

## A. The Debt Problem at the Crossroads

William Rhodes

The strategy that had been followed since August 1982, when the debt crisis began, focused on new money as the cornerstone of the financial packages that commercial banks assembled for various restructuring countries. The emphasis was on burden-sharing and cooperation among the various parties — creditor and debtor governments, the international financial institutions, and commercial banks.

The common goal was to provide the countries with both the time and resources — by postponing debt repayments and encouraging new money — while they made necessary economic reforms. These reforms, in time, would allow the countries to return to the voluntary capital markets, where they could again raise the incremental funds that they will need, as developing countries, for their future growth.

New-money exercises, which encouraged large numbers of creditor banks to continue lending to the countries, clearly were consistent with that goal.

Voluntary debt-reduction programmes were introduced in 1984 and they grew in importance. In 1988, for the first time since the debt crisis began, the countries of Latin America, as a group, managed to reduce their external debt.

An indebted country gains from debt reduction to the extent that it reduces its total debt at a discount to face value. However, the country takes the longer-term risk of limiting its future financing. Banks that have taken losses on loans to a borrower are less likely to lend again to the same borrower.

Progress was made under this new-money-oriented strategy with support from commercial banks and other creditors, many of the restructuring countries started reforming, privatising and opening their economies. Chile, Uruguay, Mexico and the Philippines, all of which have returned to growth, are cases where the right economic policies are working. As an example, during the second half of the 1980s, growth averaged 6.6 per cent a year in Chile and 4.9 per cent in Colombia, while in Mexico it has now reached 3 per cent. There have also been a few, though small, voluntary market transactions, by Chile, Mexico, Uruguay and Venezuela.

Some of the countries, however, have so far failed to make meaningful economic reforms, and progress overall has been slower than many of us had hoped.

Last March, US Treasury Secretary Nicholas Brady proposed that voluntary debt reduction by the commercial banks replace new money as the centrepiece of a changed strategy. He also made the point, largely overlooked since, that some continuing flows of new money must remain an essential part of that strategy.

In response to the Brady proposals, the International Monetary Fund and the World Bank agreed to offer certain resources to back debt-reduction programmes for countries that have viable economic programmes. Commercial banks have negotiated preliminary agreements on three packages under the revised strategy — with Mexico, the Philippines and Costa Rica. Earlier this month, at the invitation of Mexico's president, Carlos Salinas de Gortari, creditor banks started signing the first of the three packages at a ceremony in Mexico City. Negotiations are underway with several other countries, the most prominent of which is Venezuela.

The Mexican package — the most complex and innovative ever assembled in the international markets — is the first during the debt crisis to emphasise voluntary debt reduction more than new money. Yet it combines the two in a way that, the government of Mexico believes, will allow the country to put the debt crisis behind it, create a base for investment and enter a period of sustained economic growth. Given continued progress with the government's economic-reform programme, I think Mexico can accomplish this. At a recent meeting in Mexico City, President Salinas reiterated his commitment to open the economy, privatise, deregulate and maintain order in public finances by reducing the deficit as a percentage of GDP.

The response from the international banking community has been unprecedented for any package of this magnitude. Virtually all of Mexico's approximately 460 creditor banks will have signed, by the time we close the books, and issue the debt-reduction bonds, toward the end of April, 1990. In fact there may be no free-riders.

The agreement covers all of Mexico's \$48.5 bn in medium- and long-term debt to commercial banks. Banks representing 41 per cent of the debt chose to reduce principal, at a discount of 35 per cent; and 49 per cent chose to reduce debt service by limiting

interest payments to a fixed 6¼ per cent; and the remainder, or 10 per cent, chose to lend new money. If the foreign offices of Mexican banks are included in the figures, new money is approximately 13 per cent of the total.

When we announced the agreement in principle last July, it was criticised for containing too little debt reduction, not enough discount and too much new money. However, the debt-reduction instruments account for about 90 per cent of the agreement, and debt-principal reduction is twice as much as initially forecast.

Even more important, the package is a demonstration of confidence in Mexico, and recognition of its historic economic reform programme, by its various creditors — governments, the multilateral organisations and commercial banks.

This demonstration of support should help the country further reduce the cost of servicing its very large internal debt and attract new investment from domestic and foreign sources. Since our negotiations began last spring, internal interest rates within Mexico have dropped, flight capital has been returning and there have been increased signs of new investment inflows. Economic growth reached three per cent in 1989, the highest since 1982, and Mexico's reserves have risen to more than \$7.2 bn. It all comes down to regaining confidence.

I was first quoted in July 1989 saying that the Mexican agreement is no cookie-cutter. The package for Mexico is responsive to circumstances in Mexico, which differ from circumstances in other countries. For example, compared to the three basic options in the Mexican agreement, the Philippines agreement has just two options — a debt buy-back and new money — while the Costa Rican agreement has no new-money option. Some other countries may need only one debt-reduction choice. Some will need new money, others will not.

Given the different circumstances of each country, I expect that the case-by-case, or country-by-country approach, which has been followed since the crisis began, will continue.

As we look ahead, however, I have several major concerns over the changed strategy, all of them closely related.

One is the fact that the resources made available by the public sector to support debt reduction are proving insufficient to meet the expectations of various borrowing countries and, generally, to resolve the debt problem.

In this respect, it would be helpful if other surplus industrialised countries would follow the leadership of Japan and establish recycling programmes. Through the Paris Club, the industrialised countries could also help Latin America by lengthening restructurings and

grace periods and lowering interest payments, much as the commercial banks have been doing.

In addition, government export-development agencies should restore their lines of credit more rapidly to countries making progress in economic reform.

I have several specific recommendations that I hope the interim committee will consider when it next meets to review the changed debt strategy:

First, the multilateral institutions could further help the restructuring countries by allowing them more flexibility with the resources that currently must be allocated specifically to each type of debt reduction, whether a cash buy-back or instruments to reduce debt principal or debt service. The fungibility, or as I refer to it, co-mingling of these resources would enable each country to use the funds to its maximum benefit, for the debt-reduction techniques most appropriate to its particular needs.

Second, Colombia should be a leading candidate to benefit from the World Bank's new Expanded Co-Financing Operation (ECO) for countries that have not restructured their debt. At the same time, the World Bank should consider extending that programme to countries that are successfully coming out of the restructuring process, have met their obligations and are following viable economic programmes. Chile, Mexico, Uruguay and the Philippines come to mind.

Third, one of the lessons we learned from the Mexican package is the importance of up-front enhancements. The international financial institutions could help the indebted countries speed their negotiations with commercial banks by being more flexible in up-fronting enhancements for debt reduction. A group of commercial banks recently completed a \$1.2 bn bridging to the enhancements for Mexico only with great difficulty and after long negotiations.

Fourth, the World Bank could facilitate the countries' negotiations with their commercial banks by being more forthcoming in granting waivers to its negative-pledge clause. This would permit a greater variety of financing techniques specifically designed to the countries' needs.

Another concern is the overly-strong emphasis being placed, in practice, on voluntary debt reduction over continuing flows of new money. In the three packages negotiated under the changed strategy, all the public-sector enhancements are devoted to encouraging debt reduction; new money is underemphasised or ignored completely.

Many banks feel that this signal, and others that they have been receiving from some public officials, stress debt reduction only, not new money, and they are responding accordingly. Both Mexico and the Philippines needed incremental new money from commercial banks to help finance the debt-reduction

options in their packages. Yet both countries have had difficulty raising new money. Other countries, including some less successful at economic reform, could face a similar problem in future negotiations.

Of more fundamental concern, many countries in Latin America will continue to need some new commercial-bank funding over the longer term, as they have in the past, to complement their own savings, foreign investment inflows and funds from official sources.

Yet debt-reduction programmes — particularly those involving debt-principal reduction — basically encourage banks to end their lending relationships with the participating countries. It is appropriate that some banks, consistent with their business strategies, choose to go this route. It is also appropriate that such banks do so through burden-sharing, by voluntarily taking losses through debt-reduction programmes. These programmes, unlike discounted sales to third parties in the secondary market, pass on the benefits of those losses to the countries themselves.

At the same time, there is a core group of international lenders, my own institution included, that have a commitment to the future of Latin America. These banks would be willing, under the right circumstances, to continue to support, with new money where needed, those countries that are making serious efforts to reform their economies.

Consequently, commercial-bank financing packages should be designed not only to provide exit instruments for banks wishing to leave, but also to encourage a core group of banks to continue lending to the developing world. If this does not happen, many developing countries will have to rely exclusively on their own internal savings and capital flows from official sources. Recent history suggests that this dependence could severely limit the growth of Latin America and the rest of the developing world.

Specifically, I support a more balanced financing approach for future commercial-bank packages — one that, in addition to voluntary debt reduction, recognises the importance of continuing new-money flows. New-money options that have proved successful in earlier packages include: trade-finance facilities, on-lending, project financings, new-money bonds, debt-equity conversions and co-financings with the World Bank, and perhaps, with regional development banks, such as the IDB.

With the exception of co-financings, all of these options are negotiated solely between the restructuring country and its creditor banks. Unlike enhancements for debt reduction, they do not involve any public funds.

I am further concerned over significant increases in arrearages in interest payments to commercial banks by a number of countries, since the adoption of the current strategy. In some cases, this development may reflect a perception by those countries that the current strategy condones their use of arrearages as a form of external financing. The international financial institutions, for example, in some cases have broken with previous policy and disbursed funds to countries that are in arrears to commercial-bank creditors. The international financial institutions are beginning to see, however, that arrearages to commercial banks can also stimulate arrearages to them.

The arrearage problem, if not addressed satisfactorily, will have important ramifications for both creditor banks and indebted countries. Last year many creditors increased their loan-loss reserves, significantly reducing earnings. Some of them cited mounting arrearages as a major reason.

Of the three countries that have negotiated debt-reduction agreements under the changed strategy, Mexico and the Philippines were fully current on interest, and Costa Rica, though in arrears, was making regular partial payments. The Costa Ricans agreed, as part of their commercial-bank package, to clear arrearages through a 20 per cent downpayment, a repayment schedule without grace period and a rolling three-year interest guarantee on past-due interest. This part of the agreement with Costa Rica demonstrates the importance that banks place on resolving pending interest-arrearage problems.

Continuing arrearages will make it increasingly difficult to complete future commercial-bank financing packages for the countries in question and therefore will retard their programmes of economic growth and reform.

The combination of voluntary debt reduction and some new money, where needed, is therefore the most promising way out of the debt crisis. This formula can be successful only if accompanied by demonstrated progress by the countries, in reforming and opening their economies and encouraging local savings and direct investment.

Given the problems and uncertainties that I have outlined, I believe that the current strategy has positioned the debt crisis at a turning point.

If not managed carefully, the strategy could undermine the progress to date, and leave future financing for much of Latin America entirely to governmental sources. If managed carefully, however, with a renewed emphasis on cooperation among all parties it could alleviate the situation and set the stage for the eventual return of some of the restructuring countries to the private capital markets.