable solution to Brazil's financial imbalances." On the whole, the Board was hopeful that the elections would bring real change to Brazil. "The time for gradualism had clearly run out," as the Managing Director put it, but if the new government were to make a "fundamental attack on inflation," the 1990s would not have to be a repeat of the 1980s.[143]

Appendix: Fund Policy on Financing Assurances and Arrears

In 1970, the Fund formalized a policy that recognized that external payments arrears generally resulted from governmentally imposed exchange restrictions. That policy stated that Fund approval of such restrictions should be granted only if the authorities adopted a program aimed at eliminating them within a fixed period. It also provided that "Fund financial assistance to members having payments arrears should be granted on the basis of performance criteria or policies . . . [that] provide for the elimination of the payments arrears within the period of the stand-by arrangement." For the complete statement and decision, see de Vries (1985), Vol. 3, pp. 214–15. For background, see de Vries (1985), Vol. 1, pp. 591–93.

That policy was modified in 1980 by an agreement that, "depending on the member's circumstances and the length of the program, it might not be feasible in the early stages of the program to go beyond an understanding that the member would try to avoid any further increase in outstanding arrears." The new policy was as follows.

The Fund's policies on payments arrears are also concerned with their treatment in the context of stabilization programs supported by use of the Fund's resources. In these programs, member countries are expected to take steps to reduce and eventually eliminate payments arrears relating to capital transactions as well as to payments and transfers for current international transactions. In formulating policy guidelines in these programs, the staff will continue to be guided by the approach set forth in the Executive Board decision of 1970 . . . [cited above]. This approach will also be followed with respect to payments arrears arising from default. The technique chosen by a member to reduce outstanding arrears will reflect its institutional arrangements, as well as the magnitude of the arrears and the severity of the

[143]Minutes of EBM/89/137/R-1 (October 27, 1989). The quotations are from pp. 18 (Prader), 30 (Cassell), 55 (Kafka), and 56 (Camdessus).

balance of payments problem. When payments arrears are large in relation to a member's available foreign exchange resources, it may not be possible to aim at the elimination of the arrears within the program period. Special arrangements may be needed for the renegotiation of outstanding debt obligations when debt problems are particularly severe. Depending on the member's circumstances and the length of the program, it may not be possible, in the early stages of a program, to reach an understanding with the member that goes beyond requiring the avoidance of any further increase in arrears.[144]

Fund policy was modified further in April 1983 in light of the debt crisis. The Managing Director summed up the Executive Board's discussion of policies on "External Debt Servicing Problems" with the following remarks on financing assurances.

Executive Directors commented on the relationship between balance of payments assistance from non-Fund sources and the implementation of Fund-supported adjustment efforts by members experiencing debt-servicing difficulties.

First, Directors considered the way in which the Fund collaborates with official institutions in multilateral debt renegotiations to be generally satisfactory. Some of them had said that the various official creditors should receive similar, evenhanded treatment, if only to ensure continued cooperation among official creditors. Directors felt that any special elements that might be involved in the relationship between Fund-supported programs and the debt relief envisaged by the Paris Club, or other groups concerned with official multilateral debt renegotiations, should continue to be handled on a case-by-case basis.

It was evident that in the case of some countries, only the provision of further concessional aid could make the rescheduling exercise successful. In those circumstances, it would be the duty of the Fund to put the matter squarely before the members of the international community able to provide aid. The straightforward rescheduling of official debt might occasionally be inadequate; more might be required even if the provision of extended assistance were to complicate the renegotiations.

Directors recognized that the procedures for rescheduling commercial bank debt were not as well developed as those for official debt negotiations. Nonetheless, the Fund could play, and had played, a useful role in bringing about a successful outcome to discussions between a debtor country and the commercial bank groups involved. Since the summer of 1982, certain "exceptional" circumstances had arisen, in which the difficulties encountered by major debtors have had broader implications for the orderly functioning of the international monetary system. The Fund management—in concert with major creditors, central banks, the BIS, and governments—had taken the initiative in ensuring that before Fund resources could be committed, sufficient additional financial flows from governments, official sources, and commercial sources were available to support the adjustment efforts of the member concerned. Directors had endorsed that approach, although some of them had cautioned against the Fund as a matter of general policy interjecting itself too closely or too systematically into traditional commercial bank/client relationships. They had encouraged the Fund to maintain a generally neutral role. The consensus was that the Fund should proceed on a case-by-case basis in full consultation with all the parties involved, bearing in mind the need for evenhanded treatment between cases.

[144]This paragraph was taken from the concluding section of EBS/80/190 (August 27, 1980), except that the final sentence was amended by the Executive Board. It was accepted as a statement of Fund policy at EBM/80/154 (October 17, 1980) and was published in *Selected Decisions*.

Third, Executive Directors noted the inevitable degree of uncertainty regarding the amount and timing of external financing that could be made available during the period of an adjustment program supported by the Fund's resources. Such uncertainties should not necessarily prevent a member country wishing to enter into an arrangement with the Fund from doing so. But the Executive Board would need sufficient safeguards to ensure that the Fund's resources would be used to support a viable and financeable adjustment program. The best means of providing such safeguards—in the absence of any conclusion to the negotiations on non-Fund financing of a Fund-supported program—was considered to be the practice of introducing review clauses at an early stage of the program, linked, if necessary, to the satisfactory outcome of discussions on balance of payments financing from other sources. The staff would indicate in its reports what additional adjustment measures should be contemplated by the authorities if the amounts of external financing assumed by the staff did not materialize.[145]

Finally, in May 1989, the Board adopted a much more flexible policy in response to the Brady Plan. The full text of the summing up of that discussion is reproduced here.

The Chairman's Summing Up on Fund Involvement in the Debt Strategy Executive Board Meeting 89/61, May 23, 1989

This has been an important discussion, following the guidance of the last meeting of the Interim Committee, with a view to laying the basis for broad guidelines for the Fund's role in the evolving debt strategy and, in particular, for Fund support for debt and debt service reduction. It is clearly the wish of this Board that the Fund discharge in full its central responsibilities in the debt strategy, but without interference in negotiations between debtors and creditors. We recognize that we are at an experimental phase in the debt strategy and will keep all aspects of developments under review as I will describe more specifically below.

In considering Fund support for debt and debt service reduction operations in conjunction with appropriate flows of new money, Directors emphasized the central importance of sustained implementation of policy reforms in debtor countries. They stressed that all parties in the debt strategy should continue to play their respective roles and, in particular, that official creditors should not substitute for private creditors. Fund support for debt reduction operations would be linked to medium-term adjustment programs with a strong element of structural reform, adopted in the context of stand-by or extended arrangements. Particular emphasis would be given to measures that would improve the climate for saving and investment in borrowing countries, and help reverse capital flight and attract private capital inflows and direct investment. Adherence to MIGA was seen by a number of Executive Directors as a useful step in the investment area. Utilization of debt-equity swaps, where compatible with a member's fiscal and monetary policy framework, has also been seen by a number of Directors as a particularly effective means of attracting a return of flight capital.

Executive Directors agreed that requests for Fund support of debt and debt service reduction operations would be considered on a case-by-case basis. Particular reference would be made to three elements—the strength of economic policies; the scope for voluntary, market-based debt reduction operations that would help the country regain access to credit markets and attain external viability with growth; and an assessment as appropriate that such operations represent an efficient use of scarce resources.

[145]Minutes of EBM/83/58 (April 6, 1983), pp. 36–37; published in *Annual Report 1983*, pp. 162–63.

Executive Directors strongly emphasized the importance of ensuring continued support for countries that have succeeded in maintaining market access and would not engage in officially supported debt reduction. The creditor community, including the Fund, will need to watch the situation of these countries carefully to ensure that they are not harmed by changing circumstances and that appropriate assistance continues to be forthcoming. This is an important area to which Directors have agreed to return before the Annual Meetings.

Directors stressed that it will be important to keep the Fund's liquidity position under close review. It is considered that the provisions for Fund support of debt and debt service reduction operations that have been discussed could be accommodated without an undue deterioration in the Fund's liquidity position in the near term. However, the implications of the Fund's support of debt and debt service reduction operations will need to be taken into account by Executive Directors in considering the factors bearing on the need for an increase in quotas under the Ninth General Review of Quotas. In particular, Fund support for debt reduction operations must not be allowed to reduce the Fund's ability to support members that are not engaging in such operations.

As regards the particular modalities of Fund support for debt and debt service reduction, Executive Directors agreed that in appropriate cases part of a member's access under an extended or stand-by arrangement could be set aside to finance such operations. The exact size of the set-aside would be determined on a case-by-case basis, but would involve a figure of around 25 percent of access determined on the basis of existing access policy. A number of Directors noted the importance of principal reduction in helping to ease the member's debt burden, and it was agreed that set-aside amounts should be used to support operations involving principal reduction, such as debt buy-backs or exchanges.

The availability of the set-aside amounts would generally be phased in line with program performance. Where warranted, some front-loading could be considered or purchases could be phased in accordance with the specific financing needs of the member's debt reduction program.

Directors agreed that there could be an initial release of Fund resources in support of debt reduction if the program was on track, if the Board was satisfied with the authorities' description of the debt reduction program, and on the understanding that debt reduction operations would be market based or, at market-related prices, involving substantial discounts. Initial purchases under the set-aside could be made available from the outset of an arrangement if these conditions were met. Otherwise, purchase rights would accumulate and be made available upon completion of a review by the Board of the debt reduction plan.

Executive Directors also agreed that in appropriate cases the Fund would be prepared to approve requests for additional resources of up to 40 percent of a member's quota,[146] where such support would be decisive in facilitating further cost-effective operations and catalyzing other resources, consistent with significant further progress toward external viability. The additional resources from the Fund are to be used for interest support in connection with debt reduction or debt service reduction operations. It was understood that the amount of additional resources to be provided would be determined on a case-by-case basis, in light in particular of the magnitude of the member's balance of payments need and the strength of its adjustment program as well as its own efforts to contribute resources, as feasible, in support of the operations. The limit for additional access is not to be regarded as a target. In considering a request for additional resources, the Executive Board would be presented with detailed information, as available, on the operations to be supported; the timing of actual

[146]This limit was reduced to 30 percent of a member's quota (see Buff/92/133).

disbursements to the member would need to be determined in light of the specific operations. Access pursuant to such requests would be additional to that determined under the existing guidelines for enlarged access, it being understood that the present policies on enlarged access will continue to apply, including the exceptional circumstances clause.

In the event a commitment by the Fund to provide additional access for the purposes specified were not used, the commitment would expire at the end of the arrangement period. The member would be expected to make early repurchases of amounts drawn under a commitment of additional access, to the extent that the amounts were not used within an appropriate period for the purposes described in the member's request.

Directors stressed the importance of ensuring that resources made available for debt and debt service reduction operations were used effectively. Directors agreed that there would be a need for periodic reviews to consider how debt reduction operations compare to the Board's initial expectations; if appropriate, the Board could in such reviews reconsider the modalities of the Fund's support for the member's debt reduction plan.

Executive Directors noted that the World Bank would likely be involved, along with the Fund, in supporting debt reduction operations when these are important elements in a country's financial and development strategy. In these cases, Directors stressed that it was important that the two institutions work together closely in securing effective debt reduction. This does not mean each institution must provide equal amounts in each case, as the amounts will need to be taken on a case-by-case basis. The managements of the two institutions are working closely on these matters and Executive Directors will be kept informed of the progress made in support of these operations on a continuing basis.

In discussing financing assurances, Executive Directors reaffirmed the basic objectives of the Fund's Policy—ensuring that the program is fully financed; that the financing is consistent with a return to viability and with the ability of the member to repay the Fund; that there is fair burden sharing; and that the program, if appropriately implemented and supported, would contribute to the maintenance or re-establishment of orderly relations between the member and its creditors.

Nevertheless, Directors agreed that there is a need for cautious adaptation of the Fund's policy in light of the changed financial environment and the possibility that in some cases significant time may be needed for banks and the member to agree on an appropriate financing package. In such circumstances, the Fund would on a case-by-case basis approve an arrangement outright before the conclusion of such negotiations, provided that prompt Fund support is judged essential for program implementation, that negotiations between the member and its bank creditors have begun, and that it can be expected that a financing package consistent with external viability will be agreed within a reasonable period of time. Management would continue to consult with Executive Directors at an early stage in such cases. Progress in the negotiations with bank creditors would be closely monitored, and any unforeseen development brought to the Board's attention. When circumstances warrant, the practice of seeking a critical mass, as well as the possibility of approving an arrangement in principle, would remain valid.

Directors stressed that in promoting orderly financial relations, every effort must be made to avoid arrears, which could not be condoned or anticipated by the Fund in the design of programs. Nevertheless, an accumulation of arrears to banks may have to be tolerated where negotiations continue and the country's financing situation does not allow them to be avoided. Directors emphasized that appropriate safeguards would need to be incorporated into the monitoring procedures of the Fund arrangement. The Fund's policy of nontoleration of arrears to official creditors remains unchanged. The debtor member would be expected to continue to treat creditors on a nondiscriminatory basis. Directors agreed that while negoti-

ations with bank creditors were continuing, the situation would need to be monitored closely. Performance criteria would be quarterly. A review of progress in the negotiations would be scheduled at an appropriate time and, normally, before the second disbursement.

These essential points provide a clear, and clearly limited, basis for the Fund to proceed with initial country operations. We are at an early stage, but we must move forthrightly to begin implementation. It is understood that the Fund's policy, and the precise modalities for application of the policy, will evolve under the Board's guidance as individual cases come forward, or are reviewed, and in light of continuing staff studies. We will take stock of progress in connection with our discussion of the management of the debt situation before the Annual Meetings, and we will plan to review the overall experience in a year or earlier if the situation requires.

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