

MECHANISMS FOR BILATERAL DEBT REDUCTION*

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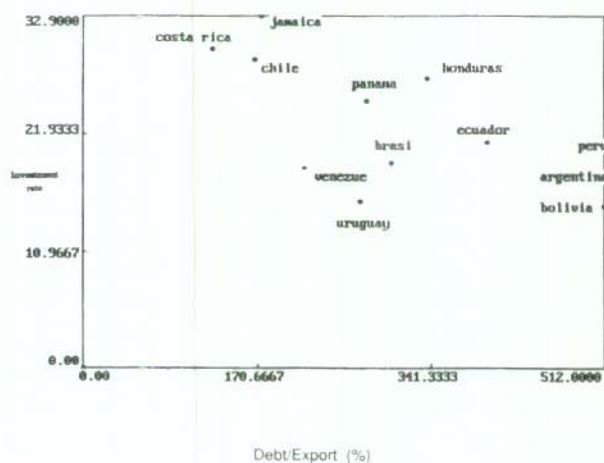
1. Introduction

There are several reasons why debt reduction has to be pursued as an important development objective. First, there exists ample evidence of the depressing effect that the debt overhang exerts on savings and investment (Fry, 1989; 1994; Cáceres, 1995; Green and Villanueva, 1991), (see graph 1), and its long term impact on economic growth has also been evidenced (Cohen, 1993). Moreover, the financial markets are not indifferent to high debt levels. In fact, the markets' perception of the negative effect of high debt indexes can be inferred by the inverse relationship existing between price of debt in the secondary market and the debt to exports ratio, such that as this ratio increases the market price of debt decreases, as can be seen in graph 2. It has been shown that for the heavily indebted countries, debt reduction yields benefits to both debtors and creditors. The latter benefit because, after debt reduction, the expected value of their claims may have a larger value than its pre-debt reduction value, a phenomenon known as the Debt Laffer Curve (Sachs and Huizinga, 1987, Krugman, 1989). Moreover, debt reduction leads to an increase in the debtor's impacts, thus benefitting the creditor countries' exports (Cáceres, 1995). The benefits derived from debt reduction are appreciable: countries that underwent Brady operations experienced significant increases in the price of their debts in the secondary market, from an average of 40 cents per dollar in January 1991, to 65 cents in May 1993. In contrast, in the medium income countries that did not carry out operations of this nature, the value of their debt declined from 28 to 11 cents in the same period (World Bank, 1993). This indicates that markets react favorably to debt reduction; it may thus facilitate the countries' efforts to regain access to the international markets. The need to reduce the less developed countries' debt overhang acquires special importance given that it may inhibit the expected beneficial effects from their recent economic reforms. But the benefits from debt reduction comprise other aspects, according to the World Bank (1993): "there are likely to be four principal benefits of debt stock reduction for severely indebted low income countries:

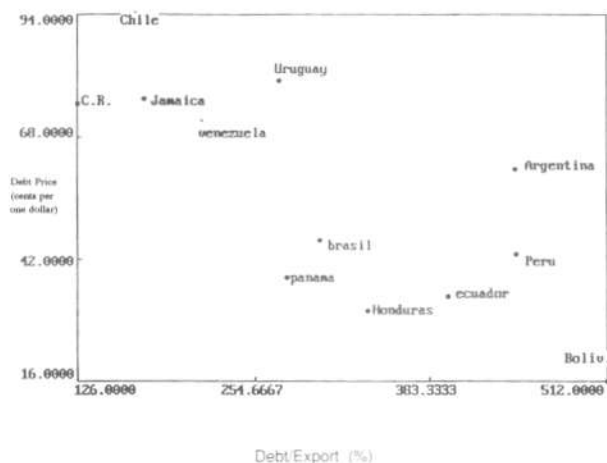
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- The reduction in uncertainty for private sector investors, both domestic and foreign, present and potential.

Graph 1
Investment Rate and Debt-Exports Ratio (1993)



Graph 2
Debt Value in Secondary Market and Debt-Exports Ratio (1993)



- The release of debtor-country policy makers from protracted debt negotiations.
- The improved availability and cost of trade finance.
- The restoration of currently disrupted relationships with external creditors."

2. Bilateral Debt Reduction Mechanisms

Bilateral debt rescheduling is one mechanism which has had relatively limited success to date among the poorer Latin American countries. The region's poorer countries have regularly resorted to the Paris Club to renegotiate their bilateral debts, as shown in Table 1. The numerous renegotiations that have taken place indicate that the Paris Club conditions have so far not been wholly effective in bringing about a viable long term solution. However, the recent Paris Club conditions granted to Bolivia constitute an important breakthrough. The Paris Club agreed on December 14-15, 1995 to reduce Bolivia's bilateral debt stock by 67% and reschedule the remaining debt on concessional terms.

Table 1: PARIS CLUB AGREEMENTS

Country/Date	Amount Consolidated (Millions US\$)	Repayment Terms	
		Year/Months	Grace Years/Months
BOLIVIA			
18 July 1986	424	9/6	5/0
14 November 1988	230	9/5	5/1
15 March 1990	485	Menu	Menu
24 January 1992	244	Menu	Menu
23-23 March 1995	n/a	Menu	Menu
14-15 December 1995	n/a	stock reduction plus rescheduling	stock reduction plus rescheduling
NICARAGUA			
17 December 1991	552	Menu	Menu
27 March 1995	n/a	Menu	Menu
GUYANA			
23 May 1989	179	19/5	9/11
12 September 1990	140	Menu	Menu
6 May 1993	41	Menu	Menu
March 96 (tentative)			
HONDURAS			
14 September 1990	364	19/7, 14/7	8/1, 8/1
25 October 1992	220	Menu	Menu
March 96(tentative)			
HAITI			
30 May 1995	n/a	Menu	Menu

Source: World Bank Debt Tables, 1994-1995.

But the fact is that, if the debts canceled by the US under the Enterprise for the Americans Initiative and by the Paris Club to Bolivia are excluded, for the severely indebted low incomes countries (SILIC) the net effect of debt renegotiation with the Paris Club has been an increase in their overall debt (See Table 2). As the World Bank (1995) has noted in the context of the Severely Indebted Low Income Country:

"One implication of the repeated rescheduling and the maintenance of positive cash inflows for SILICs has been an increase in total debt stocks from US\$173 billion in 1986 to US\$179 billion by the end of 1992. As a result, their debt-to-exports ratios have continued to increase, reaching about 320 percent on a present value basis by end-1992. In, 1991, debt forgiveness, granted mostly by bilateral creditors, reduced total debt stock by about US\$22 billion. This was nevertheless largely offset by capitalized (that is, rescheduled) interest plus accumulated interest arrears totaling US\$19 billion. Furthermore, of the US\$22 billion in debt reduction US\$13 billion was accounted for by just one SILIC Egypt, which received exceptional Paris Club treatment. For other SILICs unmet debt service has outweighed debt forgiveness"

Table 2: Cumulative Change in Total Severely Indebted Low Income Countries (SILIC's) Debt by Source of Change, End 1991 (millions of US\$)

Source of Change	Change in Debt Stock
Voluntary debt reduction	-21,902
Net flows on debt	30,954
Reschedule interest	11,764
Net increase in interest arrears	7,505
Cross-currency valuation	28,150
Unidentified changes	-1,686
Net Changes	54,785

Source: World Bank (1995).

The above would indicate that bilateral debt renegotiations, as they have been conducted until now, without debt stock reductions, have limited capacity to alleviate these countries' external debt constraints. It is convenient, then, to extend the debt reduction concessions received by Bolivia from the Paris Club to other eligible countries, and service the remaining non-reduced stocks under new schemes that would lessen the impact on their foreign exchange.

3. New Mechanisms Proposed

The Paris Club has offered the possibility to the less developed countries of reducing the bilateral debt stock through debt-for-development swaps. This possibility has been offered since as early as 1990 and is present in the treatment received by Bolivia, as

applied to the remaining stock. For example, the minutes from Boliva's recent (December 14-15, 1995) Paris Club meeting states:

"On a voluntary and bilateral basis, the Government of each participating creditor country or its appropriate institution may sell or exchange, in the framework of debt for nature, debt for aid, debt for equity swaps or other local currency debt swaps:

- (i) the amounts of outstanding loans mentioned in paragraph 1, above as regards official development aid loans and direct Government loans:
- (ii) the amounts of other outstanding credits mentioned in paragraph 1, above, up to 10% of the amounts of outstanding credits as of December 31, 1991, or up to an amount of 20 million US dollars, whichever is higher."

However, the countries have not been able to take advantage of this possibility due to institutional limitations. In effect, Mukherjee (1992) has pointed out:

"The main challenge in implementing successful debt conversion deals often lies in overcoming institutional weakness... Weak institutional performance on the part of the proposed recipient is sometimes a major constraint in the implementation of such conversions... This often prevents the debtor from being in a position to bring a suitable project to the creditor's attention, or even if this is done, the creditor has little confidence that the debtor will be able to fulfill project related obligations".

This fact suggests a possible opportunity for the international development banks to act as facilitator of debt reduction concessions granted by the bilateral creditors. It might be possible to use debt-for-development swaps as a form of "cofinancing" projects in these banks' "pipelines", thus providing the creditors some confidence that debt cancelled in this manner would lead to positive development outcomes.

In effect, in the framework of the Paris Club, the debtor country, the development bank and the creditors could agree that the latter place their discounted debt papers in a trust fund at the bank. Debtor countries would service the discounted debt in local currencies, which would be placed in said trust fund by the creditor. The bank would use such resources to finance or cofinance projects which the bilateral creditors find attractive. This mechanism would imply that the bank would try to "sell" its "pipeline" among bilateral creditors so as to induce them to finance or cofinance these projects with the local currency originating as debt service. The existence of such trust fund at the bank would permit the creditor to exit from recurrent Paris Club meetings, while keeping a voice on how the local currency debt service would be utilized.

Development banks could also establish agreements with bilateral creditors whereby poor countries' recurrent costs associated with the banks' social and environmental

projects would be accepted by these creditors as partial payments on bilateral debt.

The banks' could also capitalize on the experience of the Brady operations for the buy back of bilateral debt, which has been quoted at the same price as the private bank debt of the corresponding country. The banks could finance social projects, using the hard currency resources involved in these operations to purchase bilateral debt paper. The bank would turn these papers as grants to NGO's for example. This presupposes that the debtor country involved has agreed to honor those papers in local currency (in bonds for example), which is a matter that can be ventilated at the Paris Club. Moreover, the banks could encourage donors to provide resources for the purchasing of debt papers that would complement the bank's own purchase, thus increasing the amount to be presented to the respective Central Bank by the NGO's.

Another role that the banks could perform is to act as a "broker" of bilateral debt papers. This function can be very useful given that bilateral debt is not created in the secondary market. Therefore, based on an agreement with the creditors and debtors in the framework of the Paris Club, the banks would receive information on bilateral debts that the creditor is willing to sell at discount. The bank would disseminate this information among foundations, NGO's and private investors. The interested parties would purchase the debt paper from the creditor. The buyer would present the papers to the respective Central Bank which would honor such papers with local currency bonds, or with a physical asset in the case of privatizations. In this arrangement, the bank could prepare all the paperwork involved in the purchase of the debt papers, so as to avoid cumbersome details to the creditors and buyers. This, of course, would be subject to previous agreements.

4. Concluding Remarks

Many less developed countries do not have access to international financial markets because of their persistent debt problems. This situation gives rise to a vicious circle: these countries require external resources to grow and thus eliminate the debt overhang; however, the debt overhang inhibits their obtaining external resources and attaining sustainable growth rates, thus deepening the debt problems. Thus, it is convenient to eliminate the debt overhang by debt stock reductions as exemplified by the recent Boliva's operation. The unreduced portion of the debt can be reduced through conversion operations with bilateral creditors. This would redound in strengthening economic growth in debtor and creditor countries, thus maintaining the world economy on a sustained growth path. In these efforts, the international development banks can play an important role acting as catalysts of bilateral debt for development swap operations.

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Abstract

In this paper, it is argued that new mechanisms are required to reduce lesser developed countries' bilateral debt to manageable levels. This reduction is necessary as the debt overhang inhibits these countries from gaining access to international financial markets and because high levels of debt reduce domestic savings and investment.

It is further argued that the Paris Club mechanisms have fallen short of providing a definite resolution to bilateral debt problems. Thus, a series of new mechanisms are proposed, whereby multilateral development banks can play an important role in facilitating bilateral debt-for-development swap projects, in the framework of Paris Club agreements.

MECANISMES POUR REDUIRE LA DETTE BILATERALE

Résumé

Dans cet exposé, on constate que de nouveaux mécanismes seront nécessaires pour réduire la dette bilatérale des pays les moins développés dans des niveaux acceptables. Cette réduction sera nécessaire parce que la dette empêche ces pays d'accéder aux marchés financiers internationaux et réduit l'épargne domestique et l'investissement dans le pays.

Nous savons également que les mécanismes du Club de Paris n'ont pas trouvé de solution définitive aux problèmes de la dette bilatérale. Ainsi, une série de nouveaux mécanismes sont proposés, où les banques multilatérales de développement pourraient jouer un rôle majeur en facilitant des projets bilatéraux "swap" dette-pour-développement dans le cadre des accords du Club de Paris.

