

# The New Roles and Facilities of the IMF\*

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## Introduction

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This contribution aims to illustrate the World Bank's involvement and role in the changing debt workout process. In order to understand the WB perspective, it is necessary to go back to March 1989, and look at the position of the highly indebted countries before the Brady Plan. It is appropriate to be focussing in particular on the commercial banking situation, before looking in further detail at the WB's support of the position that debt and debt service reduction must be an essential component of any viable solution to the problem of Third World debt.

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## HICs and Their External Debt after Seven Years

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During the 1980s, the HICs suffered from overall economic deterioration, which consequently affected their commitment to debt repayment and servicing. For most indebted countries, growth rates have been negative or declining for much of the 1980s. For the so-called Baker 17 (WB's HICs), the real GDP growth rate was negative from 1982 to mid-1983, rose slightly during the following two years, but has since been declining. Per capita consumption too has not been encouraging; for HICs as a group, consumption was lower in 1988 than in 1982. This decline has also been a feature of the relatively 'good performers', such as Chile and Mexico.

Other economic indicators emphasise this pattern of declining economic growth rates. Gross domestic investment, for example, has shown a sharply negative trend since 1982. Again, for merchandise imports, rates were negative during the early 1980s, and then showed, on average, a zero growth rate between 1985 and 1987.

In the face of these discouraging trends, the debt burdens of the HICs remained ominously high. Debt service ratios have been consistently higher for the HICs than for LDCs as a whole, but whilst there has been a sustained decline in ratios for the latter since 1986, there has been no similar pattern for the HICs. Similarly with debt-export ratios, which reached a peak in HICs of 310 per cent in 1987. Overall debt owed to commercial banks by the HICs increased significantly during this period of 1982-87. For

example, Chile's debt to commercial banks in 1982 was US\$ 3.7 bn; by 1987 it had risen to US\$ 11.3 bn. In Venezuela, the commercial debt rose from US\$ 11.8 bn to US\$ 23.6 bn. Yet, while the commercial debt situation has been worsening, net flows from private sources have also been dramatically decreasing. Thus the net transfer position of the HICs has been deteriorating sharply since 1982.

As a result of the combination of the deteriorating economic situation and the considerable debt burden, there has been a discernible strain on the commitment, and even ability, of many governments to establish more open economies, with increased mobility of resources and trade. Furthermore, governments have increasingly found themselves in a position of having to resort to arrears to help fill financing gaps.

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## The Commercial Banks and the HICs

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The Brady initiative is essentially concerned with the contribution made to the debt crisis by the international commercial banking community. This is understandable, given the fact that not only are some two thirds of the external claims on the heavily indebted countries held commercially, but that the trends concerning the banks' position *vis-a-vis* the debt crisis threaten a major shift to public sector financing in the future.

However, the present external debt burden of these countries is NOT exclusively a commercial one. While it is entirely appropriate that attention be focused on the problems posed by the new realities of what could be described as the commercial banking 'market place', similar attention will need to be given in the not-too-distant future to the burdens posed by the claims of the official sector, as represented by the Paris Club.

A fundamental shift in commercial bank attitudes towards the debt strategy in recent years can be traced back to several underlying factors. Firstly, most commercial banks no longer viewed the debt problems of the HICs as being of the most pressing concern to them. This was for a number of reasons. Previously, banks had expended considerable efforts to strengthen balance sheets, but often at real cost to asset base, shareholder equity and even staff size. This is reflected in the fact that for virtually all banks, LDC exposure

has been declining markedly as a factor on their balance sheets. The amount owed by HICs, for example, as a percentage of total capital of US banks, has declined from 132 per cent in December 1982, to only 46.6 per cent in June 1989. The decline has been even more pronounced for non-US banks. In addition, for many non-US banks, the decline of the dollar has helped reduce the relative importance of HIC assets *vis-a-vis* other assets. Major reserve increases in respect of LDC holding have also taken place, and profits from other banking activities have gone up.

Secondly most banks are more concerned about profiting from new competitive challenges than they are about the debt crisis. As a generalisation, in Europe, the focus in March 1989 was on the 1992 economic integration within the EC. In the US, opportunities offered by the opening up of interstate banking, the possibility of engaging in the securities business and leveraged buyout action were prime focuses of attention. US banks were also interested in exploiting the 1992 opportunities in Europe. In Japan, deregulation of the financial sector and the opportunities for expansion into the US and European markets through acquisitions loomed large. Indeed, at the risk of oversimplification, it is probably true to say that today, the debt crisis is no longer viewed by the banks as a threat to the financial system, but rather as a potentially potent force in a competitive war. Depending on the particular bank in question, this force is either a weapon which can be used to 'beat up' competitors, or a weak link in one's defensive armoury.

Thirdly, and probably most importantly, it is doubtful whether any bank believed these countries were suffering from a temporary bout of illiquidity. For the most part, they probably saw the problem as one of creditworthiness — they believed that full recovery of existing claims was at best a long way off, with progress being uneven and subject to numerous policy failures. This had ramifications for the new money process. If you are convinced as a banker or a shareholder, whether rightly or wrongly, that a borrower may not ultimately be capable of making good in full on its debt obligations, is there not a point at which it ceases to make sense to increase one's exposure in order to keep those assets current, even at the risk of protracted arrears resulting in a number of cases?

Fourthly, the new money process has been made less attractive for banks by the fact that they have been forced into a partial recognition of losses on their LDC assets. In the last two years, as we have seen, whether as a result of regulatory pressure or inducement or because of appropriate banking prudence, provisioning against HIC assets has increased very significantly. For the US banks, provisioning does not translate into a write-down of

regulatory capital. But with the new Bank of International Settlements capital adequacy rules due to come into effect at the end of 1990, US banks are likely to consider further increases in provisions (which is probably implicit in providing new money these days) as akin to a capital loss, because these provisions will no longer be counted as capital.

If one adds to these factors the fact that banks saw very low margins on their lending to debtor countries, and the increased emphasis on profitability and capital adequacy standards, one can see that by early 1989 'new money' had become an increasingly unattractive proposition. The relative contribution of new money to debt relief declined from 1983 on, so that by 1988, only a very small proportion of total debt relief came through 'new money'.

This is not to say that the World Bank believes the 'new money' process dead. New money does enable banks to keep existing assets current, which might otherwise have had to be treated as non-performing and written down. In general, the concerted lending process worked to maintain pressure on all countries to pay the maximum possible amount of debt service, despite the fact that this process may have been generating inadequate relief for many HICs. However, generally speaking, where the losses that one implicitly risks incurring by not providing new money are 'manageable' for a bank, the predisposition will be to accept such losses, and to try to benefit from the compensating competitive advantage it may gain over banks who cannot extricate themselves, or for whom the impact of losses is more severe. Obviously how 'manageable' losses are depends on the lending arrangement, but in the case of lending to the smaller HICs, the losses are manageable for most banks. Such predisposition towards protective behaviour is greatly strengthened when prospects for a general resolution to a country's debt problems appear to be very dim.

The consequences of this trend have been most dramatic. Whereas in 1982 the commercial bank disbursements to HICs exceeded debt servicing flows back to the banks, by the end of 1986, the situation was reversed. By 1987, for every one dollar of disbursements by the banks, they were getting \$4 in return through debt servicing. Put another way, in 1986 there was a net transfer of finance from the HICs to the commercial banks of almost \$20 bn.

The 'menu' approach to debt rescheduling is in essence a reflection of this tendency amongst banks to engage in self-protective behaviour. Those banks for which the new money process continued to be desirable, or even indispensable at times, favoured the menu approach in order to make the overall process more attractive to as many banks as possible.

However, the benefits of the menu varied from one economy to another. The depth of economic activity and the state of some economies do not always lend

themselves well to some menu items, such as relending, or else do not allow significant relief to be obtained from such items. As a result, larger more complex economies were most likely to benefit from the menu approach. Other factors also limited the adoption of this approach — the time and effort required to design such packages was often daunting. Banks too often wanted to limit the scope of some menu items.

However, the biggest limitation to the menu lay in its most vaunted asset: its market driven nature. The market, as represented by the banks, can be said to have decided that self-preservation was the safest course of action in a competitive world. More importantly, concerted action was not seen as a viable route to self-preservation. The exhortations to banks by creditor governments to fend for themselves, and the regulators' drive to re-install traditional prudential practices by the banks, was taken as a signal that an independent course of action was ultimately the safest one.

In summary, in March 1989 the World Bank predicted that, in the absence of any major new initiative in the debt strategy, the number of banks participating in the new money package would be likely to narrow further, as would the number of countries benefiting from such financings. It was thought that there would be further efforts to broaden the so-called 'menu' of options. This would be aimed at encouraging continued participation by distinguishing new claims from old, and at extracting some financial relief from those banks unwilling to participate in new lending. Yet, at the same time it was realised that concerted new lending for the HIC's would only be obtained with great difficulty, if at all. In March 1988, a WB Board paper stated that:

'Despite the fact that banks continue to hold about two-thirds of total medium and long-term claims on the heavily indebted countries . . . pressures not to lend will grow, forcing selectivity and strong reluctance to accept exposure increases that in other circumstances might look quite reasonable. All countries are thus likely to experience delays in assembling new money packages, constant downward pressure on the amounts to be obtained and continuation of the short-term approach that has characterised the concerted lending process since the beginning. Some countries, particularly smaller ones, may be faced with a choice between either reduced growth or further recourse to arrears to commercial banks . . .'

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### **World Bank Support of Debt and Debt Service Reduction**

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It is from the trends and factors outlined above that the World Bank drew the inescapable conclusion that debt and debt service reduction must be an essential

component of any viable solution to the problem of Third World debt. The facilities established by the World Bank to support this solution, were adopted in May 1989, and essentially parallel those of the IMF.

There are a number of pre-conditions for a country to obtain World Bank support for a debt and debt service reduction scheme. It must have a large debt burden, and be pursuing a medium-term structural adjustment programme which is acceptable to the World Bank. The need for debt reduction in order to achieve medium-term growth and adjustment objectives must be clearly demonstrated. Finally, the country in question must show significant benefits resulting from the intended financing relief operation in terms of improved growth and investment prospects.

If these conditions can be met, the World Bank is prepared to allocate up to 25 per cent of the World Bank's planned adjustment lending programme to a country over a three year period, to support operations involving significant principal reduction. As an alternative, the World Bank will allocate up to 10 per cent of its overall lending three year programme, in those cases where the World Bank's lending programmes are concentrated on investment lending. In addition to this, there will be incremental resources available of an additional 15 per cent of the overall three year lending programme.

While these resources are intended to be made available over a three year period, the need for significant front-loading is of course recognised by World Bank management. In the case of the Mexico package, this translates into a management proposal to provide some \$1.9 bn of debt and debt service reduction support by January, 1990.

Whilst the World Bank has been fully prepared to endorse Secretary Brady's initiative and make available resources in support of this new phase of the debt workout process, the World Bank envisualises its role in the post-Brady speech world as something more specific. There is a consensus within the World Bank that its primary contribution to the debt workout process should continue to be what it has been for several years now: tackling those institutional and policy flaws in the HICs which contributed so significantly to the accumulation of huge debt burdens in the first place. The World Bank must continue to build up assistance to the investment process in these countries, without which growth will certainly be elusive. In recent years, the proportion of World Bank commitments to adjustment lending has grown steadily, especially in HICs, where adjustment lending actually exceeded project lending in the 1989 financial year, to total a little over \$4.5 bn. What this means in practical terms is illustrated with reference to the World Bank's proposed policy-based work programme for Mexico and the Philippines in the coming five years.

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## World Bank Operations in Mexico and the Philippines

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The World Bank has now become Mexico's largest single source of new money. In the past year, three major adjustment programme operations have been entered into, including a Financial Sector Adjustment Loan, a Public Enterprise Reform Loan and Industrial Sector Policy Adjustment Loan. The policy dialogue with Mexico will include:

- a) a review of the current regulatory and financial framework in industry and agriculture
- b) a study of tax reform options
- c) an intensive analysis of urban air pollution in collaboration with the World Health Organisation
- d) an assessment of infrastructure and energy sector issues
- e) the development of strategies for integrated health and nutrition initiatives
- f) the assessment of improved programmes to ameliorate rural poverty; and
- g) an analysis of environmental issues to come up with a set of recommendations.

Over the medium-term, the World Bank plans to maintain a lending programme for Mexico averaging over \$2 bn a year.

A commensurate effort is planned for the Philippines, with an overall lending programme running at an average of \$700 mn a year for the next few years. Of this, 75 per cent will be for investment purposes. The Philippines programme started in early 1989, and involves:

- a) continuing the process of trade liberalisation
- b) improving tax collection and overall revenue efforts
- c) continuing the process of privatising public corporations and government owned banks
- d) reforming regulations governing the financial sector
- e) restructuring and expanding the public investment programme
- f) supporting the social sector and poverty alleviation programmes
- g) pursuing a major agrarian reform
- h) monitoring monetary and fiscal performance to

assist in meeting targets designed to limit inflation.

Whilst the approach taken by Mexico was one of comprehensive debt reduction, the Philippine proposals place emphasis on some new money, but in combination with debt buybacks. Thus the World Bank will continue its emphasis on adjustment lending, but tie this in to support for the debt and debt service reduction process.

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## Conclusion

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Whether the process set in motion by Secretary Brady will mark the final stage in the debt workout process remains to be seen. In my view, we are probably somewhere between the end of the beginning, and the beginning of the end, in terms of achieving a viable solution. For most of the HICs, it is probably fair to say that it is a matter of years before the time arrives when they can feel, with any measure of confidence, that their debt problems have been overcome. It is also clear that we have a great deal of innovation ahead of us. Neither the Mexican nor the Philippine proposals will necessarily be appropriate precedents for other countries. Clearly, there are other countries for which the Philippine emphasis on new money plus debt buybacks will be appropriate. There may be other countries where the comprehensive debt reduction approach taken by the Mexicans will prove feasible. But, for a significant number of countries, new money prospects are very dim and the necessary adjustment programmes conducive to Mexican-type arrangements are nowhere as advanced as they are in Mexico. In these countries, ways will need to be found to provide short-term cash flow relief other than through conventional rescheduling and new money, while the adjustment effort is being intensified as a precondition for permanent debt or debt service reduction.

The fact is that dealing with adjustment and investment issues are the World Bank's *raison d'être*. It is our special responsibility to work for and support reform and adjustments designed to address those institutional and policy flaws which contribute significantly to the accumulation of debt burdens. However, the responsibility for supporting adjustments designed to address the *consequences* of such debt burdens lies with the overall creditor community. The World Bank is a part of that community, and we intend to play, and indeed believe that we *are* playing, a responsible role in addressing these consequences.